



The Impact of Executive Pay on the Disclosure of Alternative Earnings per Share Figures

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Authors: O'Sullivan, M. and Turner, T.

Synopsis

This research highlights issues surrounding the choice by firms to voluntarily disclose an alternative earnings per share (EPS) figure. Prior research has established that alternative EPS is more useful for decision making than the mandatory basic EPS figure. The objective of executive remuneration contracts is to motivate managers to act in the best interest of shareholders. A prominent component of executive remuneration is executive share options (ESOs) which give executives the right to buy a company's shares at a specified price at a predetermined date in the future, but they are worthless if the shares fail to reach that price. The research argues that the introduction of performance criteria by UK firms, when the pay-out from ESOs is dependent on the achievement of a performance criterion (and not solely on the passage of time) represents optimal contracting and aligns the interests of managers and shareholders. The findings of this research are of interest to those charged with designing and/or evaluating executive remuneration contracts.

Introduction and Background

The focus of this study is on ESOs granted to executives, a practice which has attracted attention as a result of the high pay-outs and the perceived lack of a relationship between pay and performance. ESOs were originally granted with zero intrinsic value and no performance condition(s). This led to a concern that executives in poor performing firms benefited from industry or market-wide increases in share prices even when their individual firm performed poorly. To counteract this, performance targets were introduced in the majority of large UK firms.

The choice of the performance measure is important as optimal contracting theory suggests that managers should be rewarded for their actions on a measure which is under their direct control and useful in assessing the long-term potential of the firm. 75% of our sample firms opted for a growth in EPS measure, which had to be met before an executive could exercise his ESOs which was seen as a mechanism to link pay to the performance of the firm. We ask if the inclusion of EPS targets in ESOs is efficient contracting or does it lead to opportunistic behaviour.

For the sample period, Generally Accepted Accounting Practice (GAAP) required only one basic EPS number to be included in published financial statements and importantly the precise definition of how this basic EPS figure is to be calculated is defined. The components of earnings may be classified as recurring or transitory and investors appear to understand this distinction and apply a lower weight to transitory items (Bradshaw

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A full copy of the paper can be obtained from the authors at:

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& Sloan, 2002). GAAP allows a firm choose to disclose an alternative EPS measure (Walker & Louvari, 2003); the interesting question is whether the adjustments firms make to basic earnings reflect a desire on the part of managers to provide superior information or to artificially boost reported performance.

Issues and Questions Considered

This study explores the relation between the use of EPS performance targets in ESOs and the decision of whether or not to disclose an alternative EPS figure. We extend a prior study which finds that the disclosure of an alternative EPS figure in the UK is mainly motivated by management's desire to supplement basic EPS with a more informative alternative EPS figure (Choi, Lin, Walker, & Young, 2007). In addition, analysts and compensation committees appear to largely exclude transitory expenses when determining actual earnings and compensation.

Two paradigms inform research on executive remuneration. Efficient contracting is the most dominant and assumes that boards design compensation contracts to align managers' interests with those of shareholders (Hanlon, Rajgopal & Shelvin, 2003). It is believed that efficient compensation contracts should link pay to performance thus providing executives with incentives to maximise shareholder wealth. While Bebchuck, Fried & Walker (2002) propose an alternative paradigm, managerial power, they suggest it be employed in tandem with optimal contracting, not as an alternative. This approach suggests that boards do not operate at arm's length and that management extract excessive pay.

The current research highlights a link between the disclosure and compensation literatures; disclosure studies have focused on understanding why some firms disclose alternative EPS. One thesis is that such disclosures may be strategically motivated with management using such disclosures to divert attention away from poor underlying performance. The opposing argument is that some managers appear to use alternative EPS disclosures to supplement the informativeness of basic

earnings. The implication is that managers have incentives to disclose value-relevant information when it is of higher quality than publicly available information.

We ask if equity-based compensation provides managers with incentives to be more forthcoming with disclosure. From an efficient contracting approach, the idea is that the existence of EPS targets in the managerial contracts "calls" for a good (high quality, very informative) EPS figure to base the EPS target on. Voluntary disclosure by management of private information increases transparency and reduces information asymmetry (Nagar, Nanda & Wysocki, 2003) and while there is a lack of clarity in some annual reports on the actual definition of EPS used as the performance target in ESOs, generally firms appear to use a definition which would effectively be the alternative EPS figure disclosed by firms.

From a managerial power perspective managers opportunistically set the targets and will need to disclose an alternative EPS figure that fits these targets. Given that, on average, the disclosure of an alternative EPS figure is efficient we do not expect to find a positive relation if managerial power explains the EPS target decision. In other words we expect a positive disclosure - EPS target relation only under efficient contracting.

Methodology

The main research question is addressed using logit regression analysis following prior disclosure studies. As it is possible that remuneration structure and disclosure choice are endogenous and jointly determined, the study controls for this by modelling the choice to include an EPS target in ESOs. The results are robust to a number of checks which address endogeneity, selection bias, and direction of causality. Propensity score matching is used to obtain a credible counterfactual; would firms have disclosed an alternative EPS if they did not have an EPS target in their ESOs?

Outcomes and Findings

Widespread disclosure and use of alternative EPS figures supports the

importance of enhancing our understanding regarding this disclosure choice. We examine a specific contractual setting where management is especially sensitive to reported earnings numbers, that is, when EPS performance targets exist in the executive remuneration contract.

Given that both EPS targets and alternative EPS figures use similar EPS definitions, that is, typically focus on permanent earnings excluding transitory items, we conclude that firms with EPS targets disclose alternative EPS figures more often. We argue that this is consistent with the notion of shareholders attempting to measure and reward only the managerial effort that contributes towards the objective of long-term value maximization.

One of the objectives facing designers of executive remuneration contracts is to do so in a way to ensure managers act to maximise the wealth of the shareholders. Although the choice to disclose an alternative EPS figure is voluntary, the majority of our sampled firms chose to disclose an alternative EPS figure.

Our analysis suggests that the choice to disclose (optional) an alternative EPS figure is positively and significantly related in firms where the vesting of executive share options (ESOs) is contingent on the achievement of growth in EPS. Overall, the results provide an indirect indication that efficient contracting is driving the decision to include an EPS target in ESOs and supports the conclusion that an EPS target in ESOs is in line with optimal contracting theory.

The results suggest that contractual agreements, in particular those regarding remuneration, between management and shareholders has an impact on the choice to disclose more informative earnings figures. Generally, firms appear to use the same definition of EPS for both the alternative EPS disclosed and the target EPS.

This study extends our understanding of the motives for disclosing an alternative EPS figure by highlighting the role of executive compensation contract structure in the alternative EPS disclosure choice and thus draws attention to an issue for consideration by those designing executive compensation contracts.

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