The employee share option plans of the WIG20 companies

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1. Current accounting treatment of the employee share options (ESO) in the EU

Companies governed by the law of a member state of the EU and having their securities listed on any regulated market in the EU are required to prepare their financial statements in conformity with the international accounting standards and interpretations adopted in the EU for the reporting periods following January 1, 2005. On February 19, 2004 International Accounting Standards Board published International Financial Reporting Standard 2 (IFRS 2) *Share-based Payment*. This standard was adopted in the EU by the Commission Regulation (EC) No 211/2005 of February 4, 2005 [European Commission, 2005)]. As a consequence the full recognition and disclosure of share-based transactions became mandatory for European listed companies. Since employee share option grants fall into the category of transactions covered by IFRS 2, their full reporting and expensing is now also required.

IFRS 2 sets main requirements with regard to option valuation models, treatment of vesting conditions, expensing, recognition and minimum disclosure of employee share options granted by an entity in its financial statements.

The standard does not recommend any single specific valuation model but prescribes a number of parameters that shall be included in any model actually used by an entity. These parameters are: the exercise price of the option, the life of the option, the current price of the underlying shares, the expected volatility of the share price, the dividends expected on the shares and the risk-free interest rate for the life of the option. The standard gives some more detailed guidance on the treatment of early exercise features of options. Further, it treats differently the impact of market and performance conditions on the vesting period and the recognition of option expense. Options shall be expensed over their expected vesting period with a corresponding increase in equity based on their fair value at grant date. An estimate of vesting period based on market conditions is not subject to revision while an estimate based on performance conditions may be subsequently revised. Vesting conditions other than market conditions shall not be included in determining the fair value of the option.

A company shall provide in its financial statements a comprehensive description of its share-based transactions and in particular shall disclose the number and weighted average exercise prices of all options outstanding at the beginning of the reporting period, as well as options granted, forfeited, exercised and expired during the period and outstanding and exercisable at the end of the period. In addition, the number of options outstanding at the end of the reporting period together with the range of their exercise prices and weighted average remaining life shall be reported. Further, an entity shall provide information on how the fair value of options is computed, including the characterization of the option pricing model it applies together with the required model inputs. An explanation of the method used to establish the expected volatility as well as any other assumptions related e.g. to early exercise or market conditions adopted in the valuation process should also be described.

The standard shall be applied to annual periods starting on or after January 1, 2005, to the instruments granted after November 7, 2002 and not yet vested at the effective date of the standard. A company shall disclose nevertheless the required information on all instruments regardless of the grant date.

2. The ESO plans of the WIG20 companies

The data on the ESO plans presented here was collected from the consolidated financial reports for the first half of 2005 of the WIG20 companies. The only company not included in the review was Cersanit as its financial reports could not be found on its web page. The data for MOL was taken from its 2004 annual report as the mid-year 2005 report was also not available.

Of the companies included in the index as of October 21, 2005, six were found to have granted stock options either directly or through other instruments, e.g. convertible bonds: BRE Bank, Computerland, GTC, MOL, Netia and Bank Pekao. The capitalization of the companies with stock option plans as of October 21, 2005 ranged from PLN 0.6bn for Computerland to about PLN 26.7bn for Bank Pekao and PLN 29.5bn for MOL. The capitalization of Netia was about PLN 1.8bn, that of GTC PLN 2.8bn and that of BRE Bank was equal to PLN 4.3bn. The details of the ESO plans available in the reports are reviewed below for all these companies.

BRE Bank (BRE)

BRE Bank established two ESO plans. Under the first one, initiated in May 2000, 479.5 thousand options were granted at 1% of the strike price of PLN 135.8. The options were then subscribed over the 3 year period until 2003 and the holders were granted bonds convertible into shares in the period from February 2, 2004 until June 30, 2006. No options were exercised as of June 30, 2005.

Under the second program, initiated in 2003, 500 thousand options could be granted at 0.1% of the strike price vesting in five installments until June 30, 2007 and with the exercise period from June 1, 2005 to June 30, 2008. On October 15, 2003 471.3 thousand options were granted with the strike price of PLN 96.16. On July 30, 2004 further 21.7 thousand options were granted. No options were exercised as of mid–2005.

There were 972.5 thousand options exercisable in mid–2005, and the number of basic shares outstanding at that time was 28.815.125. The number of outstanding options was therefore equal to about 3.4% of outstanding basic shares.

Within the two programs 159 and 175 thousand options respectively were granted to the Board of Directors. BRE did not repurchase its shares in the 2004 and 1H2005. It issued 5,742,625 shares in April 2004.

Computerland (CPL)

Computerland established its ESO plan for 2002–2005 in October 2001. The plan set the maximum number of options to be granted over this period at 3.25, 2.75, 2.25 and 2.00% of the total shares outstanding in the successive years.

The strike price during the first five years of the option program was fixed as a 3m average of the CPL share price during June-November period preceding an option grant. After that period the strike price should be increased annually by 8.5% with respect to the strike price at the end of the preceding year. The maximum exercise time is 10 years, with 25% of the granted options vesting each year over the 4 years since the grant date.

There were 852,513 options outstanding as of June 30, 2005, with an average strike price of PLN 88.87. In the 1H2005 137,200 options were granted with the average strike price of PLN 109.20. During that period 27,525 options were exercised with the average strike price of PLN 84.45. In mid–2005 476,738 options were exercisable at the average exercise price of PLN 82.14.

There were 6,892,575 CPL shares outstanding as of June 30, 2005. It seems that prior to that date 157,962 options were exercised in total. The company did not repurchase shares in 2004 and in the 1H2005. The total number of the outstanding options was equivalent to 12.37% of the shares outstanding.

GTC

Although some stock awards were granted more broadly to employees, GTC granted stock options to a single person only, the Chairman of its Supervisory Board. The total of this ESO incentive program, established in February 2004, consists of 446,385 options vestable until the end of 2007. 148,795 options were subscribed in January 2005, and subsequently 89,001 options were exercised with the exercise price of PLN 1 and 7,720 options with the exercise price of PLN 41.71, while the rest of the 2005 grant was canceled. The reason for such exercise structure was not disclosed in the report. At the end of 1H2005 19,964,841 GTC shares were outstanding. The company did not repurchase its own shares over the recent period. It issued almost 5 million new shares in 2004.

MOL

MOL adopted a new stock-based incentive plan in September 2003, following an earlier stock award plan. In October 2003 the eligible executives could subscribe to the privately-placed convertible bonds with the nominal value of HUF 10 million, convertible into 1,779 shares of MOL each. That means that the conversion price was set at about HUF 5,621. Out of the total number of 1,200 bonds, 920 were subscribed with bank loan financing, and 280 retained in a pool for future use. The bonds are convertible into MOL shares in annual portions over the five years. 220 bonds were converted in November 2004. Further, in 2004, 80 bonds were repurchased from exiting holders, 180 more were subscribed by new executives and 24 more were sold to previous holders. At the end of 2004, 824 bonds were outstanding and 156 bonds were held in the pool. That means that the total outstanding subscribed bonds were convertible into about 1.46 million shares. The weighted average number of MOL ordinary shares outstanding in 2004 was about 103.1 million. Except for a structured transaction linked to an acquisition MOL did not repurchase shares in 2004. The closing price of MOL shares on the Budapest Stock Exchange at the end of the third and the fourth quarter of 2004 was HUF 9,715 and HUF 12,710 respectively. The MOL closing price on the BSE on October 21, 2005 was HUF 19,100.

Netia (NET)

There were 393,928,518 basic shares and 1,000 preferred shares of Netia outstanding at June 30, 2005. A maximum of 18.4 million shares may be issued to cover the 2002 Option Plan adopted by the company. At the end of 2003 there were 7,936,975 options outstanding, with the average strike price of PLN 2.56. During 2004 2,228,877 options were granted at the average exercise price of PLN 2.81 and 1,872,498 options were exercised at the average strike price of PLN 2.53. In the first half of 2005, 2,154,497 options were granted at PLN 4.01 on average, and 302,016 options were exercised at the average price of PLN 2.53. The number of outstanding options at the end of June 2005 was 8,696,159 or 2.2% of the shares outstanding. Options granted may be exercised within 3 years, until December 20, 2007. There are some restrictions on the exercise linked to performance conditions (no details provided) and the stock price. At exercise the company issues its shares with value equivalent to the payoff from the exercised options. Due to the financial restructuring program, the company issued about 26 million shares in the first half of 2005. At the same time it initiated a repurchase program under which it may buy back up to 10% of the outstanding share capital until June 30, 2006 for a maximum of PLN 120m. In the first half of 2005 the company bought back about 7.75m of its shares.

Bank Pekao SA (PEO)

Within the existing incentive program 830 thousand options were granted both in 2003 and in 2004. Their strike price is PLN 108.37 (the average PEO closing price in July and August 2003) for the 2003 options and PLN 123.06 (the average closing price in February and March 2004) for the 2004 options. The options expiry is 2010 for the 2003 grant and 2012 for the 2004 grant. The exact vesting schedule was not disclosed, but it is dependent on some individual holder performance milestones as well as on the PEO group ROE in the 2004–2007 period. No options were exercised so far. There were about 166.5m PEO shares outstanding as of June 30, 2005. The company issued 360 thousand shares in 2004.

3. Main ESO plan features in the sample and some conclusions

The main features of the employee stock option plans adopted by the WIG20 companies and the related financial policies may be summarized as follows.

Only two companies exhibit more consistent option activity with options regularly granted and exercised: Computerland and Netia. In the first half of 2005 both companies, the only technology firms in the sample, granted options on about 2% of their shares outstanding. Computerland has by far the largest plan in the sample, as measured by outstanding options, followed by BRE Bank and Netia. The size of GTC plan size is comparable to that of Netia if we treat the options to be subscribed as outstanding. Out of the six companies only three (BRE, CPL, NET) have a wider option plan. The three remaining companies have small plans addressed to the top management and, in the extreme case of GTC, just to a single person.

The exercise price of the options was set explicitly as a market average price over some period by Bank Pekao and Computerland. The Computerland options exhibit an exercise price step-up feature. Only Bank Pekao and Netia options have some performance conditions attached. Not all details of option plans are always clearly disclosed by the companies. The options are valued mainly with basic Black-Scholes-Merton or binomial model without taking into account more specific contractual features.

There is no mention of the dilution management of the plans, and no company in the sample, except Netia, did repurchase recently its shares in the market. Some firms issued a substantial number of shares in 2004 or 2005: BRE Bank, GTC and Netia. All companies, except Computerland and GTC, are paying out a dividend.

On the basis of this review we can make some observations on the corporate governance and financial management of the WIG20 companies.

Looking at the ESO plan adoption in the top WSE companies in a broader perspective, it is clear that the stock options are not a widely accepted instrument, both in terms of the fraction of companies implementing option-based incentive plans as well as in the scope of existing plans. Leaving aside the recent extensive discussion on the adequacy of the incentive characteristics of option plans in the corporate governance literature, the lack of broader share-based compensation plans demonstrates that the rise of the market share price and the corresponding increase in shareholder value may be largely beyond the immediate interest of the executives of the largest firms listed on the WSE. Incidentally, in retrospect, low option grants in recent years mean that many executives and employees missed an additional profit opportunity, given the increase in the stock market prices in 2005.

A financial policy characteristic evident from the reported findings is the absence of share repurchases and the prevalence of dividend payouts. This feature is in line with the results of more extensive studies conducted in other markets. For example Kahle, 2002) found a link between repurchases and ESO plans. Surprisingly, except Computerland, the tech companies included in the WIG20 index did not introduce option plans so far. Elsewhere, option plans are usually larger in technology firms. The option plan size of the top European tech companies was found to be about 4–6% of the shares outstanding and that of the top US tech firms to be in the 14–16% range in recent years [Grabowski, 2005)].

The findings reported in this paper may be consistent with the view that the largest firms in the Polish stock market emphasize traditional dividend policy and that their managers seem to be less concerned with the long-term increase in the share price of their companies. In addition, managers seem to exhibit significant risk-aversion and/or adopt short-term view of the financial performance of their firms. More detailed study of the compensation policy of the WSE-listed firms and its links to the shareholder structure could also provide more explanation of such financial behavior.

References

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