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HOW WE REGULATE EXECUTIVE STOCK OPTIONS: THE INTERACTION OF LEGAL RULES AND ACCOUNTING STANDARDS

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With regards to executive compensations, it is not about what you give but how you give it.
-- Jenssen.

Synopsis

On 31st January 2008, YL, one of China's leading enterprises in dairy products issued a prior announcement of a possible deficit in the fiscal year of 2007 for the first time in its 30 years of operation. Prior to this report, the company had realized profit of RMB 330 million yuan, or 0.64 yuan per share in the first three quarters of the year of 2007. The deficit is largely due to the stock options plan put into force the year before, which, as required by Chinese accounting standards, were accounted for as an expense. Such an unfavorable report raised concern amongst the investors. Consequently, the company's share price has declined as much as 37% in only 60 transactional days since the announcement. [1]

It sounds like a joke that a company incurred loss due to the implementation of an incentive plan. It is well known that such stock options plans are incentives given to the management and/or employees of a company with the goal of raising the staffs' enthusiasm at seeing the company's business improve and thus raise the value of its stock. However, the exact opposite effect is observed in YL's case. Is this a corporate management problem or stock option incentive problem? The public continues to dispute over this matter. Disappointed investors

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[1] YL's closing price on the transactional day before the announcement was made was 26.91yuan. The opening price was 24.40 yuan the day of the announcement. Thereafter, there was a continuous fall up til 22nd April where it was 16.88 yuan, a decline of 37% from before the announcement. It should be taken into account that this took place Taipan share at the Chinese Stock Market was declining. Taipan stock prices fell from 4,330 on 30th January to 3,147 on 22nd April, a decline of 27%. YL stocks fell by 10% more as compared to Taipan. *Securities Transactional Systems Online*

accuse corporate management for being the source of such, claiming that it is the greed of high level management who frame stock options' ability to enhance the value of a company's stock as their excuse to have such a plan. On the other hand, some analyst stress that the deficit is a kind of paper loss resulting from the way in which the accounting standards treat stock options and this has nothing to do with the company's commercial performance/potential. [2]

The existence of various views demonstrates the necessity of further investigating YL case and stock options. The author would like to take YL as a good example to show the negative effects of the "golden handcuffs" and the insufficiency of legal rules on stock options in preventing the excessive executive compensation. The purpose of this paper is to explore the possibility of integrating accounting into legal process in regulating stock option, on the assumption that the deficit "deriving from" the stock option incentive is neither a mistake nor a nonsense figure produced by the accountant. Rather, accounting standards try to reflect the economic consequence faithfully and directly by recognizing as compensation cost the fair value of stock options. In other words, the unpleasant picture depicted by the accounting standard may work as a special restrain on the management supplementary to legal control.

This paper is divided into 5 parts. The first part discusses the conflict in managerial stock options and the difficulties in evaluating the reasonableness of stock options. Part 2 describes how legal system regulates stock options in a process-oriented fashion by emphasizing information disclosure and business judgment. Part 3 analyzes the significance of accounting principles which require companies to recognize stock options as a cost and its possible constraints in management incentive to over-pay themselves After discussing the limits in both the laws and accounting principles, part 4 will take a look in depth at YL's stock option plans, assessing the economic consequence of the plan based on the accounting treatment. The main focus is on why the constraints the accounting standards is expected to imposed on the management failed. The final part of this paper summarizes the lessons we should learn from YL case and draw the conclusion that the operation in isolation of legal control and accounting treatment would hardly produce the result expected. It also explore the possibility of integrate accounting into legal process-oriented control, for example, the company law may require

[2] For more information on the related debates, please refer to "Stockholders' rights causes negative impact on YL stocks", *Shanghai Securities Paper,* 31/1/ 2008; Xiao Liu, "Whether YL will have the ability to refrain from excesses of their stock options plan", *Securities Times,* 1/2/2008; Li XiaoHua, " The duet of Fund Companies & YL's 2007 deficit", *21st Century Economic Reports,* 17/2/2008.

a well-informed judgment on made by directors and relevant professionals based, at least partly, on the economic consequence depicted by accounting standards.

I. The Conflict of Interests Behind Executive Stock Options and the Difficulty in Evaluation of Reasonableness

An executive stock options (hereinafter ESO) plan is often called "Golden Handcuffs". For the past decade, it has been regarded by scholars in corporate governance as the medicine for curing agency cost problem by offering managerial level staffs a long term incentive. It is the core tool which attempts to align the manager's personal interest with the company's and its shareholders' long term interest. An executive stock option carries the right, but not the obligation, to buy a certain amount of shares in the company at a predetermined price in consideration for services performed by the management for the company. If the company's stock rises, holders of options experience a direct financial benefit. For companies with a high growth rate, the benefits are very visible. In general, companies are most often generous when considering the amount of ESOs as giving out ESOs do not require them to fork out cash. According to a statistical data complication in 2005, in the United States where ESOs are most commonly used, stock-based payment may account for more than two thirds of the value in a managerial pay package. [3]

From the surface, a company does not suffer any detriment when it issues ESOs. Moreover, when a manager decides to exercise his or her option, he has to contribute in cash for the shares, thus increasing the company's equity interests. For such reasons, ESOs have been regarded by some as a genies gift for both the managers and the shareholders as a whole. In reality, that is by no means the case. The market price of the share will normally be much higher than the strike price at the time a manager chooses to exercise his option. This means that the company would have gain much more capital if these stocks were offered to the market rather than offered under ESOs. The difference between the market price and the strike price would be the benefit a company award to its managers when they exercise their ESOs. This in effect would result in a lower net asset for all shareholders, sacrificing the shareholders' benefit.

This, however, is reasonable if the managerial level staffs are able to contribute such levels of service which are comparable to the awards

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[3] Finance Serious, Vol. 10 (Jul. 24, 2006), at 14. published by *Caijing Magazine*. (《财经・金融实务》，总第10期第14页，《财经》杂志2006年7月24日出版)

rendered. Then no doubt the shareholders would be willing to make such sacrifices. "Reasonableness" is a definition coming from common sense which has also been accepted as a general principle of law in some jurisdictions such as United States. In the 1960s, the United States Court of Delaware had expressed this fundamental, two pronged rule for stock option in *Beard v Elster*:

All stock options plans must be tested against the requirement that they contain conditions, or that surrounding circumstances are such, that the corporate may reasonably expected to receive the contemplated benefit from the grant of the options. Furthermore, there must be a reasonable relationship between the value of the benefits passing to the corporation and the value of the options granted. [4]

In real world, the assessment of the reasonableness a is not a easy job. Whether it is the calculation of the value of stock options or the relationship between the value of the benefits passing to the corporation and the value of the options granted, they are both very complicated issues. Today, the problem of valuating stock options has for the most part been resolved with the assistance of financial engineering. Black-Schole option-pricing model offered by Nobel prize winning economists is widely used for evaluating stock options. However, too rationally link portion of the financial performance or the increase in company's share price or net worth to the effort of certain managerial effort is almost an impossible task. There are too many factors in addition to management's effort which attribute to the growth of a company's profit or the rise of its share price, such as interest rate, commercial cycle, commodity prices, investors' psychology, labor management relations and so on. However, it is almost impossible to evaluate each factor's function separately.

Against this background, some commentators argue that market force is a better mechanism to determine the reasonable level of management reimbursement. This is true so long as a competitive market for manages and headhunters exist. What legal system need to do is to push companies to provide the market with sufficient information. Then the salaries of managerial staffs will acquire a comparative and objective standard. This would prove to be more effective than if it were decided by either regulators or courts. It also prevents contrived interventions that would prevent the free flow of the managerial market.

[4] 160 A.2d 731 (Del. 1960), at 737。

II. Legal System's Response to Executive Stock Options: A Process-Oriented Contol Mechnisam

According to prof. Robert C. Clark, "the legal system chooses a middle way between intrusive regulation and complete laissez faire. The approach has two aspects: market-enhancement measures and a fail-safe device" [5] The enhancements focus on disclosures and decision making, especially approval by outside directors and ratification by shareholders meeting. Courts, on the other hand, provide judicial redress for compensation "that has somehow slipped through the normal array of market forces and process-oriented legal controls". [6]

The legal system in both US and China seem to fall into this fashion.

A. American Law

Disclosure of compensation information has been the highest priority by the regulatory body in US for regulation of ESOs. On 11th August 2006, the American Securities and Exchange Commission (SEC) announced a new rule on directors and executive compensation which replaces the 1992 stipulation. The new rule focuses on strengthening public disclosure to reflect the underlying changes in salary-setting process in the past decade. SEC emphasizes that goal of regulation is wage clarity, not wage control. It believes that the source of the problem in executive compensation is in the transparency of the matter. If there is sufficient information, the market would be more able to manage this problem. [7]

Under state law, courts have the jurisdiction over the disputes on the reasonableness of stock option plans, but they tend to resorting to the company's business judgment. Especially under circumstances where such compensation policies have already gotten the approval of the board of directors and the shareholders, courts are very reluctant to challenge the company's decision except there is apparent defect in the compensation - setting process itself. [8]

Neither corporate law nor SEC disclosure regulations provide any substantial restrict on ESOs. Interestingly, US Inner Revenue Code , by applying preferential tax treatment to so called "incentive stock

[5] Robert C. Clark, Corporate Law, Aspen Publishers, Inc, 1986, at 193.
[6] Id, at 194.
[7] Christopher Cox， SEC Chairman's Opening Statement: Proposed Revisions to the Executive Compensation and Related Party Disclosure Rule (Jan.17, 2006), at hittp://www.sec.gov/news/speech/spch011706cc.htm. Interviewed on 20/4/2008.
[8] Robert C. Clark, Corporate Law, Aspen Publishers, Inc, 1986, at 195, 215.

options" (hereinafter ISO), in contrast to the non-qualified stock options, help to make popular some restrains on ESOs. They include but not limited to: (1) Options granted must be exercised within 10 years; (2) Option price must not be less than FMV of the stock at the grant date; (3) The maximum amount of stocks bought by a grantee under the ISC must not exceed 10% of the company's total outstanding stocks; (4) The maximum FMV of the option vested per year must not exceed $100,000; (5) The stock under ISO are not sold out until two year after the grant date of or one year after the exercise of options, etc. [9]

B. Chinese Law

China's method of managing executive's stock options is in essence a type of restrictive mechanism which focuses on disclosure of information and procedural guidance.

At present, China's Company law does not address the issue of managerial level salaries but leaves such decisions to the directors of directors of a company.[10] The implementation of a stock option incentives plan involves the company distributing new stocks or repurchase back outstanding shares, both under the shareholders' meeting's control[11]. Therefore, according to the new company law rulings, stock option plans are brought up by the board of directors and approved by the shareholders.

In practice, Chinese Securities Regulation Commission (hereinafter CSRC) and State Assets Administration and Supervision Commission has issued regulations on listed companies and state owned enterprises' stock option plans respectively. These regulations clarify the form of share-based payment, the maximum amount, striking price, waiting period, etc, which bears great similarity to those restrain put by US Inland Revenue Code. Here, the author takes CSRC Regulations Listed Companies' Share-based Payment Plans (issued in 2005, hereinafter CSRC Regulations) as a sample to analyze the features presented by current Chinese legal system. There are three aspects that worth nothing: basic conditions, examination and approval procedures and disclosure.

i. Stock Options' basic constitution

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[9] Internal Revenue Code (IRC) 422.

[10] Under art. 47 of the Company Law of PRC 2005, the board of directors exercise their authority to making decisions on a company manager's remuneration, and, according to the nomination of the manager, deciding on the hiring or dismissing of vice manager(s) and the person in charge of finance as well as their remuneration. According to art. 109, the board of directors have the power to 'establish the company's core management policies', this includes salary policies.

[11] Articles 28,100 and 143 of the Company Law of PRC 2005.

According to CSRC Regulations, listed companies are allowed to offer share-based payments to directors (with the exception of independent directors), managers, supervisors and other employees of lower ranks. The share-based payments can take the form of stock options, restrictive stocks, stock appreciation rights and other forms. The regulation is however, aimed at directors, managers and the managerial level staff whereby they are to required to meet performance targets as specified in the payment schemes.

The shares involved in a incentive plan should not surpass 10% of the company's total shares. Any one candidate are allowed to obtain stocks of no more than 1% but the shareholders general meeting are permitted to make a special resolution authorizing an exception.

Validity period of the Stock options are not to surpass 10 years. During the valid period, listed companies should stipulate how a grantee is to exercise his or her options by stages in stipulated proportions. Among them, the requisite service period before the first proportion of options vest and can be exercised (namely the vesting period) should not be shorter than one year. Furthermore, Chinese Company Law stipulates that once the right has been exercised the directors and managerial level staffs shall not sell more than 25% of their stock holdings each year.

With regards to striking prices of a stock option, CSRC Regulations requires that the striking price for the target share should not be lower than the closing market price of the share on the day before or the average price within thirty transaction days before the publication of the draft of stock options plan, whichever the higher.

To avoid using insider's information to the management transfer of benefits, CSRC Regulations prohibits listed companies to grant stock options within thirty day before issuing the periodic financial report or within two days after the disclosure of material information in interim report.

ii. The Process for Setting and Approving the Executive Stock Option Plan

CSRC Regulations stipulate in detail the process that a list company must go through when setting its share-bases payment scheme. Procedural control involves the board of directors (including and independent directors), independent financial consultants, lawyers and shareholders.

As for ESO plan, the compensation committee, one of three subordinate committees under the board of directors, is responsible for drafting the ESO plan for the consideration of the board of directors. It may request the company, if it thinks necessary, to employ an independent financial consultant to dictate and to obtain their professional opinion on such matters as whether the stock options plan is feasible, whether it is beneficial for the growth of the company, whether it harms the company as well as the shareholders. During the board's discussion, independent directors have to give their own opinion on the effect the ESO may have on the interest of shareholders.

At the same time, the company must hire a lawyer to issue a legal opinion on the validity of the stock options plan by looking through its contents, setting process, disclosure. The lawyer has to check whether the laws, administrative rules and regulations including CSRC Regulation are adhered, whether it would bring obvious harm to the company and shareholders.

Once approval is obtained from the board of directors, all material reports are to be handed in to the CSRC for filing. If the CSRC does not object in 20 working days upon submission of the reports, then the company may convene a general shareholder's meeting to ratify the stock options plan.

iii. Disclosure

In the setting process of the stock options plan, listed companies should disclose the draft plan, the financial advisor's opinions and legal opinions, providing the board of directors and shareholders with complete information. Independent directors should request for a vote from shareholders at the general meeting upon notification of the stock options plan.

In the period when an ESO plan is been implemented, the list company must disclose in its annual report the information about the ESO. The information includes: (1) the scope of the grantee under the stock options plan during the reporting period; (2) the sum of options granted, exercised or expired during the reporting period; (3) the accumulated amount of options which have been granted but not yet exercised at the end of the period; (4) the modification of the striking price that has been made and the most recent adjusted price; (5) the compensation status of directors, supervisors and senior managers; (6) Changes in the company's capital due to the exercise of options; (7) the accounting treatment of stock options.

C. A summary of China's Regulation on ESO

The China's current regulation on ESO is, in essence, similar to that in U.S. in that it aims at controlling the ESO-setting procedures and emphasizes on information disclosure, though the Chinese regulator, the CSRC, does not clearly state the "wage clarity, not wage controls" ideology as its U.S. counterpart. Unlike SEC who is lucky to have a judicial system and tax rules to share with the burden of restraining excessive management compensation, CSRC in China has to do much more due to the silence in either company law, tax law or the court. CSRC Regulations have made very detailed provisions as to the setting and approval process of stock option from the perspective of corporate governance. It even step in the control procedures by veto, if it think proper, a stock option plan when filed. CSRC Regulations, however, does not stipulate the performance requirement for an executives to exercise his or her options. Furthermore, it does not limit the amount of benefit a manager is allowed to receive. [12] It leaves to the company the difficult job of setting a reasonable level of compensation and balancing the interests between shareholders and the managerial under a ESO plan.

D. Pre-requisites of Process Oriented Legal Control

Whether a legal process-oriented control is effective or not depends on whether decision makers in the process could perform their duty effectively. Several elements attribute to the success of the system. One element is the presence of a competitive executive's market which could provide a salary standard for decision makers. Actually, the existence of a competitive executive's market provides the justification for a process-oriented legal control. Another element is the diligence with which decision makers in the process do their job.

The success of a legal control based on procedural monitoring faces greater challenge in China. Since China presently lacks a competitive executive's market, there is no salary standard. Hence, the determination of the reasonableness of stock option offers which has troubled American judges are similarly troublesome for corporate

[12] By contrast, the SASAC stated clearly that incentives should be controlled by equity executives within a certain percentage for state controlled shareholding companies. On December 2006, the "Implementation of Equity Incentives' Pilot Scheme" was published. Article 11 in this scheme stipulates that foreign listed companies should have a ratio of 40%.

directors, professionals and CSRC in China. Besides, the CSRC's current regulatory framework may produce more problem as the CSRC possess the final right of veto. This has created an adverse psychological effect on independent directors, independent financial advisers and lawyers alike who might not take their assignment seriously as in the end the CSRC would also be doing its test and maintaining the safeguard.

It is against this background can we find the clue to the failure of the legal control in YL case which is to be address later in this paper.

III. The Significance & Related Matters of Stock Options Accounting Standards

The accounting which emphasizes on "substance over form" serves as a contrast to the legal procedure controls. In so far as stock options concerned, accounting standard have played a substantive role in preventing excessive grant of ESO. The restriction is achieved through the recognition of the fair value of stock options as a cost for financial reporting purpose. When a company grants to its managers stock option or other share-base payment in exchange for their service, it must measure or estimate the fair value of stock options and recognized it as a cost over the period in which the managers are expected to provide their service. The American "Financial Accounting Standards No. 123 - Share-based payment" (hereinafter referred to FAS123), as well as China's "Enterprises Accounting Standards No. 11 - Shares Payment" (hereinafter referred to EAS11) both requires companies to recognize ESOs expenses in their financial statements.

The recognition of ESOs are as an expense has three implications:

- It recognizes the granting of stock options as a sacrifice. It represents the remuneration given to the management by shareholders and is similar to pre-tax payment of salaries in nature. Therefore, the 'expense' reflects faithfully the economic consequence of stock options and exposes the conflicts of interest between shareholders and executives. [13]

[13] Given the potential consequences of stock options as a company's cost, the two American accounting standards – APB25 and FAS123 on stock options have been formulated and implemented under intense controversy until after the Enron stock options case where it became compulsory for stock options to be considered as company's expenses. For more information, especially the 2003 amendments to the FAS123, the final rules, see the FASB, Summary of Statement No. 123 (revised 2004), http://www.fasb.org/st/summary/stsum123r.shtml, last revisited on 18/4/2008.

- Help preserve the investor's interest. Since the fair value of options are recognized as an expense, to put the biggest chunk of an executive's salary into the loss and profit account would eliminate inflated profits, bringing the level of stock prices down, decreasing the amount in which investors are to pay for each share. [14]

- Helps restrain the excessive increase of stock incentives. For an executive, the vesting of stock options is generally conditioned on some performance targets, in addition to the requisite years of service. For example, net profit level is a indicator most commonly used. When stock options are regard as a cost, the negative effect they have on the bottom line of the income statements would become a kind of disincentive for a manager to over pay himself. If the stock incentives granted are too high, it will result in the decline of net profits, even below the performance target. As a result, the manager is unable to exercise his options due to failure to meet the performance target. In addition, where a manager exercises options and sells the target shares shortly after the vesting period, the market price then might have been affected by the poor financial performance influenced by the recognition of compensation cost, hence preventing the executive from yielding an abnormally high profit. These two incidents highlight that the greed of management cause damage not only to shareholders' interests but also to themselves.

Taking into account the negative impacts of ESOs as an expense, a rational company or sensible management of the company would be very discreet when granting stock incentives, to prevent accruing a large expense, causing the company's profits to plummet. In turn, this will cause stock prices to fall or even the inability of a manager/stockholder to make a profit from selling his shares. For the convenience of analysis and clarity in this paper, the negative effect of accounting treatment of ESO on the executive's exercising of options is termed as "a restrain on options exercise". The accounting treatment's negative effect on shares price through the decline in profits highlighted by a narrower gap between the market price on the day of sale and the striking price is termed as "a restrain on benefit from shares sale".

In summary, the uniqueness of accounting standards' restriction on excessive stock incentives is nothing but telling a truth. By recognizing the fair market value of ESOs as a cost, the accounting

[14] For example, Microsoft started accruing stock options as expenses in 2003, retroactive adjustments of their net profit from 2001 -2003 which was down by 32.8%, respective years in exact were 32.9% and 25.2%. See "Microsoft's 2003 annual financial report appendix - accounting policies - employees' options", http://www.microsoft.com/msft/ar03/alt/notes.htm, last visited 20/4/2008.

standards aim at reflecting the economic consequence of such a transaction full and faithfully. The effect is evident in the financial statements and relevant information is disclosed to the investors, the market, especially those decision makers in the process of compensation-setting. Accounting standards do not ascertain the legality of a stock option plan, it does not even ascertain whether the plan is reasonable or not. What it essentially does is to present those who gain a profit or make a loss out of the process. If revealing the truth is an act of cruelty, this is definitely part of market forces. Among various ways to strengthen market forces in order to control unreasonable even wasteful stock options, accounting standards accruing ESOs as an expense has made its unique contribution.

IV YL Stock Options Plan: the Dos and Don'ts of Accounting Standards

Let's now turn to the YL stock options plan. It is the application of accounting standards which requires the recognition of stock options as a cost that has caused a conflict of interests. YL is just but the first case that has come to light.[15] The case also shows the advantage and disadvantage of the restrictions imposed by accounting standards.

A. Summary of YL Stock Option Plan

In Nov. 2006, YL declared an eight-year stock option plan for its management staffs totaling a sum of 50 million shares, each with a right to buy one YL share at the strike price of RMB 13.33 yuan.[16] That amounts to 9.68% of the company's outstanding shares. 28th December 2006 was later picked as the grant date. The options vest according to a graded schedule with 25% for the first year service and the remaining for second year service, with certain performance conditions to be satisfied.

The performance conditions are as follows:

i. According to YL's ESO Plan Test Measures, a grantee must pass the performance test in the year running up to the grant

ii. For the first exercise of the 25%, the company's net profit in the year before the exercising year must increase no lesser than 17%, and the main business revenue must increases no less than 20%.

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[15] Several days later, another listed company declared its pro forma loss due to accounting treatment of ESO. See 矫月，"海药亏损真相：股权激励方案不合理是根本"，载《证券日报》2008年3月11日。

[16] The strike price was later adjusted to RMB 12.05 yuan and the amount of stock options to 64.5 mil due to the company's distribution of profit and issuance of warrants. This adjustment did not change the fair value of the stock options as a whole, nor the expenses. This paper uses the original price for the convenience of reference.

iii. For the subsequence exercise, the company's main business revenue must increases
no less than 15% at compound rate as compared to that of 2005.

B. The Conflict of Interests behind ESO Disclosed by Accounting Standards

What does it mean to have an ESO plan with 50 million options? There is no observable market price for an option with same or similar terms in China's securities market. So the financial counsel to YL estimated the grant-date fair value of the options using Black-Scholes option-pricing model. It is expected that all the grantees will exercise their rights when qualified. The financial council drew the conclusion that the total options reached a fair value of RMB 739m yuan, each option valued at RMB 14.78 yuan.

Enterprise Accounting Standard (EAS) No. 11 requires that the company recognizes the compensation cost for awards over the requisite service period. With 28th December 2006 being fixed as the grant date, making the first vesting date 28th Dec 2007, the company took the view that the year of 2006 and 2007 are the periods of the requisite service required of the executive. [17] It allocated 25% of the compensation cost into the financial statements of 2006 and 75% into that of year 2007. That resulted in the reduction of retained earnings of the year 2006 by RMB 185m yuan, [18]and a cost of RMB 554m yuan to the current year earnings ending at 31st December 2007. The effect of the compensation cost on the financial statement was enormous. YL had to report a loss of RMB 115m yuan in 2007, the first net loss in its thirty years of running, though it realized a net profit of RMB 440m yuan from its normal business operations.

Nothing can be more alarming than this to create an awareness amongst the public investor s who now realize that there is a conflict of interests behind the exercise of executive stock options. Both the company and some analysts tried to calm the market down by emphasizing such facts as that normal business operations are making more profit or that no cash actually flew out of the company to management, etc. But it is difficult for them to explain why the profits failed to cover

[17] This may not be a correct understanding of vesting period. For options vesting according to a graded schedule, the requisite service period shall take into account the last vesting day into accounting. In YL's case, that would mean a a three year rather than a two year vesting period, ending at the date of Dec 28, 2008 when the remaining option will be vested.

[18] For reasons unknown to the public, YL did not pick a grant date until September 2007. As a result, the financial statements for the year 2006 did not take into accounting the compensation cost for stock option. YL made the adjustment in 2006 year end financial statement at the same time when it published its financial statements for the year 2007.

the compensation cost. Taking Microsoft as a comparison, the company is famous for its stock option plan. When Microsoft applied FAS 123 in 2003 to recognize compensation cost, it reported a reduced 2003 year-end net profit by less than 30% and restated its earning in 2001 and 2002 each by 38% reduction. What happened in YL echoed a metaphor given by a famous financial professor of "master and servant": what a master intends is to share the fruits with the steward but the steward took all the fruits and further cuts a big piece from the master's savings. Nobody would regard that as a reasonable distribution.

In common sense, the huge compensation cost may also alarm the management of the decline in earnings and the potential failure to satisfy the performance condition. Why did YL's management direct the company into such a mess? Aren't their option rights effected by the poor performance?

C. How Accounting Standards Failed to Restrict the Management to Exercise Options

In an executive stock option plan, the performance condition for the exercise of option is a core term. A reasonable performance requirement would provide enough incentive to the management on the one hand, and keep shareholders' interests on the upward trend on the other.

The performance condition in YL's plan reads like this: for the exercise of first 25% option, earnings in the year before must increase no less than 17% and main business revenue in the year before must increase no less than 20%; for the remaining option, the main business revenue in the year before must increase no less than 15% by compound rate in comparison to that of 2005.

Regardless of whether the targets in the condition is too low or not[19], one can easily find some unreasonableness in this arrangement. Only the first quarter of option is subjected to the earning performance, the remaining are related purely to the revenue increase. There is a great difference between earnings and revenues for the interests of shareholders. If the company incurred large cost to realize an increase in the revenue, resulting in a big loss, such a way of revenue increase is a disaster rather than a contribution to the welfare of shareholders.

[19] Readers may draw their own conclusion, given China's GNP annual increasing rate of 10% for almost twenty years, with the government's promotion of milk consumption for children and the general public, YL's occupies the biggest and top farms in China and have been the leader in China's market in the past years.

That may explain why YL management did not care about loss reporting in year 2007. The remaining 75% of options will be vested as early as from 28th December 2008, based on the performance in 2007, i.e. the business revenue increasing at no less that 15% annual compound rate in comparison to 2005. Obviously, it would have nothing to do with the vesting of option whether the company reported gain or loss in 2007. Even with a big loss, performance condition is satisfied if the business revenue reached an annual increase rate of 15%. Here the accounting standards requiring recognition of compensation cost posts no worries to the managers.

The story does not end there. YL later modified the earning requirements for the first quarter of the option,. It passed a resolution at the annual shareholder general meeting for 2006 year-end in mid 2007, changing the way of calculating the earnings in the stock option plan to get rid of the effect of compensation cost on the earnings. To express in a formula, the annual increase of earning is:

Increasing rate = (current annual earnings + compensation cost allotted for the current year) / (earnings of the previous year + compensation cost allotted to that year) x 100%

At first sight, it is difficult to assess the consequence of the modification. One may wonder whether the result would be different with both numerator and denominator added up with compensation cost. But that would never happen. Earning as performance requirement only applied to vesting of the first 25%. Since the first vesting date is on 28th December 2007, the earning it is the performance of the year before, i.e. earnings in 2006 that would be measured up against that in 2005. YL began to implement the executive stock option plan in 2006, compensation cost occurred in 2006, but not in 2005. Thus the modification of the formula only lead to the adding up of compensation cost totaling RMB 185 million yuan to the earnings in 2006. With certainty can we expect that the effect of compensation cost on the earning imposed by the accounting standards will be erased completely, so does the obstacle to the vesting of the first quarter of options.

The reasoning above has been supported by the reading of YL’s financial statements in 2005 and 2006. The following format shows the earning’s increased rate before and after the modification。

Earnings in 2005 financial statements (1)	Earnings in 2006 financial statements (2)	Increasing rate (3)=(2)/(1)	Earnings in 2006 without recognition of compensation cost of RMB 185mil. yuan (4)	Increasing rate (5)=(4)/(1)
293.39m	145.47m	-50%	344.59m	17.5%

It is quite clear that YL's management was unable to satisfy the performance condition if it recognized the compensation cost in 2006 financial statement with the earning drop of 50%, as showed in the column (3) above. On the contrary, YL realized an earning increase in 2006 by 17.5%, just above the benchmark of 17%, without recognition of compensation cost.

A conclusion may be drawn here. YL reported extraordinary loss in 2007 due to its confidence that the poor financial performance would not have any negative effect on vesting of executive stock option. By relating the vesting of option to the revenue rather than earnings, by modification of method of earning measurement, YL managed to get around of the requirement of accounting standards and get rid of the restriction that the accounting standards may impose on selfish management.

E. Improving the Regulation on the Conflict of Interests Behind ESO – Bridging between the Legal Systems and Accounting Standards

Hardly could there be a better example than YL's ESO plan to display the conflict of interests between the management and shareholders in a modern company setting. The case also points to the weakness or even failure in the current method of regulation on executive compensation. On the surface, both legal process-oriented control and the application of accounting standards were in right place and were respected fully by the company. In essence, both ways of control lose the strength when operated in isolation.

Take for example the legal control. YL went through the whole procedure when setting their ESO plan, including approval by board of directors, ratification by the shareholders general meeting and no-objection comment when filing with securities regulatory agency. All those charged with the responsibility to check the plan, i.e. financial counsel, corporate lawyer, independent directors, issued OK opinion.

The plan seemed to fit perfectly in the frame made by the regulatory agency in terms of the maximum amount of options, vesting period, striking price, etc. Even the modification of the performance condition was presented for the shareholders' meeting for consideration. The company did in fact perform its disclosure responsibilities quite well.

Then comes the accounting standards. YL satisfied the EAD 11 requirement by recognizing the compensation cost in the vesting years based on the fair value of ESO. The company reported a loss in 2007 due to the recognition of such a huge amount of compensation cost, the information fully delivered into the market which caused the fall of the share prices. In this aspect, the market functioned quite well based on the information generated by the accounting procedure.

However, the picture is quite different if we combine both legal procedure and accounting treatment. The extraordinary loss resulting from accounting treatment of ESO seems to be a hint on the excessiveness of executive compensation. The performance requirement conditioned on the level of revenue rather than earnings and modification of the measurement of earning further pointed to the self-interests of the management. That leads to a conclusion that YL's ESO plan did not strike a balance between the interests of the management and that of the company and the shareholders as a whole. Priority has been given to interests of the management, even to the detriment of shareholders.

All those charged with the responsibility of checking and examination in the legal process seemed to take a blind eye to such an unreasonable ESO plan. The financial counsel, the corporate lawyer, the independent directors repeated their confidence in the ESO plan to benefit both the shareholders and the management. The proposal from the management for the modification of the measurement of earning under the ESO plan should have alerted them of the potential negative effects brought by accounting procedure, guiding them to the significance of accounting standards and its potential restrictions on the management's tendency to excessively compensate themselves Unfortunately, they ignored once again the signals of danger, providing justification for the modification by way of legal process as board decision and shareholders' meeting.

In some sense, the success of the legal process-oriented control depends on the due diligence with which the person in charge performs his or her duty. Legal control would be no more than a 'scarecrow' if the responsible person acts negligently or even recklessly. Turning back to the judgments made for the ESO plan. Due diligence is more than the checking of the box provided by the Regulations on ESO. The directors, counsels and other responsible professionals shall make well-informed decision when their judgments are sought in the process. Where does the information come from? If there is a competitive market for the executives, information about the reasonable level of executive compensation would be available, the board of directors and relevant professional may find it easy to make a informed decision. In case the market does not exist, like the current situation in China, the financial result deriving from the accounting procedure provides an alternative reference. The accounting standards for ESO aims at reflecting the economic consequences by requiring a company to recognize the cost of executive services received in ESO payment transactions. By comparing what executives get as opposed to the costs incurred by the shareholders as a result of it, the responsible person in the legal process may get a flavor of the ESO plan, like ordinary investors in the market. That facilitates in some way, their judgment on the reasonableness of the ESO plan.

Some consideration shall be given to the difference between financial counsel and corporate lawyers and independent directors. Current Regulations on ESO applies two sets of standards to relevant parties in terms of due diligence. For financial counsels, their duty is to make a judgment on whether the ESO plan will cause "damage" to the company and shareholders, while a corporate lawyer or an independent director has the duty to be alert to "obvious damages" on the company and the shareholders. Certainly the standard of due diligence is higher on the shoulder of financial counsels than on a corporate lawyer or an independent director.

By saying that, a corporate lawyer or an independent director shall not take a blind eye to the economic consequences of an ESO plan by claiming that they are not experts of accounting principles. When the financial result is extraordinary enough to alert the public investors, those charge with the responsibility to protect the interests of the company and shareholders as a whole are under a duty to stand up, be alert to the conflict of interests between the management and the shareholders, and when necessary, take proper action to stop the damage to the company and shareholders.

Closing Remarks

The rapid growth in executive pay, in particular, the current epidemic of large companies granting stock options as a major component of the remuneration package, is one of the most contentious issues in the securities market. The "Golden handcuffs" has triggered a conflict of interest between the management and shareholders, causing various concern. As measurements of the value of labor and management contribution are quite difficult, if not impossible, the existing legal system's response to this is a process-oriented control, by creating terms such as "without prejudice to the interests of the company" or "reasonableness" and other abstract theories. As to the details, it has been left to the company to formulate and approve. On the other hand, the accounting standards require companies to recognized the fair value of stock options as a cost, in a bid to faithfully reflect the economic consequence of the transaction. This respond to the investors ' real concern in the stock options transactions and also achieve an indirect constraint on the executive's exercise of options and the potential realization of profits later.

However, the YL's farce loss due to its stock options plans shows that the separate operation of the legal system and accounting will not constitute an effective constraint on the selfish-driven behavior of the management. In particular, not only does the feature of the process-oriented legal requirements tilt towards formalism, it even grants companies with the legitimate right to remove accounting standards which could have played an indirect role in disciplining the process. To this end, it is necessary for the legal system and accounting standards to integrate. To copy prof. Joel Seligman's word, "In the real world, the language of corporate governance is accounting"[20], so too is the language of executive stock options. Actions shall be taken in this fashion. For example, the China's Company Law may require stock option plans to meet the test of "reasonableness" based on the economic consequence of the transaction. This in effect incorporates the accounting standards into law, providing some guidelines for directors, executives and related professionals on how to fulfill their duty of care in the design, review, approval of the stock options plan. Only then can we expect to create a truly effective restraint of executive stock options, reducing the conflict of interest between the management and shareholders.

[20] Joel Seligman, "Accounting and the New Corporate Law", 50 Wash. & Lee L. Rev. 943.