Asian Social Science; Vol. 8, No. 11; 2012
ISSN 1911-2017 E-ISSN 1911-2025
Published by Canadian Center of Science and Education

On the Implementation of Equity Incentive and the Risk Control in Chinese Listed Companies

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Received: April 22, 2012 Accepted: May 15, 2012 Online Published: August 17, 2012

doi:10.5539/ass.v8n11p133 URL: http://dx.doi.org/10.5539/ass.v8n11p133

Abstract

The application of equity incentive in Chinese listed companies faces many problems, e.g. preconditions are too broad, performances cannot be assessed strictly, or expected returns are unpredictable, ultimately which cause greater risks in equity incentive. Risks in equity incentive impact the establishment of long-term incentive mechanism in Chinese listed companies, weakening employees' enthusiasm for work. Equity incentive risks are chiefly derived from the absence of owners, the imbalance of corporate governance, the non-regulated securities market, and the imperfect regulatory system. To identify and control the risks in the implementation of equity incentive to achieve the purpose of equity incentive needs to be resolved urgently for the reform of pay system in Chinese listed companies.

Keywords: equity incentive, application, risk, identification, control

1. The Application and the Risks of Equity Incentive

Equity, i.e. share ownership, is legally entitled to the rights of investors to the company. Equity incentive means the shareholders have the right of possessing all or part of equities of the company in accordance with legal provisions and agreements. It is a fair distribution of the company's future value- added benefits and a way for long-term incentive. Equity incentive is essentially a means to deal with the contradictions between human resources and material resources and can help to form a risk-sharing mechanism for managers and shareholders. It is an acceptance to values of human resources, an effective way to motivate talented people, and a method to make implicit benefits of control right transparency and monetization. Types of equity incentive include stocks incentive, futures incentive, and options incentive. The specific forms of equity incentive are stocks, futures, options (stock options, profit options, equity options), restricted stocks, stock appreciation rights, job stocks, technology stocks, and management stocks. Measures for the Administration of the Equity Incentives of Listed Companies (Trial Implementation), Trial Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Domestic), and Trial Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Oversea) mainly regulate four incentives, namely stock options, restricted stocks, performance stocks, and stock appreciation rights.

The risk is the probability of losses. The risk of equity incentive refers to the probability of the listed company and shareholders suffering from losses of values when implementing equity incentives. In other words, improper implementation of equity incentives will cause negative effects and deviate from the purpose of equity incentives. The equity incentive, as a contract, faces a variety of risks in implementation due to complex reasons. The risk of equity incentives cannot help to achieve the purpose of equity incentive and eat up stock values and assets of shareholders, worsening the company's management environment. Therefore, the implementation of equity incentives in Chinese listed companies must control the occurrence of risks effectively.

2. The Identification of Risks of Implementing Equity Incentives

Risk identification is the assumption and speculation of risk events that might occur in the future. It is the recognition and judgment of the potential risks.

2.1 The Types of Risks

The types of risks in the implementation of equity incentives include system risk, market risk, program risk, and moral risk.

The system risk is caused by imperfect equity incentive system. Due to all kinds of defects, it cannot restrict agents effectively and results in internal control. The market risk is caused by immature securities market. Because of system defects, the management level manipulates information and performances and stock prices fail to reflect the value of company. The program risk is caused by defects of the equity incentive program, unscientific indicators for performance evaluation, uncontrolled implementation of program, and overuse of incentives. The moral risk means the program makers and incentive targets do not fulfill the fiduciary duty entirely, betray the professional ethics, and hurt the interests of the company and shareholders.

2.2 The Sources of Risks

The risks of equity incentives are mainly from these following aspects. (1) Defects in theoretical assumptions. The principal-agent theory is one of important basis for equity incentive. It assumes the principal and agents are both rational economic entities, but in reality they have some irrational behaviors and thoughts. It assumes the principal is the final owner of the company and there is no collusion between the principal and the agent, but in Chinese listed company the principal of equity incentive program is also the agent and there is a probability of collusion between the principal and the agent. It assumes the capital market operates normally in a perfect legal environment, but in China the securities market needs to be improved and so does the law. (2) Defects of equity incentive program. Some equity incentive programs consider more about the interests of managers instead of shareholders. Some set low standards for incentives and lack of precise assessment of corporate performance, without calculating the percentage of managers' expected return to expected corporate revenue or total salaries, which result in giving rewards for poor performances or managers' higher return than corporate revenue. (3) Imperfections in equity incentive system. (4) Subjectivity of performance appraisal. (5) Injustice of intermediaries in securities market. (6) Government regulatory oversight. (7) Moral corruption of corporate executives. (8) Low cost for violations of laws and disciplines.

2.3 Effects of Risks

The inappropriate implementation of equity incentive may bring about many risks. The consequences will harm the values and the development of company, the employees' enthusiasm for work, and the social justice. If there are greater defects in the incentive program, or the incentive objects fall in moral corruption, or the securities market fails to reflect business performances, the implementation of equity incentive will lead to an unfair distribution of values, away from national conditions, which will inevitably hurt the interests of company and shareholders and business development. According to the equity theory, unfair pay distribution will severely strike the enthusiasm of employees for work, cutting the cohesion of company. Besides, the unfair distribution will cause public criticism, which will ruin the social image of company, and bring confusion of social values.

3. The Risk Control for the Implementation of Equity Incentive

On the basis of a clear understanding of risks of equity incentive, shareholders, directors, supervisors, regulators, and intermediaries should take positive actions to prevent against or control the various risks of equity incentive. As for the thoughts of equity incentive, we should follow the principle of increment incentives, combination of incentives and restrictions, balance of risks and revenues, and consistency of interests of company, shareholders, and management, being regulatory, careful, and step by step. As for the practice, we should control disordered, non-risk, unconditional equity incentives, preventing too much incentives or insufficient restrictions. As for methods of risk control, we should make best use of risk control by shareholders, the board of directors, the board of supervisors, the objects of incentives, the institutions, the market, and social public regulatory. In practice, we should focus on the following aspects to achieve risk control.

3.1 Control the Risk of Equity Incentives by the Pay System

Modern enterprise pay system is a combination of basic pay, performance rewards, long-term incentives, and benefits, including material and non-material compensations. Equity incentives are the long-term incentives, which might cause changes of stock ownership and dilution of stocks. We must use equity incentives carefully. (1) Establish equity incentives in the pay system. The percentages of cashes, short-term incentives, long-term incentives, and benefits should be in accordance with the trend of modern enterprise pay system. We should design the pay system scientifically, taking account of cashes, benefits, equity incentives, non-economic rewards, incentive structures, and incentive orientation. (2) The principle of pay incentives should not deviate from the company's development strategies and values. Equity incentives should match with the company's development strategies, human resource management, financial management, business development, position analysis and assessment, performance appraisal, laws and regulations in order to effectively motivate the core talents. (3) Equity incentives should be appropriate and in line with national conditions. Since the objects of incentives only contribute to the creation of new values for increment assets, and the equity for incentives, no matter whatever it is initially preserved, repurchased, or transferred by major shareholder, produces costs because it is the company that firstly gets the equity, plus the psychological impacts of pay fairness on employees, the intense and the difference of equity incentive should be controlled under certain range, compatible with national conditions. We should take reference to the internationally accepted option pricing model or the stock fair market value, and scientifically estimate the expected value of stock options or the expected return of restricted stocks and the probability of acquiring interests. Then, according to the predicted return from equity and the prices of stocks for incentives, we can establish the quantities of equity for incentives, avoiding excessive incentives. (4) Keep equilibrium of distribution of equity incentive. In the listed companies with equity incentive programs, the uneven distribution of values prevails. Therefore, we should avoid giving too many equities to directors and executives but few to core employees. (5) The company may choose different long-term incentives due to different development cycle. The company in strong growth is more appropriate to take equity incentive, but the company in maturity is more appropriate to cash incentive.

3.2 Apply Risk Prevention to the Design of Equity Incentive Program

The conditions for a listed company implementing equity incentive are: the company has normal governance structure and operates properly; the Remuneration and Appraisal Committee is composed by external directors and works well; the internal control system, the pay system, the employment regulations, and the performance appraisal system are established and sound; the company has clear development strategy and operates well. The implementation of equity incentive should be in accordance with the reform of company, especially with the improvement of corporate governance structure.

In designing the equity incentive program, we should strictly follow the principle of increment incentive. We cannot quantify the stock assets free of charge. The equity incentive program should include the returns to shareholders, the quantity of salaries, the distribution of pay, the proportion of long-term incentive to other incentive means, the changes of objects of incentive, and the background of implementing incentives.

The objects of incentive mainly focus on the executives and the employees who contribute a lot to the improvement of corporate performance. In principle the objects of equity incentive are limited to the directors and senior managers and the core technicians and management backbones who directly affect the overall performances and sustainable development of listed company. The supervisors, independent directors, and the external directors who are not from the controlling companies of the listed company are excluded from the equity incentive program at present.

The quantity of equity for incentive should follow relevant provisions of some equity incentive laws and regulations. The number of stocks for effective equity incentive program should be reasonably established in the range of 1% to 10%, and should not exceed 10% of the total corporate stocks, considering the size of corporate stocks, the scope of objects of incentive, and the level of incentive. For the first implementation of equity incentive program, the number of stocks should be controlled less than 1% of total stocks. Any employee can get stocks from the equity incentive program, but the accumulated stocks should not exceed 1% of total corporate stocks.

As for the orientation of incentive, the distribution of equity should be fair enough and inspiring. The principle of fairness requires that the distribution between executives and core employees should not deviate too much and the equalitarianism is not allowed between executives or core employees. The right way is to draw distances according to different contributions. The distribution policies of companies with different natures should emphasize on different aspects. For example, high-tech companies should emphasize on core technicians. Real estate companies should emphasize on managers who contribute significantly to the realization of corporate strategic objectives.

As for the means of incentives, different means generate different costs, effects, and benefits. Therefore, the company should make the choice based on actual conditions and market situations. The legal equity incentives for state-controlling listed companies include: stock options, restricted stocks, performance stocks, and stock appreciation rights. Among them, the incentive of stock options is based on higher requirements for company's growth and its effects are significantly under the influences of company's growth. The incentive of restricted stocks can overcome the defects of stock options.

The shareholders' meeting is not supposed to pass any equity incentive programs that do not satisfy those conditions above and China Securities Regulatory Commission should stop these equity incentive programs.

3.3 Control Risks in the Implementation of Equity Incentive Program Effectively

The problem in front of equity management is to achieve effective supervision on the implementation of equity incentive program in listed company, preventing the collusion of business managers and market forces. The listed company must build and improve the performance appraisal system and the assessment methods and take indicators of performance appraisal as the preconditions for the implementation of equity incentive program. We should build an objective overall performance appraisal system focusing on the key performance indicator (KPI) and the balanced score card (Bsc) and use the actual data of performance indicators to manage the equity incentive program dynamically. Carry out the provisions of the Administration of Equity Incentive Measures. No less than 20% of long- term incentives should be realized after the duty appraisal by the end of term. The problem is that the expected benefits for objects of equity incentive in state-controlling listed company may out of control. If the price of stock is abnormally high, the actual benefits from equity incentive will exceed the expectation. Therefore, we must make reasonable adjustment to the actual return and keep the exceeding returns to the company itself. As for the restricted stocks, the expected return is not supposed to exceed the growth of performance indicator.

3.4 Control Performance Risks by Performance Indicators

Performance appraisal has a decisive effect on the scientific, reasonable, and relatively fair pay system. We must take scientific performance appraisal methods and indicators to precisely assess the work and the performance of incentive objects. The financial performance appraisal indicators, such as net profit growth and return on net assets, frequently used by domestic listed companies, are affected greatly by macro economy, interest rate, and exchange rate. In addition, the return on net assets does not consider the costs of equity capitals and fails to precisely measure the performances generated by subjective efforts. Therefore, this indicator needs to be modified. As for the references, it is necessary to compare to the past and the industrial average, as well as the leading company. The performance indicators should include both objective indicators, such as profit growth rate, return on net assets, assets maintenance and appreciation, and solvency, and subjective indicators, such as cooperation ability, innovation capability, work initiative, and reliability. Besides, the assessment performances should mainly focus on objective indicators, taking subjective indicators as assistants and preventing against being abused in practice. The objectives of performance should emphasize on future and challenge. The price of granted stocks for incentives should not be lower than the average of the recent three years and the average of the industry. When the stocks for incentives come to cashes, the price should be higher than the granted point. Because of the connection between performance indicators and stock prices, the performances might be distorted. We can use the indexation options, the economic value added (EVA) indicator, the balanced score card (Bsc) indicator to confirm the performances generated by subjective effects of incentive objects and put emphases on the company's profitability and sustainability of development. If the price increasing of stocks is caused by industrial or market changes, without connection with managers, the management level will not be granted stocks for this.

3.5 Control Risks by Improving Corporate Governance

The equity incentive is a decision under the corporate governance frame. At present, the corporate governance in Chinese listed companies is generally at a lower level. Without perfect capital market supervision, the implementation of equity incentive faces potential risks. In perspective of the composition of the Board of Directors, the external directors and independent directors are few and the independent directors are not independent enough. The Director of the Board is also the general manager, which causes the high overlap of the Board and the business operation, ultimately resulting in the imbalance of internal supervision mechanism and the phenomena of internal dominance.

In order to prevent the directors and executives obtaining improper interests by equity incentive, we must improve the corporate governance. (1) Establish a sound internal control mechanism. By means of classified voting system, granting the regulatory commission with strong and practical supervising right, increasing independent directors and external directors, we can achieve the restriction of the shareholders' meeting to the Board of Directors and the regulatory commission, the restriction of the regulatory commission to the Board of Directors and the directors, and the restriction of independent directors to executive directors. Set up a special committee in the Board of Directors, especially an auditing committee dominated by external directors and independent directors, and a pay and appraisal committee to objectively and fairly audit and supervise the behaviors of executives and managers. In order to prevent accounting frauds, managers should not be the one being audited and the one as auditing clients at the same time. The regulatory commission, or the independent directors, or the shareholders should be the auditing clients in order to make sure the independence of accounting firm as the third party. (2) Build the excellent corporate culture and develop the social trust culture in order to prevent against moral risks of agents. (3) Develop the market of directors and managers to form a competitive pressure for the directors and managers in services and force them to work hard. (4) Make the administrative supervision and social supervision play a role and ensure the legitimacy and rationality of equity incentive program.

3.6 Balance the Risks by Incentives and Restrictions

The equity incentive might be used by executives as the way obtaining returns by control right. For example, as the market value cannot reflect the actual business performance, the equity incentive might result in the management level's pursuit for market value of stocks. Under the condition of imperfect corporate governance and internal control problem, the incentive objects, methods, assessment, and objectives may not reflect the interest of investors completely. The imperfect internally controlling system may easily lead to excessive incentive. In order to suppress the negative effects of equity incentive, we must strengthen restrictions. For the stocks granted to executives for incentives, the listed company must set strict regulations on the lock term, the gradual reception, and the necessary preservation for possible resign. If the performance appraisal does not meet the standards, the stocks should be granted at all. During the valid time period for equity incentive program, the executives' personal expected returns should be controlled in a legal range precisely. To grant, cash, or unlock the stocks is under the restriction of annual performance appraisal. For the granted stock options, the cashing needs to make dynamic adjustment based on annual performance appraisal. For the granted restricted stocks, establish the quantity of unlocked stocks according to annual performance appraisal. If fail to unlock the restricted stocks during the fixed time period, the listed company should take back or repurchase the restricted stocks at the initially granted price.

3.7 Control Market Risks by Improving the Securities Market

Equity incentive could be realized with the assistance of securities market. The basic functions of securities market are: optimizing resources allocation, financing, and capital pricing. Because of the imperfect system related to the issuance and transfer of stocks, the information disclosure, the stock dividends, the operation of securities market, and the Government supervision, under the condition of system risks, human manipulation, and accounting fraud, the pricing function of securities market might be distorted and cannot reflect the actual stock price and performance, which ultimately causes equity incentive risks. Therefore, we must constantly improve the institutions and regulations in securities market, build a credit system for listed companies, adopt the zero-tolerance punishment measures for executives violating laws in listed companies, and make listed companies face risks of exiting from the market and compensations all the time, in order to suppress the negative effects of equity incentive.

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