Analysis and Research on the Equity Incentive of Listed Companies in China

Ling JIANG¹ and Zhi-jun WU²,*

¹School of Economics and Trade, Guangdong University of Foreign Studies, China
²Guangdong University of Foreign Studies, China
*Corresponding author

Keywords: Listed company, Equity incentive, Company value.

Abstract. Under the condition of modern property rights structure, the equity incentive is an effective way to improve the growth of company value. Nowadays more and more companies use equity incentive to promote its development, especially listed companies. The authors analyze the problems the listed companies confronted when they implement equity incentive plans. And put forward some policy suggestions.

Introduction

Equity incentive, based on the company stock, is a long-term incentive for directors, supervisors, senior management, key employees and other personnel. After a long time, directors, supervisors, senior management and other personnel as equity incentive target can get an option to purchase a certain amount of the company's stocks in accordance with a certain price. This regulation is designed to encourage the executives from two aspects. Firstly, executives must complete a predetermined targets as to obtain the company’s stock. Secondly, executives must make the price of the stock remained rise in the long term so as to obtain more proceeds when sell the stock.

Since the scrolling implementation of equity incentive traverses a long period, the effect of equity incentive is much better than of bonuses and other compensation for long-term incentives. Therefore, to a certain extent, equity incentive can solve the principal-agent problem of modern enterprise and achieves the long-term incentive compatibility between operators and owners. If the energized executive left the company during the implementation period of equity incentive, then the equity incentive which had not yet been implemented would be voided. It will increase the losses of the executive to leave the company. So equity incentive is also known as "golden handcuffs" to help to stabilize the company staff team.

Type of Equity Incentive

Worldwide, there are several implementation methods of the equity incentive including the following.

Stock Options

The stock option is an option granted to the executives. The executives can buy a certain number of shares of the company within a specified period with a pre-determined price, or they can give up this right. Stock option is the most widely used equity incentives. It is more suitable for company in the start-up and growth stage, or for the company which has financial risk.

Restricted Stock

Company prior grants executives a certain number of shares, of which the source and sale are with some special restrictions. Only when did the executives complete the intended target, they could sell their restricted stock and benefit from it. If not, company has the right to withdraw the restricted stock or to buy back the restricted stock with the price granted.
Stock Appreciation Rights
Company grants executives a right. That is if the company stock price has risen, executives can obtain benefits through exercising the right. Executives need not pay cash for the exercise. After exercising the right executives can receive cash or the equivalent company stock.

Virtual Stock
Company grants executives a virtual stock. Executives can gain a certain amount of dividends and benefit from the stock appreciation based on their virtual stock. But they have no ownership and voting rights. Also the virtual stock cannot be transferred or sold. When executives leave the company, the virtual stock will lapse automatically.

Performance Stock
At the beginning, company will determine a reasonable goal of the end. If executives accomplish the goal, they will be granted some certain amount of stock or money to buy the company's stock.

In addition, equity incentives also include Employee Stock Ownership Plan, MBO (Management Buy-Outs, MBO), Deferred Payment, etc.

Equity Incentive Problems of China's Listed Companies
According to relevant regulations, our equity incentive model includes stock, warrants and stock options, not including cash-based virtual stock, stock appreciation rights and other means. The incentive objects are determined independently by the company, including managers, senior management and key technical personnel.

Who Should Be Motivated?
Who can be motivated besides executives? Because of the intense competition in the market and the complex business environment, enterprise needs the contribution of executives, so as other employees’ hard working. However, if too many employees could be motivated, the incentive would turn into the common benefit in disguise and even damage the interests of shareholders.

Commission promulgated the "Memorandum about Related Matters of Equity Incentive" which caused an issue of Supervisors’ resignation. The memorandum announced by the Securities Regulatory Commission of China clearly states that "Supervisors of listed company shall not be the object of equity incentive." Some supervisors resigned in some companies which intended to introduce or have introduced a draft of equity incentive. It makes the supervisors not exercise their oversight functions.

In addition, the role of independent directors and the intermediaries cannot be reflected. The management regulations encourage that the Remuneration and Appraisal Committee may require listed companies to hire an independent financial adviser if necessary, for giving their professional advice about the equity incentive plan. And then the independent directors deliver their independent opinions about the equity incentive plan. From the implementation in fact, the small listed companies still have not hired an independent financial adviser, and their independent directors have never made any dissent about their equity incentive plan. The supervisory role of intermediaries and independent director has not yet been reflected.

Equity Incentive Plan Lack Effective Monitoring
The company's managers are the real controller of many listed companies. The functions of shareholders are weakened. In this case, the equity incentive decisions are often controlled by management. The implementation of equity incentive is often "He motivates himself". To achieve the interests of management, the company changes the exercising conditions of the incentive stock option, or even hides the future planning and growth potential of the company. Incentive plans are designed without the positive expectations of the company, and thus can be easily exercised. This incentive plan does not represent the true intentions of the shareholders, while they may be abused.
by the management of the company, and even more the management will harm the interests of shareholders when designs the incentive plan.

Furthermore, Chinese listed companies lack effective internal oversight mechanisms. For the company's financial accounting, evaluation of managers’ performance is lack of being monitored and the management lacks the necessary supervision and restraint, resulting in short-term behavior of listed companies as well as improper related transactions between shareholders. Executives will take short-term behavior in order to achieve their own interests that may harm the long-term benefits of company. For example, executives will reduce research and development costs, improve profit margin, sell their stocks in high price, motivate beneficiaries to whitewash report, adjust profits and manipulate stock price.

Thus, when designing the equity incentive plan, the designer should consider the balance of input and output and the balance of the interests of different members. How to match the increasing operating costs and benefits when there are too many incentive options or the options are low priced? Whether can it effectively play the role of motivation when executives have lower percentage of ownership?

Issues about Personal Income Tax of Stock Options

China currently has no special tax preferential measures for equity incentive. And incentive stock has to be with lock-up period and other restrictions. With the costs of the tax, the equity incentive is not more attractive than wage. The unreasonable tax policy reduces the attractiveness of equity incentive. Specifically, the date to exercise stock options is the taxable date in China. Since the equity incentive plan clearly defined the incentive stocks with a lock-up period, in the stock option exercising date, the shares acquired cannot be sold, and the incentive objects do not receive any real benefits. However, they must immediately pay personal income tax, which will cause a financial burden for incentive object and is not conducive to the implementation of equity incentive. As the incentive objects cannot get cash, if the stock price fell down in the future, they may not only bear the loss caused by the stock but also the loss of personal income tax they have paid.

Problem about Securities Fraud of Equity Incentive

Equity incentive is low-risk and high-yield. This unequal incentive may lead to the moral hazard of executives. Especially the stock option system, as call options, gives the incentive object endless earnings momentum which is more likely to be manipulated by executives.

Policy Suggestions

Strengthen Internal Governance of Listed Companies

Sound governance structure of the company is the basis of effective equity incentive, or equity incentive policy will be a tool to feather his own nest by some executives. State-owned listed companies should resolve quickly the problem of vacancy of investors. The Board of Directors and the Board of Supervisors really play a role in constraint functions. Focus on strengthening the supervisory role of the independent directors, supervisors and the remuneration committee, to avoid equity incentive to become a kind of "self-motivation" means by the management.

Recommend supervisors to become equity incentive object. After the introduction of the memorandum, some supervisors resigned for being the incentive object. It is not conducive to the stability of the Supervisory Board and the supervisors to exercise oversight functions normally. It is recommended that supervisors should become equity incentive object.

Think about the non-director, senior management, and core technical personnel to become incentive objects. The incentive objects should focus on the executives and core technology personnel who have a direct impact of the company's operating results and the company's developments in the future. If the company expands the scope of incentive object just for not reserving the shares, it is not a true reflection of the role of equity incentive scheme, and become benefits for all employees.
Develop a Reasonable Equity Incentive Plan

Listed companies should determine equity incentive targets and develop scientific and reasonable equity incentive programs according to the development strategy and the development situation. Adjust incentive objects during different periods to make the behavior of incentive objects be consistent with the company's strategic goal, thus effectively improving the incentive objects' enthusiasm for work and promoting sustainable development of the companies. Meanwhile, companies should establish a rational constraint mechanism of exercising or quitting options to avoid executives being unambitious and affecting the development of companies when they have got equity interests. This mechanism will make the incentive options really play the role of motivation. Establish a scientific performance appraisal system, and improve operating performance evaluation system. Listed companies should constantly improve the performance evaluation system, and strengthen the performance evaluation and assessment of the incentive target.

Improve Policies and Regulations of Equity Incentive

To improve laws and regulations (Company Law, Securities Law, Tax Law and the relevant accounting standards) related with equity incentive based on the actual situation of our country. Strengthen the supervision of fictional performance, market manipulation, insider trading and other misconduct. All of the misconduct should be severely punished. Based on the characteristics of implementation of equity incentive in China, determine a reasonable accounting treatment of equity incentive. Determine the process of accounting cost allocation of equity incentive. Remove barriers of the legal system for the Implementation of equity incentive. Amending the tax policies about equity incentive, including provide preferential taxation policies to those who use normative plans of equity incentive and the expenses related to them can be a deduction before corporate income tax, to guide the companies to establish more scientific and reasonable incentive schemes.

Improve the Information Disclosure of Equity Incentive

Strengthen the supervision of operational processes of the equity incentive and the disclosure of elements. Level up the disclosure standards of important details such as the information about the adjustments of the exercising price and exercising volume. Particularly to revise the disclosure requirements of regulatory blind spots upwards like the disclosure of the proportion of equity incentive components in the total executive’s compensation and the disclosure of the information about the implementation of equity incentive in the listed companies’ prospectus. Given the disclosure rules in foreign countries, improve comparative information disclosure of the equity incentive revenue, company performance, industry performance, company's share price and market indices. Improve the feasibility of investors to monitor the over motivating behavior of listed companies.

Strengthen the Supervision of Listed Companies’ Equity Incentive

The tasks such as strengthening internal governance of listed companies, improving the capital market, building the market of managers and improving the legal regulations are not able to be completed in a short time. During the implementation of equity incentive in listed companies, the regulatory authorities should be strict for the approval of the equity incentive plan, the information disclosure of listed companies, and the supervision of the equity transactions related to equity incentive. Meanwhile the regulatory authorities should speed up the pace of the approval of the equity incentive plan to make the reasonable equity incentive plan be implemented as soon as possible.

Enhance economic penalties and investigation of equity incentive involving securities fraud. Enhance penalties of false statements, insider trading and market manipulation and other behaviors which damage the interests of investors. It is supposed to establish economic disciplinary regulation and enlarge the responsibility identification of securities fraud. Confiscate related personnel’s improperly obtained salary and other income. Enhance the penalties of irregularities associated with personal emolument. Enlarge the responsibility identification of executives’ irregularities.
Acknowledgement

This work is supported by the Department of Education of Guangdong Province and Guangdong University of Foreign Studies.

References


