



Executive Remuneration in Hong Kong

There is no magic formula for how much directors should be paid, but investors want to see some linkage between pay and performance

Executive compensation contracts that are designed on the basis of firm performance can be an effective mechanism for reducing agency costs by aligning the interests of a firm's executives with its shareholders. However, the debate on the level of executive compensation and the extent of pay-for-performance is highly visible and controversial in Hong Kong, with accusations of compensation being excessive and compensation policies being non-transparent and self-serving.

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First the Facts

Between 1991 and 1998, average directors' salaries went up by 350 per cent, yet profits increased by only about 180 per cent. In Hong Kong, the average pay of a listed firm director/CEO in 2000 was about HK\$5.7 million, while the highest paid executive director in 2002/2003 received HK\$373 million. These payments include salaries, bonuses, stock options and other allowances. In the US, the average pay of CEOs in 2002 was less than 2001 by 10-15 per cent, although the median pay still increased by 6 per cent. Internationally, the US is ranked the top and Hong Kong the fifth (and first in Asia) in terms of senior executives' pay.

Reports in the media in recent years have woken Hong Kong investors up to the issue of excessive pay packages for company executive directors. The issue has become specially controversial because, at the same time, company profits have dropped. In an often cited example, the directors at PCCW received a huge payment of HK\$768 million in 2000 (50 times the amount of 1999), despite the company's record loss of HK\$6.9 billion and a 72 per cent fall in its share price, as reported in the *South China Morning Post (SCMP)*. According to a *SCMP* survey, the total directors' pay in 2001 among the 33 Hang Seng Index firms increased by 63 per cent, despite a 33 per cent fall in the combined net profit of these companies. Other Hong Kong firms that pay high salaries despite poor performance include Dickson Concepts, Luk's Industry, Emperor International, Far East group, Century City, Sunday and Sincere. Certainly, a few companies are exceptions. For example, the directors of the Shui On Group cut their own pay by 10 per cent in 2002.

Pay for Performance

In the US and the UK, academics have long examined the relationship of senior executive compensation, firm performance and other firm characteristics. However, these findings are largely mixed and may not be applicable to the Hong Kong environment. Based on the past two years of corporate data in Hong Kong, it was found that the growth in pay for executive directors far exceeds the growth of stock prices, net profits and wages. There is no evidence that executive pay is significantly linked to firm performance. In addition, executive pay has a higher association with accounting earnings than stock price.

In a recent Hong Kong study by the author, it was found that directors' ownership had a negative and moderating effect on the total amount of pay to the top five executives of a firm and the total cash bonus that is paid to executives. It seems that pay-for-performance compensation schemes are not major factors in setting top executive remuneration in Hong Kong. Moreover, board size, firm size, market to book assets, and the existence of a bonus plan have a positive and significant effect on the total amount of pay to the top five executives.

Among those few firms that link pay to performance, blue chip companies without controlling shareholders tend to pay the fairest. In family-controlled firms, pay for performance may not be important because the executives have contributed their own capital and personal reputation to the business. This union of ownership and management tends to lead to a difficulty in distinguishing between personal and company assets. Company directors in family firms might use their control to manipulate the system and use compensation to benefit themselves and their associates at the expense of minority shareholders. In Hong Kong firms with controlling shareholders, small shareholders have very little say about directors' pay because the board can make a proposal to the shareholders' general meetings and obtain approval quite easily.

INED Pay

While executive directors are over-paid, there is a common perception that independent non-executive directors (INEDs) are under-paid. There have been suggestions that INEDs pay should be commensurate with their quality, risk profile and performance. There are also arguments that each INED should hold a very small

percentage of a firm's stock (say not more than one per cent) in order to show their commitment to the firm. However, the issue of shareholding by an INED is still controversial although such practices are quite common in the US and UK.

Although strongly recommended, the formation of remuneration or compensation committees, composed mainly of INEDs and deciding on payments using objective benchmarking, is voluntary, and only 40 per cent of listed firms in Hong Kong had such committees in 2000. As most INEDs are not truly that 'independent' in Hong Kong, the real effect of a remuneration committee of INEDs on making executive pay awards more accountable may not be as significant as many policy-makers believe. In the current regulatory environment and given the relative weakness and passivity of minority shareholders, directors can get away with it. To get a better deal for shareholders, one suggestion to improve the situation is that only minority shareholders should be allowed to vote on company proposals to increase the pay of individual directors by more than a certain percentage. However, the relative influence of minority shareholders looks unlikely to increase in the foreseeable future. In the short term the only answer may be regulation aimed at directors' remuneration more accurately reflecting the realistic health of a company.

Hong Kong is well-known for its opacity on executive compensation

Pay Disclosure

Hong Kong is well-known for its opacity on executive compensation. Local companies usually disclose very little about their policies on compensating their directors and senior executives. They have resisted proposals to increase disclosure of directors' pay on the grounds of privacy. Disclosure requirements on executive pay in the US and UK are much stricter and demanding than they are in Hong Kong. In recent years, steps have been taken to increase the disclosure of executive pay, in the hope that it would increase transparency and be more closely tied to firm health and performance of the

company. The Hong Kong Society of Accountants (HKSA) has proposed more detailed disclosure requirements of directors' incomes such as aggregate amount, analysis by components, analysis by bands, remuneration policy, fixed *versus* discretionary pay, the value of options realised, and amounts specified by individual names.

In the Hong Kong Exchanges and Clearing (HKEx) Corporate Governance Consultation Paper, listed firms would be required by the revised Listing Rules to disclose individual (unnamed) directors' remuneration, their computing method and a list of decision makers. It is also hoped that the future Listing Rules will require the explanation of a company's executive compensation and stock option policies, including exercise price, effective period and numbers, in their annual reports. Furthermore, firms will need to divide the total pay into fixed basic salaries and performance-based bonuses. Currently all these important disclosures are on a voluntary basis. The corporate governance Consultation Conclusions of HKEx will amend the Main Board Rules to require issuers only to disclose directors' remuneration on an individual basis, but they will not be required to disclose the directors' names due to respondents' concerns about directors' privacy (similar to existing GEM requirements). It only recommends in the revised Code of Best Practice that issuers are encouraged to disclose directors' remuneration on an individual, named basis in their annual reports. In mid-2003, it was reported that the HKEx Listing Committee has further reviewed this issue and it is not known yet whether HKEx is brave enough this time to break the 'wall'.

The Power and Abuses of Stock Options

In theory, incentive-based compensation schemes should use a weighted combination of benchmarks such as company earnings, share price and other factors. A trend to watch for is the increasing importance of stock options for directors and CEOs. Most US companies link their directors' pay strongly to the share price, mainly from options which in theory are a legitimate and valuable form of employee compensation. A stock option gives an employee the right to buy a certain number of shares in the company at a fixed 'favourable' price for a certain number of years and then later sell the stock at a higher price. These companies believe that earnings are short term, but the share price reflects future earnings so that one can measure the impact over a longer horizon. Yet

this assumes that the market is efficient and that share prices cannot be manipulated.

After the Enron and Worldcom incidents, many people believe stock option compensations benefit executives to the detriment of shareholders. In the US, the heavy adoption of executive stock options and not treating them as an operating expense in a company's financial statement (only shown in footnotes), leaning more in favour of a share price peg, has stimulated some senior executives to behave opportunistically (such as engaging in 'earnings management'), or unethically (such as exaggerating revenues, fraudulent reporting or insider trading) so that the stock price can rise in a short time.

One cause of the Enron collapse was probably its abuse of stock options. During market booms, all market players made profits and were happy with the capitalist model. Good corporate governance practice and internal controls were treated as cosmetic. As has now become clear, much of this was a cover-up, and serious deficiencies existed in the system. The mostly unregulated practice of giving executives stock options to boost compensation remained popular with boards of directors until 2002 in the US when several executives were caught cashing out millions of dollars in salaries and bonuses from their overvalued firms. Since then many in Congress have lobbied to limit stock options given to corporate managers.

The exclusion of employee stock options by Enron and other large enterprises from their current year income statement of expenses have lead many people to worry about these off-balance-sheet liabilities. In recent years, only a few US firms such as Boeing have treated share options as operating expenses. In fact, since the early 1990s, the Financial Accounting Standards Board (FASB) has attempted to develop accounting standards requiring firms to treat share options as expenses. However, due to strong opposition from high-tech firms lobbying Congress, the plan was suspended. If the share options of firms such as Cisco, Microsoft, Intel and Sun, had been treated as expenses they would have had substantial net losses, or much less net profits, in recent years. They might be able to retain valuable professional staff, but would lose competitive power. It is estimated that average earnings would drop by seven per cent if the income statements of large US firms over the past three years were adjusted by treating stock options as expenses.

However, some experts point out that treating share options as expenses would not stop companies issuing share options, but would only make their financial reporting more transparent. Investment guru Warren Buffet indicated that not treating share options as expenses would be unethical accounting practice inflating a company's earnings. Currently, US companies like Coca-Cola, GE, General Motors, Microsoft and IBM have agreed to treat share options as expenses in their accounting systems. In the short term, this may affect their earning figures negatively, but in the longer term, this will increase investor confidence in the companies.

Item 19 of the International Financial Reporting Standards (IFRS, formerly known as IAS) governs the accounting and disclosure for employee benefits (that is, all forms of consideration given by an enterprise in exchange for services rendered by employees). The principle underlying all the requirements of IFRS 19 is that the cost of providing employee benefits should be recognised in the period in which the benefits are earned

by the employee, rather when they are paid or payable. However, there is no equivalent accounting standard in Hong Kong yet. Current requirements in this area under Hong Kong Statements of Standard Accounting Practice (SSAP) are restricted to disclosure requirements (particularly the Listing Rules and the GEM rules). In May 2001, the Hong Kong Society of Accountants (HKSA) issued an Exposure Draft proposing a revised SSAP based on IFRS 19 but there has been no official pronouncement yet as of mid-2003.

This slow standard-setting process in Hong Kong is probably due to the difficulties in identifying a commonly-agreed and easily understood method of calculating the fair value of stock options granted. In the US the major valuating method is the Black-Scholes option pricing model, but this approach involves complicated estimations and computations. In any case, once such an accounting standard were released in Hong Kong, it would probably affect more the earnings of firms which are short of cash, less profitable, or listed on the GEM board. The average drop in earnings would be ►

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about three per cent (although in individual firms it could be up to 40 per cent) and this drop is still far below that in the US.

The reduced negative impact on earnings in Hong Kong is due to the fact that Hong Kong firms adopt far fewer executive stock options schemes than their counterparts in the US. Most listed firms in Hong Kong are controlled by a family or individuals, these controlling shareholders/directors have invested their own personal assets and reputations in the business, and therefore there is little need to give extra incentives to the owners/directors. In general, these firms also tend to grant cash bonuses rather than stock options to employees as they believe accounting earnings or other performance indicators are more reliable than short-term stock prices.

Research in 2002 by Terry Shevlin, the current Editor of *The Accounting Review*, found that little evidence of widespread mistreatment of stock options by US top corporate executives exists, despite the highly publicised scandals involving former officials at Enron, Global Crossing and Worldcom. Rather, a study of more than 1,000 companies shows that for every dollar of stock options given to a company's top executives, that firm's earnings increase an average of US\$2.85 over the next five years. This shows that if adopted and managed properly, the granting of stock options can lead to higher firm performance. However, due to unavailability of public data, this study could not be retested in Hong Kong. Ho and Lam (2003) found that the existence of a stock option plan is not associated with the amount of pay, directors' ownership, dividend yields, P/E ratios, earnings and market value ratio, leverage ratio, market value and net fixed asset ratio, and capital expenditure. This could be explained by the fact that the adoption of stock options schemes is not common in Hong Kong.

Of course, in order to achieve the powerful incentive effects of stock options, the existing legal, financial, and accounting infrastructures should be further improved with bold steps so that executive compensation loopholes are tightened up. Specifically, it is wise to reapportion the ratio of fixed to variable pay that executive directors receive so that the variable pay should not exceed, say, 60 per cent. Moreover, rules can be introduced so that these options cannot be exercised within several years unless the performance of the firm exceeds the average of the stock prices

in the market, or only when these executives leave the company for at least three years. Directors and executives should be excluded from selling their holdings of company shares while serving on the board. Some experts also suggest executives' net gain (after tax) after exercising their options should be held in the company stock until a certain number of days after they leave the company.

Recently, to avoid the potential drawbacks of stock options, a few giant US firms such as Microsoft have proposed to issue shares that can be sold only after several years, instead of stock options to their employees. Many people wonder whether this will become a new trend for US firms. In fact, the motivation of such firms to adopt stock shares schemes may be due to other reasons, such as overflows of cash or avoiding complicated accounting procedures. However, they often overlook the real power of stock options and how these options schemes could be effectively managed to avoid potential abuses. Further, the cost of granting a stock option (at least as part of a pay package) is always less than issuing stock shares or cash bonuses. Issuing share stocks always requires firms to treat such benefit payments as expenses of the year, and therefore there is no difference in terms of accounting treatment. The only merit of issuing shares may be that firms have no need to save large amounts of cash when employees exercise their options in the future. Thus, it is doubted that issuing stock shares would be a major trend in the future.

There is no magic formula for how much directors should be paid. However, there must be some theoretical linkage to show to outside investors that the amounts paid are not random or controlled by the directors themselves, that they are based on reasonable models and that they are transparent and acceptable to minority shareholders. From an outsider's point of view, if directors continue to enjoy higher levels of pay regardless of the profitability of the company, this is clearly not in the interest of the investing public.

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