

# International assignment perspectives — *special alert*

**Executive incentives: A trusted ally in the talent wars—under scrutiny, underwater, undergoing change in tough economic times**

*In this Special Alert, authors Simon Davies and Pam Weems revisit the theme of their September 2008 report, "Equity compensation compliance for the globally mobile workforce," through the lens of the current economic crisis and its bearing on executive compensation.*

The global market mayhem that ushered out 2008 and rang in 2009 has reverberated from the halls of Congress, the Oval Office, and C-suites the world over. Not even the least market-savvy observer could remain unaware of the precarious state of today's world financial markets. Blame for the crisis quickly fell on executive pay, a topic that was already receiving its share of scrutiny and negative publicity.

Says a professor at Europe's top-ranked B-school, "...Stock options lead to excessive risk taking, like subprime mortgage securities, because they have no penalty for the manager, nor damage to her/his wealth in the case of collapse<sup>1</sup>."

Business leaders, too, recognize the daunting nature of striking the right balance in compensation programs. Seventy percent of financial services executives who responded to a recent PwC poll named reward systems as one of the top three factors that contributed to the credit/banking crisis. And 95 percent believe that compensation systems need reform.<sup>2</sup>

The stakes are high and the ramifications are wide, as incentives have become a key way to satisfy business objectives and attract and retain top talent. Stock options can be the string that pulls together the interests of shareholders, executives, and employees. The imperative to attract and retain the best and the brightest is likely to grow, as leading-edge baby boomers retire; the remaining global workforce ages; and a widely anticipated worldwide talent war looms.

Corporate leaders from around the world agree that this form of compensation is a key driver of success, with 97 percent of those participating in PwC's fifth annual Global Equity Incentives Survey saying that the benefits of equity

compensation outweigh the costs, up from 75 to 80 percent in 2003 through 2006<sup>3</sup>. But compliance challenges loom large. And our survey uncovered some disturbing disconnects between the degree to which businesses think they're compliant and the degree to which they actually are.

One-third of survey participants cited compliance as the most challenging aspect of global equity compensation, and nearly all said their plans were compliant in HQ countries. But the actual practices they rely on to manage compliance risk indicate those responses may be too sanguine: Less than half cited appropriate sourcing of equity income, and one-third lacked procedures for tracking global mobility—a critical means of promoting tax compliance by recording employee assignment histories.

This is concerning in the face of increasing scrutiny from tax authorities and heightened focus and sophistication in their approach to this area. In the UK, for example, we understand that HM Revenue & Customs (HMRC) is looking to increase its focus on UK subsidiaries of non-UK companies that provide share incentives to their employees and have set up a special team to look at this. We believe the team will specifically focus on whether UK subsidiaries of non-UK companies (primarily from the US, we have heard) have applied the right tax treatment and met their PAYE tax withholding obligations for awards made to their employees, particularly expatriate employees.

We are not yet aware of any companies being selected for this review, and believe HMRC is still in the process of deciding which companies to approach.

Globalization, along with evolving tax rules and regulations, has added to the complexity and expense of managing and administering equity compensation programs. Today's market challenges, regulatory environment, and shareholder scrutiny have companies working to shape effective equity compensation strategies, even as markets ebb and cost-cutting measures take center stage in deference to a recessionary global economy.

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<sup>1</sup> "Current Global Financial Crisis: An Incentive Problem," Pascual Berrone, Professor of Strategic Management, IESE Business School, University of Navarra, October 2008.

<sup>2</sup> PwC-Economist Intelligence Unit global survey, May 2008.

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<sup>3</sup> PwC's fifth annual Global Equity Incentives Survey, a detailed look at the design and administration of equity incentive compensation plans for multinational companies, 2007.

## Options down as stocks go down

Plunging values on outstanding options add another challenging dimension to the compensation conundrum. With current stock prices sinking below the exercise prices of stock options, options are sapped of their allure and ability to spark motivation and boost retention. It's a widespread concern: More than 90 percent of Fortune 500 CEOs held underwater stock options as of mid-October, with the median value of aggregate options diving 63 percent since the end of 2007.

As companies seek ways to stem the loss, option exchanges are on the rise and their applications are broadening. These days, underwater options are exchanged for options with lower exercise prices, full value shares, and cash, along with other alternatives, many of which carry complex tax and accounting implications. About half the financial services executives responding to PwC's survey are considering exchanges, and roughly half of those say exchanges may be extended to international assignees.

All the while, the regulatory grip continues to tighten globally for executive compensation practices—from tougher standards for severance and CIC<sup>4</sup> provisions to new rules for TARP<sup>5</sup> participants, from an increased probability of "say on pay" in the US to the FSA's<sup>6</sup> criteria for "good" and "bad" remuneration policies in the UK, in addition to a flock of newly approved and potential measures in the EU.

Compliance issues are already a key—and sometimes unrecognized—challenge. We strongly recommend that companies administer global equity reviews and routine practice and policy updates to confirm compliance and determine whether their practices align with existing and emerging global challenges and realities.

With the economy volatile, executive incentives crucial yet controversial, and intense global mobility growth all but inevitable, smart business leaders will find ways to run the executive compensation gauntlet without running afoul of government compliance and public trust.

*PwC will be releasing results from its sixth consecutive Global Equity Incentives Survey in July 2009. If you would like to request a copy of the executive summary in advance, email [SurveyAdmin@us.pwc.com](mailto:SurveyAdmin@us.pwc.com) with your contact information.*

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<sup>4</sup> Change in Control

<sup>5</sup> Troubled Asset Relief Program

<sup>6</sup> Financial Services Authority