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Corporate Governance of Executive Remuneration With Special Reference to Bangladesh

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This discussion paper focuses on corporate governance issues associated with executive compensation arrangements. An historical perspective is used to demonstrate the absence of a sound empirically-based understanding of good corporate governance practices in relation to share-based payment arrangements. The paper provides an overview of issues including the potential earnings dilution and volatility effects of the introduction of regulations affecting executive remuneration. Potential research questions have been framed addressing each of the major issues identified in this paper. It is concluded that corporate regulators should ensure they are familiar with and that they consider best practice models for corporate governance when developing new or revising existing business regulation. It is proposed that further research to remedy this deficiency would enable a more accurate assessment of the impact of management on accounting regulation and the better design and implementation of regulation.

Field of Research: Corporate Governance, Regulation

1. Introduction

The structure and amount of remuneration paid to corporate executives is an issue that has attracted much attention in the wake of the global financial crisis (GFC). Concern has been raised over whether the remuneration of executives is excessive and whether the form of executive remuneration encourages appropriate behaviour. There have also been calls to consider the effectiveness of the existing framework for the oversight, accountability and transparency of remuneration practices including 'the role, structure and content of remuneration disclosure and reporting' (Australian Government 2009: p.v).

There is evidence of some diversity in the management and reporting of share-based payment. Although the use of share-based payment has been a growing trend since the 1970s there is as yet, relatively little academically-based literature on the methodologies used for the corporate governance of such arrangements. This implies that limited scholarly assessment and evaluation has been conducted in this area. According to the 2007 IAS Plus Update and the SAFA comparison, International Financial Reporting Standard IFRS 2- Share-based Payment (effective 2005) was adopted as a Bangladesh standard in July 2006 and has been effective from January 2007. However, there is no further information as to the extent of compliance of BASs/BFRSs with the corresponding international standard (eStandards Forum Bangladesh, 2009).

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The issue of equity instruments to employees as a form of remuneration is not new (Gray 2006; Ledden 2006). Share-option plans in particular are now a common feature of executive payment. They have also been extended to other employee levels as a means of aligning employees' interests with those of the firm, and encouraging employee retention.

The concept of share-based payments is broader than employee share options. Bangladesh Financial Reporting Standard 2 – Share-based payment (BFRS 2) encompasses the issuance of shares, or rights to shares, in return for services and goods. Examples of items included in the scope of BFRS 2 are share appreciation rights, employee share purchase plans, employee share ownership plans, share option plans and plans where the issuance of shares (or rights to shares) may depend on market or non-market related conditions. However, the accounting standard does not apply to share-based payment transactions other than for the acquisition of goods and services. Share dividends, the purchase of treasury shares, and the issuance of additional shares are therefore outside its scope. Under BFRS2, all share-based payment transactions must be recognised in the firm's financial statements. The view adopted in this accounting regulation is that all share-based payment transactions ultimately lead to expense recognition. Thus, firms are required to reflect the effects of such transactions in profit or loss. Before BFRS2 there was no accounting requirement to identify the expenses associated with share-based payment transactions or to measure and recognise such transactions in a firm's financial statements. The imposition of this new accounting regulation shows the success of the regulators in arguing that recognising the cost of share-based payment in financial statements improves the relevance, reliability and comparability of the financial information, helps users of financial information to understand better the economic transactions affecting an enterprise, and supports resource allocation decisions (FASB 2004a).

In a share-based payment arrangement equity instruments, commonly share options, are issued to employees as a component of a remuneration package. The equity instrument gives the employee the right to purchase the employer firm's shares usually at a discounted price in exchange for their own services (PriceWaterhouseCoopers 2004). The value of share options is reflected in the market value of the firm's shares. The firm issues (grants) the share options at an exercise (buying) price which is usually the same as the current market price of the underlying shares at a certain date. The option gives the holder a right to buy shares at the exercise price during a certain period (the 'option' period). A change in the firm's share price will affect the value of its share options. If the share price increases so that the exercise price is lower than the market value of the underlying shares, the option-holder (employee) makes a gain. On the other hand, if the share price falls below the exercise price a rational employee will not exercise the options. Theoretically, this phenomenon creates an incentive for employee participants in the share-based payment arrangements to align their work-related efforts to the firm's wealth maximisation objectives.

A useful historical synopsis of the development of share-based payment is provided in Fisher and Wise (2006a). Their synopsis is reproduced in table 1. The relatively broad chronology of dates and events they provide is useful for understanding the increasingly popular use of share-based payment as a component of employee payment. The emergence of share options is dated to the 1920s. It was not until much later that the use of share options as a component of employee payment emerged. This is linked to the reduction, in the United States (US), of taxes on the sale of shares in the 1950s. The chronology suggests that share options remained largely irrelevant until the early 1970s when, submitting to intense opposition, the Financial Accounting Standards Board (FASB) declined to mandate the expensing of share options. This event aroused awareness of the potential to use share options as a component of executive payment. The broader use of share options for employee payment appears to flow from Microsoft Corporation's decision to extend these arrangements to all its full-time employees. By the 1990s the use of share options as a component of employee payment was widespread. Then, in the late 1990s, corporate regulators began to issue warnings about the potential overstatement of firms' earnings due to the non-recognition of share options. The 'dot.com' boom-bust era emphasises this effect. In 2001 Enron Corporation failed and its chief executive officer testified before the US Congress about the importance of executive share options in the failure. In 2003 Microsoft Corporation abandoned its employee share options arrangements in favour of share award plans. Much more recently, regulators have moved to mandate the expensing of share options: in Bangladesh this took effect from 1 July 2007 with the adoption of BFRS2 based on the international financial reporting standards IFRS2 Share-based Payment (IFRS2). In Bangladesh, the IFRS standards began to be adopted progressively for reporting periods effective from 1 January 2007.

This chronology of events, particularly the introduction and then abandonment of employee share options by Microsoft Corporation and the abuses concerning this type of employee payment by Enron Corporation, highlights the absence of a sound conceptual basis guiding the corporate governance of share-based payment. There is a pressing need to identify available corporate governance standards appropriate for addressing the mandatory requirements of BFRS2, and then use these corporate governance standards to undertake a comprehensive study of their performance for financial reporting in this area. The results of such research should, in turn, inform the development of 'best practice' methodologies for corporate governance of share-based payment in Bangladesh and other nations.

2. Methodology

This is a discussion paper. In which corporate governance issues associated with executive compensation arrangements are considered. An historical perspective is used to demonstrate the absence of a sound empirically based understanding of good corporate governance practices.

There are two main objectives in this paper. The first is to argue that there is a need for a sound empirically-based understanding of how firms manage share-based payment arrangements. The second objective is to develop research questions, based on important issues emerging in the literature, as a guide to future research in this area. Carroll (2006) suggests that further research into the management of regulation within the firm is important as it is likely to improve our understanding of the impact of management on regulatory compliance. In particular, it should enhance our understanding of how a new accounting regulation, such as the Bangladesh Financial Reporting Standard (BFRS-2 Share-based payment (BFRS2) has been managed within Bangladeshi firms. Further research should also facilitate the design of more efficient and effective regulation and of best practice in the management of regulation.

In the next section an assessment is made of the literature to support the claim that only a limited understanding of the corporate governance of share-based payment within the firm exists. The future research questions developed within this section are directed to the Bangladesh environment.

3. A Review of the Literature

A review of the emerging literature has revealed a number of important developments where future research may improve our understanding of issues affecting the corporate governance of share-based payment. These areas are identified and discussed and a series of research questions has been formulated as a guide for future research into each of these issues.

A broad chronology of events affecting and influencing share based payment arrangements is presented in Table 1. This is followed in Table 2 by a summary of the effective dates for the Bangladesh International financial reporting standard governing share based payments (BFRS2).

Bhattacharjee and Islam (2009) argue that for Bangladesh to achieve a high-quality corporate financial reporting environment depends on the effectiveness of its enforcement mechanisms. Merely adopting international accounting and auditing standards is not enough. They argue that three important links exist in the enforcement sequence: (a) directors and top management must ensure that financial statements are prepared in compliance with established standards; (b) auditors must act independently and judiciously to ensure that financial statements comply with applicable accounting standards and represent a true and fair position of the enterprise's financial condition; and (c) regulators, both self-regulatory organisations and statutory regulators, must implement arrangements for efficient monitoring of regulatory compliance and consistently take appropriate actions against violators.

Table 1: Broad chronology of share-based payment arrangements

Date	Event	Importance/Implication
1920	Emergence of share options	Initiative of the 'Roaring 20s share market boom
1950s	US reduces taxes on share sales	Firms begin using share options for executive payment
1972	FASB decides not to mandate expensing	Use of share options continues
1975-1985	Bull run in share markets, emergence of corporate superstars	Demand for executive compensation commensurate with superstar status
1984	Microsoft offers share options to all employees	Use of share options as a component of non-executive employee compensation popularised
1990s	Bull run in some major share markets	Use of employee share option plans multiplies
1994	FASB requires footnote disclosure for share options	Warnings of overstated earnings due to non-recognition of share options
2001	Enron files for bankruptcy	Enron CEO testifies before US Congress on importance of employee share options
2003	Microsoft abandons share options in favour of share awards	Possible decrease in the use of share options and increase in the use of share award plans
2005	IFRS2 effective, mandates expensing of share options	Regulatory impact includes earnings dilution
2007	BFRS2 effective	What else?

Source: Fisher C and Wise V (2006) (adapted from Nowicki 2006), adapted to include BFRS2 in 2007.

Table – 2: Adoption Status

IFRS No.1	BFRS Title	Effective Date
IFRS 2	BFRS 2 Share-based Payment	For annual periods beginning on or after 1 January 2007. Effective date of 2008 amendments (paragraph 21A and 28A) from 1 January 2010.

Source: Deloitte IAS Plus, August 2007.

Hossain, Haque and Haider (2004) pointed out that the Bangladesh accounting standards board pursues mandatory compliance with the local accounting standards by requiring companies to prepare their financial statements strictly in accordance with the prescribed accounting standards. Ali, Ahmed and Eddie (2009), using a large sample of listed companies that included Bangladesh, India and Pakistan, found that the extent of adoption of international financial reporting standards (IFRS) was mixed. They noted that there are a number of areas where both measurement and disclosure adoption is low. They argued that this is due to a lack of awareness of the treatment of issues and a lack of enforcement of the standards. They concluded that South Asian companies are not sufficiently complying with IFRS and need to improve the extent of their adoption.

3.1 Economic Significance and Earnings Volatility

A significant emerging issue brought about by Bangladesh's Institute of Chartered Accountant's objective of fostering acceptance and observance of international financial reporting standards (ICAB 2010) is the consideration of how firms should account for payments that are linked to their share values. The international accounting standard IFRS2 and the Bangladesh version, BFRS 2 *Share-based Payment* regulate this matter.

IFRS2 (and consequently BFRS2) mandates the recognition in financial reports of the goods and services acquired or received under share-based payment arrangements that are settled in either cash or equity regardless of whether the counterparty involved is an employee or other party (Wise 2005). Prior to the introduction of this requirement firms were able to ignore these transactions or they simply provided footnote disclosure in their financial statements. This situation has been fundamentally altered with the cost of such transactions now required to be included directly in the determination of earnings (BFRS2 paragraph 8). Accordingly, Picker et al. (2009) make a general prediction that the introduction of an accounting standard regulating share-based payments will lower the earnings of firms which are significant users of share-based payment transactions as a means of compensating their employees. Earlier, Chalmers and Godfrey (2005) made a similar prediction. Given the potential significance of this particular regulatory change to firms participating in share-based payment transactions, it is important to understand both the consequences for a firm's financial results and the corporate governance issues in the use and management of such financial tools.

As BFRS 2 requires the use of fair value for share-based payments it introduces the potential for earnings volatility. This result occurs because the cost of equity instruments issued under a share-based payment arrangement is measured as the difference between the current market value and the exercise price of the equity instrument at the valuation date. Kitney and Buffini (2006) provide some anecdotal evidence that when IFRS2, was adopted in Australia (AIFRS 2004) it introduced non-trivial volatility to firms' results. Volatility, they imply, is confusing to investors and likely to undermine corporate credibility. Thus, if the earnings and/or volatility impact is significant it is predicted that firms will manage earnings in order to avoid adverse consequences.

Fisher and Wise (2006b) investigated the economic significance of the dilution effect of IFRS 2 on the reported earnings of a small selection of listed Australian firms. In their study, the annual cost of share-based payment arrangements was measured and the relative impact on earnings determined. Their results suggested a dilution effect of between 1.7 and 2 percent of earnings. Despite this relatively low average dilution effect, they noted that for individual firms, the new accounting regulation appeared to introduce considerable volatility in earnings and suggested that this volatility may provide a disincentive to the use of share-based payment. Accordingly, the major research question addressed by Fisher and Wise (2006b), and earlier by Chalmers and Godfrey (2005), could be extended to listed Bangladeshi firms in order to determine the full extent to which earnings may have been diluted by the introduction of BFRS2.

While minimising a potentially adverse impact on earnings is likely to provide an important incentive to avoid share-based payment arrangements, firms are also likely to select low-impact arrangements or to alter pre-existing arrangements to minimise dilution effects. Thus, the introduction of BFRS2 with its requirement to recognise the cost of share-based payments in earnings may provide sufficient incentive for management intervention to mitigate potential adverse effects including avoidance of share-based payment, dismantling and/or restructuring existing arrangements, or selecting new arrangements so as to minimise adverse earnings consequences. The following research, which if applied to the earnings data of Bangladeshi firms are likely to provide a better understanding of corporate governance practice in this regard.

1. What is the earnings effect of share-based payment arrangements on listed firms?
2. Have firms selected low earnings/volatility impact share-based payment arrangements?
3. Have firms restructured adverse earnings impact share-based payment arrangements (as Microsoft did) to reduce earnings dilution?

4. Have firms dismantled or discontinued pre-BFRS 2 share-based payment arrangements in order to avoid an earnings impact?

3.2 Incentive Arrangements

The opportunistic perspective of positive accounting theory suggests that share-based payment arrangements will provide an effective bonding mechanism for the linking of employee performance with reward. The efficiency of this strategy may be affected by the introduction of the requirement, in BFRS2, to include the cost of share-based payment arrangements directly in earnings. Understanding strategic reaction to regulatory change is an important part of gaining a full understanding of regulatory impact and determining appropriate corporate governance practice. Paskelian and Said (2010) observe that government ownership of China 's listed firms is awakening awareness of the pay-performance link for top managers and thus possibly making China's listed firms less effective in solving the opportunistic agency problem. They argue that such effects exist for both direct government ownership though state shares and indirect government ownership though legal person shares. They found that private ownership seems to strengthen the pay-performance link compared to government ownership and collective ownership.

The extent to which firms will continue with share-based payment arrangements in the regulatory context of BFRS 2 is unclear. If a firm engages in share-based payment transactions its reported earnings and balance sheet are affected. This in turn affects any earnings-related ratios and some balance sheet ratios. For instance, share-based payment incentives affect the earnings per share ratio in the following manner. If an employee chooses to exercise the right to buy shares the number of outstanding shares will increase: there follows a decrease in earnings per share as net income is divided across a greater number of shares. Thus shareholders pay for a share-based payment program through a dilution of their ownership. Additionally, the market value of their shares suffers a dilution effect as a result of the additional shares issued. On the other hand, the 'pay-for-performance' rationale embraces the view that share-based payment will enhance, not diminish, shareholder value as employees have an incentive to align their work-related efforts with the firm's objectives.

There is relatively little discussion of the link between positive accounting theory and share-based payment evident in the literature, particularly for emerging economies such as Bangladesh. Further academic consideration of this conflict would strengthen the literature and promote a better understanding of corporate governance issues relative to share-based payment arrangements. Accordingly the following questions are posed for future research.

5. Is there a systemic difference in the incidence of performance-related share-based payment arrangements in the pre- and post- BFRS 2 periods?

6. Are share-based payment arrangements efficient mechanisms for the optimisation of shareholder value?

3.3 Pay-for-Performance

As discussed above, one of the theoretical underpinnings for the current popularity of share-based payment is the view that such arrangements provide an incentive for employees to align their work-related efforts to the firm's wealth maximisation objectives. This may be a reasonable assumption if employees carry the risk burden attaching to share-based payment instruments such as share options. However, employees may be able to hedge these instruments and effectively remove the risk of their holdings in their employer's equities. Buffini (2006) reports some views relating to this matter.

> "If you have at-risk remuneration without risk, you defeat the whole purpose of aligning executive and shareholders interests" (Mather R, BT Governance Advisory Service).
>
> "... hedging unvested incentives should be barred and hedging vested incentives should be disclosed." "...where executives are held out to have a similar interest to shareholders because they have a large shareholding or options, and if they have ... hedged out the risk, ... that is a misleading statement" (Balzer F, Australian Shareholders Association).
>
> "They are supposed to be at risk, so that (hedging) shouldn't be allowed ... but once they are the property of the individual, and so long as they disclose what they've done, they're free to dispose of them" (Evans R, Australian Institute of Company Directors).

Clearly, a theoretical consideration of the implications of hedging by employees of their risk in respect to share-based payment arrangements, will contribute significantly to the development of an appropriate corporate governance methodology for such practices. The following research question may provide a useful starting point for further research of this matter.

7. What are the theoretical and corporate governance implications for the hedging of share-based payment instruments by employees?

3.4 Principles versus Rules-Based Accounting Standards

Accounting standards provide a guideline for reporting a firm's economic transactions and events (McCombie & Deo 2005). When preparing financial reports on a firm's performance, accountants must follow the requirements of the relevant accounting standards. Principles-based accounting standards require subjective judgment as to their appropriate application, and little is yet known as to how consistent the application will be with the objectives of the accounting standards. A major change brought about by the introduction of IFRS2 (and its national equivalent, BFRS2), is the consideration of how entities should account for payments that are tied in some way to share values (Emanuel 2005).

Principles-based standards ‘can have more than one valid interpretation’ (Kitney & Buffini 2006, p.1). Kitney and Buffini (2006, p.11) also quote Ernst and Young partner, Ruth Picker, as suggesting that ‘... answers may change as we become more sophisticated in interpreting IFRS ... and some companies may have restatements of their accounts ...’. Evidence of the need to restate financial statements as a result of the application of new accounting standards regulating share-based payment has already emerged in the US. Bloomberg (2006) reported that McAfee, the US’s second largest maker of anti-virus computer software, declared that it would have to restate its results after a review of its stock option grants. McAfee is one of more than70 companies in the US whose option-granting practices were examined by either the Securities Exchange Commission or the Justice Department. The inquiries were in relation to whether options were backdated to raise value to their recipients.

Further evidence that corporate governance of share-based payment may not be robust is clear in the case of Nephros Inc., a US medical device company. Nephros announced (in August 2006) that it would be restating its quarterly financial statements to reflect a correction related to stock-based payment expense and filing an amended quarterly report with the US Securities and Exchange Commission. The company stated that it had identified a material weakness in its internal control over financial reporting relating to this item which it is in the process of remedying. It said that as a result of an error ‘the previously reported financial statements should no longer be relied upon’ (PR Newswire 2006). The error occurred during the process of adopting the new standard for accounting for stock options under Statement of Financial Accounting Standards No.123 (Revised 2004), ‘Share-based Payment’. An overstatement was made in the non-cash stock-based employee payment expense. Additionally, the company announced that it had not properly allocated the expense among the research and development and selling, general and administrative expense categories.

The appropriate interpretation and application of accounting standards is a corporate governance issue that is usually managed by firms through embedded internal control structures and processes. Al Farooque, Zijl, Dunstan and Karim (2007) examined the effect of board ownership on firm performance in Bangladesh and found that ownership and performance are endogenously determined and there is either a reverse-way or two-way causality relationship between the two. They argue for strengthening the internal control mechanisms within listed firms in Bangladesh. Of interest in this discussion paper is the strength and reliability of such corporate governance mechanisms in the management of new and often complex accounting standards such as those relating to share-based payment arrangements. The following research question has been framed to commence an examination of this issue.

8. Are there systemic differences between corporate governance issues for principles-based and rules-based accounting standards relating to share-based payment?

3.5 Grant Conditions

Share option granting practices are under intense scrutiny as questions are raised about the propriety of the timing of the grants, repricing, and the manner in which the strike price is set (Bloomberg 2006). The propriety of share-based payment transactions is particularly open to criticism where the exercise of share option grants occurs shortly before significant share price increases or coincide with what appear to be abnormally low share price levels (BusinessWeek Online 2006). Further, some firms have backdated the pricing of executive share options to reflect the changing market values of their shares. Attempts to regulate this area include the requirement in BFRS2 of disclosure of all the significant terms and conditions of executive share-based payment arrangements.

Of interest to researchers in this area is whether corporate regulators will prohibit or otherwise restrict the back-dating of share options issued under share-based payment arrangements. A useful research question might be framed as follows.

9. What are the corporate governance implications of grant conditions permitting the back-dating and/or repricing of share-based payment instruments?

3.6 Share Buy-Backs

Firms are able to use their cash reserves to buy-back shares, and the incidence of share-buy backs has increased as firms enjoy record levels of cash and have become net savers (Nowicki 2006). In addition to signalling a preference by firms to return cash reserves to shareholders and reluctance on the part of firms to invest, this strategy may be indicative of an attempt to avoid the earnings dilution that accompanies the exercise of employee share options. Accordingly, the following research question is posed.

10. What are the implications for corporate governance of share-based payment, of the return of capital to shareholders via share-buy backs?

3.7 Share-Based Payments with Non-Employees

BFRS2 focuses on share-based payment transactions with both employees and other providers of goods and services. No discussion of share-based payments with parties other than employees was detected in the literature review conducted for the purposes of this paper. This suggests that the use of share-based payments with non-employees is likely to be trivial and brings into question the need for such transactions to be directly regulated through an accounting standard. The following research question may assist in further understanding this matter.

11. What is the incidence of non-employee share-based payment relative to share-based payment arrangements for employees?

3.8 Disclosure

Some regulators (FASB 2004) and commentators (Buffini 2006) have called for more extensive disclosure in relation to share-based payment arrangements. As an example, US companies now have to disclose the amount paid to executives under new rules adopted by the Securities and Exchange Commission.

> “SEC commissioners have approved the first major changes in pay regulations for 14 years, requiring US companies to reveal at least as much as European companies about boardroom pay packages.” (The Guardian 2006)

The adequacy or otherwise of disclosure of these matters by Bangladesh firms is not yet clear from the results of annual financial reporting subsequent to the introduction of BFRS2. However, Islam, Al-Hossienie and Al-Baki (2010) argue that most Bangladesh finance companies are disclosing most mandated information which they say is evidence of good corporate governance. They argue that the improvement in corporate governance of finance companies is the result of recent government initiatives. An empirical examination of the share-based payment disclosures made by Bangladesh firms in their post-BFRS2 annual reports has the potential to make a valuable contribution to the corporate governance literature. To assist in addressing this matter, the following research question has been framed.

12. What is the level/measure of disclosure about share-based payment?

4. Summary and Conclusions

This paper focuses on the corporate governance issues associated with share-based payment arrangements. An historical perspective has been adopted in order to demonstrate the absence of a sound theoretical basis for determining appropriate corporate governance practices in relation to share-based payment arrangements. A number of emerging issues, including the potential earnings dilution and volatility effects of the introduction of new accounting regulation in BFRS2 have been considered. Potential research questions have been framed addressing each of the major emerging issues identified in this paper.

It is expected that this discussion and the emerging data from related studies will be of interest to both academics and professionals active in the corporate governance and regulatory arenas. In particular, it is suggested that corporate regulators should ensure they are familiar with and consider extant best practice models for corporate governance of financial reporting issues when developing new, or revising existing accounting regulations.

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