



PRODUCTIVITY COMMISSION

BEST PRACTICE LONG  
TERM INCENTIVE BASED  
REMUNERATION

The Australian and  
International Experience

By  
John K Day and Gary D Fitton  
Directors  
Remuneration Strategies Group Pty Ltd

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## A. INTRODUCTION

RSG is about developing and optimising the value of human capital as a business asset.

The value of human capital is optimised by:

- **Attracting** the right employees for the right jobs.
- **Retaining** employees.
- **Developing and Training** employees as key assets.
- **Aligning** employees' vision with shareholders' vision.
- **Motivating** employees to achieve organisational performance objectives.
- **Recognising and Rewarding** human capital as a valuable asset.
- **Succession Planning** for management and/or employee buyout.
- **Reducing** business cash outflows.
- **Maximising** capital investment creating more jobs.
- **Sharing Surplus Value** with employees.

This is best achieved by ongoing employee training and development projects and by linking through long Term Incentives ("LTI's") employees to the company by utilising the right kind of remuneration and related equity programs.

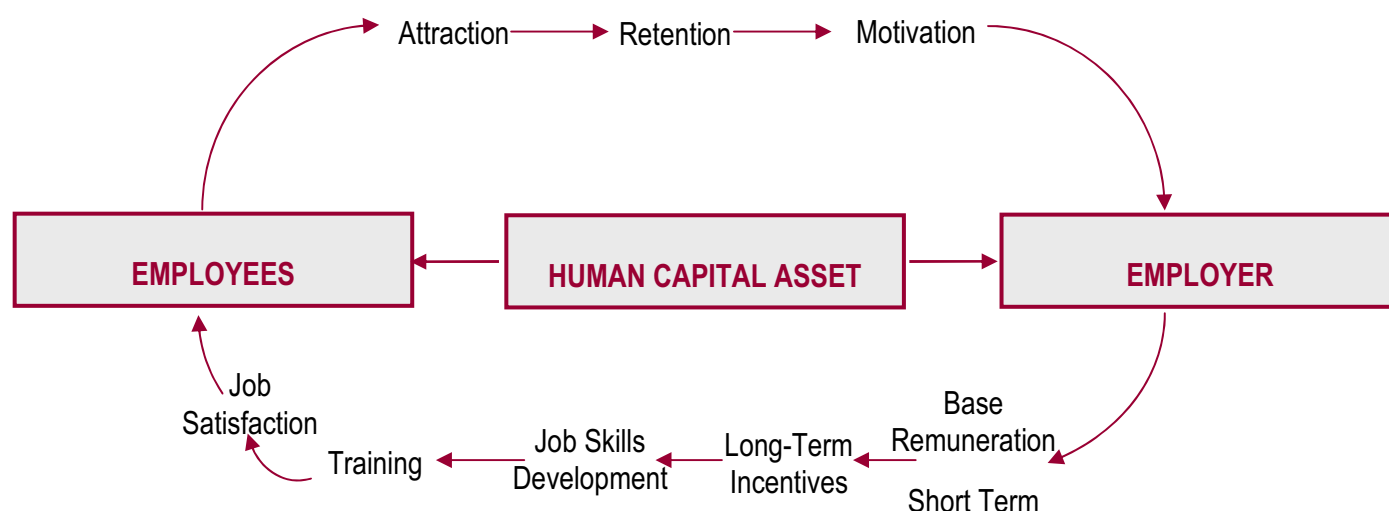
There is a direct link between Employer Equity Programs, Human Capital Management and Companies Financial Performance.

International experience demonstrates that LTI Employer Equity Plans assist in the attraction, motivation and retention of employees.

Furthermore, for employees that human capital value should be manifested into actual asset values emanating from effective short and long term equity based incentives, providing an enduring and valuable capital base.

It is RSG's experience, supported by extensive international studies, that the optimal methodology for the design, implementation and administration of effective employee LTI programs for all stakeholders is to base the LTI program on Employer Equity Plans. These programs are most effective where equity holdings are maintained and not dissipated by short term profit taking.

## The Human Capital Dynamic



## B. LONG TERM INCENTIVES

### 1. Why

LTI's assist in the retention of employees, which means the business can afford to spend more money on training. Additional training results in better qualified employees and a more productive and profitable business. And because employees are trained to develop job skills they feel more appreciated, more respected and have greater levels of job satisfaction which will ensure that they remain employed longer.

### 2. Retention

An Australian Human Resources Institute ("AHRI") survey has found Australian employers are losing an extra \$20 billion per year as staff turnover increases dramatically.

- A dramatic increase in staff turnover figures across Australia is putting people management practices under pressure.
- An AHRI HR pulse survey has found most organisations have employee retention problems.
- An overwhelming majority reported an impact on the organisation's effectiveness and the bottom line.
- Most also believe their organisations are not prepared to deal with the labour crisis.

Staff turnover in Australia has increased by more than 5% as the continuing staffing crisis caused by the skills shortage and the ageing population puts people management practices under pressure.

A study last year by Vedior Asia Pacific put the cost of replacing an employee at closer to 150% of salary when recruiting, training, specialist knowledge and productivity are included in the cost.

AHRI's quarterly HR pulse survey, has recorded a turnover rate of 17.4% for large employers and an average of 18.5% across all organisations. The survey was carried out in conjunction with retention specialists, TalentDrain. Research last year confirmed the rate at 12.6% in large Australian companies (AIM National salary survey 2007).

More than 60% of the people surveyed admitted they had a problem retaining staff and 80% reported an impact, cause by retention issues, or organisational effectiveness and financial performance.

An overwhelming majority of respondents to the HR pulse survey (82%), believed that their organisations were not prepared for the continuing skills shortage.

### **3. All Types of Businesses**

LTI plans delivered through employee participation plans are no longer the exclusive preserve of senior management of large, publicly listed companies.

It is no secret that the skills shortage is crippling many industries. And so, tools and strategies that attract, and keep key staff are more crucial than ever. Employee Share Participation Plans ("EPP's"), are one such tool. These are arrangements whereby business owners share the surplus value (profitability and capital value) of their enterprise with employees.

Businesses of all sizes and types can develop EPP's which generally aim to encourage employees to invest in the business they work in, and to more closely align employee performance with corporate financial and business objectives.

While EPP's might seem complex or costly to implement, the key message to businesses is that EPP's can be put in place for all types of organisations and all types of employees and/or contract non-employees working in Australia. And given the current skills crisis facing many industries, EPP's could be your answer to acquiring and retaining key employees.

The whole purpose behind employee ownership is that the employees have a share in the business, and it's considered that will give them greater incentive to perform. And as the business grows, they benefit.

Consequently, these plans offer potential benefits to employers such as helping to retain key employees, motivating staff, and improving productivity, efficiency and competitiveness.

Because employee retention improves, so too does the financial efficiency in investing in training and development, to improve the value of the business Human Capital Assets.

### **4. Optimum Remuneration**

The optimum remuneration strategy has three elements: fixed remuneration (what you are paid to come to work), short-term variable remuneration (your profit share, incentives and bonuses) and long-term incentives (usually a share in the capital value of the organisation – an EPP).

Fixed remuneration or base pay, as it is also known, is commonly defined as the salary or the pay amount given to an employee for performing the daily duties of the defined job.

Short-term incentives – including annual incentives, bonuses, commissions and the like – reward the individual employee for achieving certain goals over a short period. The measurement period for short-term incentives is most often quarterly, semi-annually, or annually. Short-term incentives can be measured based on the individual's own performance, group or team performance, or the companies overall performance. This depends on the organisation, the incentive plan, and the level of the individual within the organisational hierarchy.

LTI's delivered through EPP's – including shares, restricted shares, share options, phantom shares, share replicators, participating units, and the like – measure organisation-wide performance, typically over several years. The intent of such plans is to provide incentives for employees to improve the overall performance of the organisation by linking the employees' long-term rewards to the organisations long-term results.

## **5. EPP Plans**

EPP plans reward participants (e.g. employees) for attaining results over a longer measurement period. For this purpose, long-term generally means more than one year, and typically is between two and five years.

The form of benefits and delivered from a long-term incentive plan is normally cash or equity. The reason an employer would choose one or the other depend on the goals of the plan, the type of recipients and the availability of cash or equity for delivery of those benefits.

## **6. Cash Based EPP's**

Cash-based plans allow organisations to target specific performance levels over a long term. Organisations using such plans need to exercise caution to avoid confusion and complication that may result from implementing a long-term cash incentive plan that looks like the organisations short-term incentive plan.

Cash-based plans have their place. They are effective in rewarding employees, teams, groups, departments and other entities for meeting or exceeding performance milestones that span more than one year. One of the benefits to the employer of using a cash-based plan is that the plan and its rewards can be very specifically tailored. For example, if the goal of the company is to increase market share for a particular product line from 10% to 33% over the next 39 months, the company can match a long-term incentive plan to that goal (presuming there is a reliable measure of market share for that product). Further, because the payments are made in cash and not equity, there is no need to introduce a second variable (e.g. share price) that complicates and confuses the linkage between the performance and reward. That is, the value of the awards can be pinpointed the day the program is in place because the currency does not change over time.

Cash-based plans are effective when:

- The target recipients are to be rewarded for performance that isn't precisely correlated with share performance.
- The share price is not tracking properly with the company's performance (e.g. the industry is out of favour).

- Shareholder dilution is a concern.
- Broad-based employee groups are targeted for EPP's and they have shown strong preference for cash rather than shares (Companies sometimes find it favourable to pay with cash rather than to pay with shares when they believe employees will sell any shares as soon as possible to convert them into cash).
- Employee retention is critical.

## **7. Equity Based EPP's**

Equity-based plans are the most common form of EPP; and share option plans and restricted shares are perhaps the single most common for of EPP in use.

Equity-based plans are effective when:

- The employer wants to create a strong link between the employee's performance and the company's performance.
- There is limited cash available for employee incentives. This is most prevalent among early-stage start-ups that are cash poor and therefore use equity for its high risk/high reward characteristics.
- It is desirable for employees to feel and act like owners.
- Retention is important.
- The employer has substantial growth (i.e. "blue sky") potential.

Equity-based plans can take two forms; entire value, or appreciation only. The primary difference is that one form provides full value of the equity whereas the other measure only the increase in value of the same equity – typically measured from the equity's value on the day of the original grant. Neither form is better than the other, each has its strengths and weaknesses. Plans with awards based on appreciation only are perceived to be stronger when the goal is to reward for future performance – that is, to reward for the increase in value from today. Plans with awards based on entire value provide a broader continuum of payments, allowing awards to be paid if the share value drops below its current level. These plans provide more stability in payments and typically less volatility overall.

## **8. Linking Performance**

For some time, executive remuneration has been a high profile issue. It seems that every day there is an article splashed across the business pages of the newspaper, expressing concern about the amounts of cash and equity being delivered to executives. A large part of the concern is that executives are seen to be rewarded independent of company performance. The perception is often that executives get rich at the expense of the shareholders.

In this environment, it is extremely important that executives' and employees' remuneration strategies have been closely linked to company performance and shareholder value creation. Choosing effective performance measures in long-term incentive programs will ensure that rewards are commensurate with performance, and that shareholders feel they are all being treated fairly.



## **9. Australian Experience**

In the past, Australia has missed golden opportunities to develop and maintain effective employee ownership policies. Given looming demographic pressures, any future failure to promote commitment and productivity in the workplace will have a serious effect on this nation's prosperity and the distribution of that prosperity. Ordinary Australian workers must have the chance to become significant co-owners of the businesses in which they work.

The Shared Endeavours report into employee share ownership was tabled in the House of Representatives in October 2000. In March 2003, the Federal Government responded, but then only to support limited measures. These included the establishment of an Employee Share Ownership Development Unit within the Department of Employment and Workplace Relations ("DEWR"). Subsequently, at the 2006-07 Budget, the Government extended the tax provisions governing employee share plans to ASX listed stapled securities.

## **10. Government support for employee share plans**

The Federal Government in February 2004 announced its policy intention to develop a program to encourage equity participation in Australian businesses – with the aim of doubling the current level of employee equity participation from 5.5% to 11% over a five-year period. As a part of that process, RSG was awarded the tender to design a range of employee share plans which could be used in a wide range of Australian businesses.

The Government believes that it is in the public interest to promote employee share plans to:

- better align the interests of employees and employers;
- to develop national savings;
- to facilitate the development of sunrise enterprises;
- to facilitate employee buyouts and succession planning; and
- to develop internationally competitive, best practice, remuneration strategies for employees of all organisations.

The Federal Government, by way of the Department of Employment and Workplace Relations (DEWR), accepted RSG's recommendation that, in order to achieve its target levels of equity participation, it needed to encourage equity participation in all its forms (that is, real and replicated), for application in all types of Australian employer organisations, for all categories of employees.

The RSG Road Map and Plan Framework resulted from this project (refer pages 19 and 20).

## **11. What is Human Capital**

Human capital management ("HCM") has been described as 'a strategic approach to people management that focuses on the issues that are critical to an organisation's success' (Kingsmill, 2003) and 'the possession of knowledge, applied experience, organisational technology, customer relationships and professional skills that provide a company with a competitive edge in the market' (Edvinsson, 1997).

Human capital is a component part of the 'intellectual capital' of a company, which is linked to the difference between market value and book value of a company. 'Recent estimates suggest

that 50 to 90 percent of the value created by a firm comes, not from management of traditional physical assets, but from management of intellectual capital' (ICAEW, 1999).

The term "human capital" represents an asset with a flow of benefits that are greater than the cost of the asset. To most, the term human capital means assets that yield income, so that when using the term human capital, it means the value added by the workforce.

There is no question that it pays to manage people correctly and maximise the human capital assets of the organisation.

Organisations have long focussed resources on other aspects of their companies, including infrastructure, R&D, sales and advertising, just to name a few. These things can increase shareholder value creation in measurable ways. Some – but certainly not all – tried to optimise their human capital to increase returns to shareholders. But even these companies were taking a shot in the dark, because no one could quantify which human capital programs were linked to good outcomes. Some companies failed to maintain and develop their optimal human capital programmes.

It is now incontrovertible LTI's delivered through EPP's form an integral part of Human Capital Management.

## C. LTI – WHAT'S HAPPENING INTERNATIONALLY

### 1. Overview

There is currently, a large amount of international research in the area of ESOP's, the majority of which emanates from the US and, more recently, from the European Union ("EU"). The key difference between the US and EU research is that the implementation of ESOP's is relatively widespread in the US in comparison to the EU (and Australia). The widespread acceptance of ESOP's in the US has broadly been explained as a direct result of tax-incentives introduced in the 1970's and 1980's in the US. Many of these incentives continue to have effect today and encourage further acceptance of ESOP's by both employers and employees in the US.

### 2. United States of America

A Statistical Profile of Employee Ownership  
Updated February 2008

Estimated Number of Plans and Employees; Value of Plan Assets

Type of Plan	Number of Plans (as at early 2008)	Number of Participants (as at early 2008)	Value of Plan Assets (as at early 2008)
ESOP's, stock bonus plans and profit sharing plans primarily invested in employer stock.	7,774	11.2 million	\$928 billion +
Section 401 (k) plans primarily invested in employer stock	748	1.5 million	\$133 billion
Broad-based stock option plans	3,000	9 million	(several hundred billion, not realistic to estimate)
Stock purchase plans	4,000	11 million	(not realistic to estimate)

Approximately 15% of the workforce have some form of EPP.

The dramatic growth in plan assets and in participants in these plans over the last few years appears to result from the better performance of ESOP's companies and a huge increase in the number of ESOP's doing acquisitions.

### **Multiple Plans**

Many companies offer multiple plans, and many employees participate in more than one plan. For example, many employees participate in the company's section 401(k) plan and in the companies other stock option and equity compensation plans.

### **3. Europe<sup>1</sup>**

The situation in Europe regarding the application of financial participation schemes has developed slightly overall since the publication of the initial PEPPER Report. There is more encouragement given to financial participation than fifteen years ago in virtually all member states. However, there is a growing disparity between the acknowledged financial participation countries (such as France and the UK) and those countries with the least developed financial participation policies and institutions. Those countries committed to financial participation have taken active steps to develop financial participation further, but these actions have not been followed by other member states. Part of the problem is that there appears not to exist any exchange of information between member states regularly either on legislation or good practices.

In summary:

- There is an increase in the use of schemes in Europe.
- However, the substance of share ownership in Europe is generally small, which means that there are relatively isolated experiments going on.
- There is a growing awareness at all parts of industry that employee share ownership might be a new employee benefit to be applied.
- A growing number of trade unions develops a pragmatic attitude towards the phenomenon and tried to be involved.
- There is a growing need for sharing information and a growing need for models and exchange of experiences on best practices and on solutions for apparent problems that show up when practising these schemes.
- Moreover, following the research and discussions more insight should be acquired concerning employee choices and employee representatives' views.
- And more insight should be gained on the views of the social partners on this phenomenon.
- Due to bookkeeping scandals and subsequent impact on these types of schemes financial participation are much more critically approached than at century's end and may have lost some broad based support.

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<sup>1</sup> Changing Patters of Employee Financial Participation in Europe

A survey among listed Firms in six European Member States

Final report by Erik Poutsma (Ed)

Danial Albra, Panu Kalmi, Andrew Pedleton, Stephan Trbucq, Eckhard Vozz

#### **4. Differences Between European Countries**

As expected there are large differences between countries. The UK appears to be the country with substantial application of share schemes. France appears to be a country with mandatory profit sharing schemes. Spain appears to be a country with a tradition of co-operatives. Germany is a country with established capital accumulation plans for employees, and the Netherlands and Finland appear to be countries with a national wage saving system. These country differences determine the existence of schemes to a large extent. Most broad based employee financial participation appears to be a result of the possible benefits provided by government policies in certain European countries.

#### **5. Supportive Legal Context and Government Policy**

There is an increase of the use of these schemes in all countries. The development is supported by legislation in certain countries, most notably the UK and France. In these countries financial participation becomes sophisticated and to a certain extent part of national sectoral income policy. The main arguments to promote the system is wage flexibility, productivity and wealth redistribution.

#### **6. Australia in Comparison<sup>2</sup>**

In Summary

- In Australia there is conflicting and limited data regarding the implementation of Employee Share Ownership Plans (“ESOPs”).
- There is no comprehensive (accurate) survey of the incidences of the various types of ESOP’s by business type in Australia.
- The limitations of previous research include a lack of differentiation between:
  - ‘type’ of ESOP and the key factors that are limited take-up;
  - the focus of the ESOP at the company level, and whether the plans are narrow-based plans (offered to top management group only) or broad-based plans (offered to most or all of the employees, generally considered to be greater than 50%); and
  - the size of the entity, and whether barriers to implementation of ESOP’s differ by entity type and size.
- Australian incidence of employee share ownership is low compared to a number of other countries, such as USA, UK, France and Japan. However, employee share ownership in Australian is similar to that in Germany. It also appears that employee share ownership is more concentrated among managerial occupations than in some other countries.

#### **7. Trends and Statistics**

The Australian Bureau of Statistics (“ABS”) collects data about shares as a benefit of employment; data was collected on this in 1999 and 2004.

As at 2004, 5.9% of the total employees have employee shares as a benefit of employment. This is an increase of 0.4% from 1999 and a total increase of 3.5% from 1989.

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<sup>2</sup> Research provided by TNS Social Research, ACT

Full-time employees constitute 400,600 of the total number of employees. The ABS data indicates an increase of 0.1% to 0.7% from 1999. An estimated 3.4% of the 80,700 total part-time employees also have employee shares, which is an increase of 1.2% from 1999 and a total increase of 2.9% from 1989.

In comparison to other types of employment benefits, the percentage of employees with shares (5.9%) ranked above other benefits such as study leave (4.2%), holiday expenses (3.8%), union dues/professional association (3.0%), medical (2.1%) and child care/education expenses (0.6%).

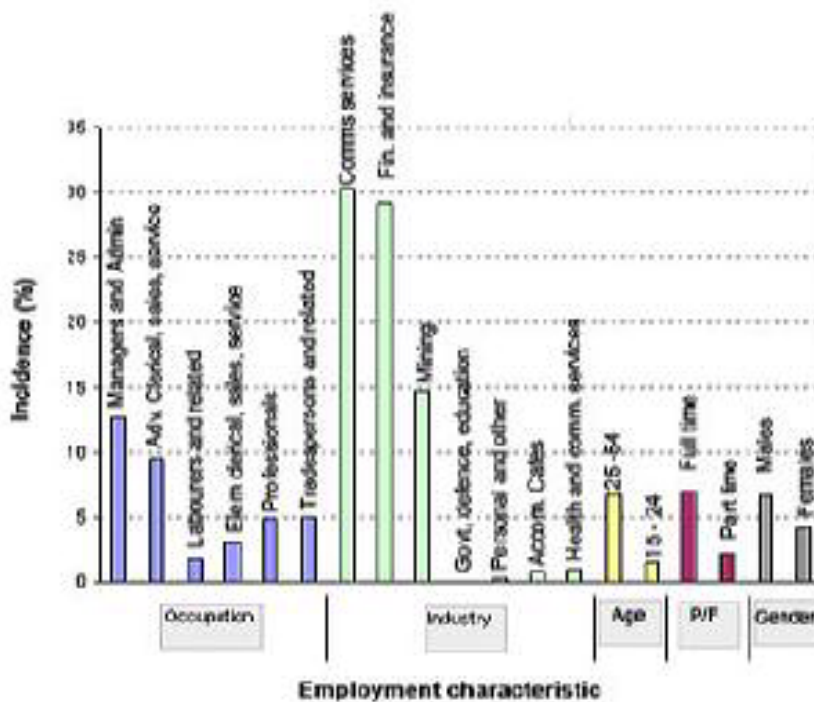
These statistics indicate that the incidence of employee share ownership is on the increase.

Data from ABS Survey of Employee Benefits and Earnings from 1986-1999 provides the following levels of employee share ownership in main job and occupation:

	1986	1987	1988	1989	1990	1991	1992	1994	1999
Total employees in main job (%)	1.40	2.15	3.25	2.39	2.61	2.76	2.83	3.90	5.54
Managers and administrators (%)	5.76	8.67	9.25	8.25	8.46	8.95	8.13	9.79	12.57
Non managers and administrators (%)	0.95	1.70	2.71	1.96	2.21	2.30	2.42	3.42	5.15

As at 1999, an estimated 5.5% of all employees and 12.6% of managers have employee shares.

Incidence of employee share ownership - by employment characteristic



## **8. Listed and Unlisted Companies**

A very high proportion of listed companies have employee share ownership plans (estimated to be around 90% of listed companies and 56% of subsidiaries of overseas listed companies have at least one employee share ownership plan, noting some of these are executive only plans (*Mercer, 2002*)). A number of reasons are given by the companies surveyed for this high level of employee equity participation, including developing an ownership culture, attraction and retention, and long-term incentives.

A much lower number of unlisted companies have employee share plans (i.e. estimated to be about 9% of companies). According to the House of Representatives Inquiry into Employee Share Ownership, the main reasons for employers not putting plans in place are cumbersome administration, cost implications, and, because difficulties with approval and corporate structures not considered to be appropriate (*Shared Endeavours: an Inquiry into Employee Share Ownership in Australia*).<sup>3</sup>

In the USA 90% of both listed and unlisted companies have employee share plans. This is due to the prevalence of geared ESOP's in the unlisted market place.

## **9. EPP's Value**

The value of employee share ownership is unknown, but was estimated by the Nelson Committee to be worth between \$3 billion and \$4 billion in unlisted companies. About \$1.5 billion of the total was estimated to be holdings in executive only plans. A significant proportion of the total comes from a small number of very large firms.

## **D. EPP SELECTION**

### **1. How to choose an EPP for your business**

In this section we will provide an outline of the plans and how to start deciding what plan(s) are most suitable for your business.

Many companies have a pretty good idea of what kind of EPP they want to use, usually based on specific needs and goals. However, sometimes they might be better served with another kind of plan or a combination of plans. And yet others say they'd like to have an EPP, but they are not sure what it might be.

### **2. The challenge is to optimise the portfolio of EPP's.**

There are a broad range of plans to choose from. Quite often it is appropriate to have more than one plan. For example:

There may be a broad based offering of EPP's involving. Qualifying 13A Exempt and Deferred Plans, or a Broad Based Loan Participation Plan or Loan Share Plan.

These plans may have little or no downside risk and are designed to maximise employee participation. They are able to be designed to encourage retention i.e. shares vest and only become available after a certain period of service or they may only vest if a certain performance criteria being met or a combination of both.

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<sup>3</sup> Shared Endeavors: An enquiry into Employee Share Ownership in Australia

Share Plan Options could be designed for senior management which more closely align their success to those of the shareholders and can be designed on achievement of a stipulated total shareholder return as well as achievement of other individual key performance indicators.

Where an employer does not have shares – e.g. a joint venture, then it may be a combination of Employee Loan Participation Plan i.e. facilitating investments in other than employers shares and/or a Replicator Plan.

Many of Australia's largest companies are subsidiaries of overseas based companies, sometimes listed on different overseas exchanges.

The Loan Participation Plan facilitates through a trust arrangement, the ability to acquire shares on market on those foreign exchanges or from new issues of shares which may have vesting conditions attached, or may be acquired as part of a salary sacrifice/bonus sacrifice equity based remuneration strategies.

Other plans may be designed to encourage senior executives to use salary sacrifice and bonus sacrifice sums to acquire shares in their own company or in an approved list of investments.

There are many combinations to suit the specific purposes of every type of business and any level and type of employee/contractor.

### **3. Choosing the Best Plan: A Roadmap**

The term EPP covers a broad range of arrangements in a variety of organisations. When considering the optimal plan for an organisation, one should match the purpose of the plan in the context of the circumstances of the organisation, and the objectives of implementing an employee share plan.

The plans have been designed for universal application. That is, the intention in the design of the plans is that any employer organisation (that is, incorporated, unincorporated, listed, unlisted, government or private) operating in Australia will be able to utilise a plan and implement an employee share plan for all their employees.

Special consideration has been given to designing plans for those organisations for which implementing employee share plans were believed previously to be too difficult or inappropriate.

For example, for those organisations without available shares (for example, closely held family companies, government corporations, unit trusts, and co-operatives) so-called 'replicator' plans and loan participation plans (that is, enabling investment in non-share securities) have been provided.

While certain plans have been designed with specific types of organisations in mind, for example:

- qualifying share plans for ASX listed companies; and
- replicator plans for unlisted or non profit organisations,

A listed ASX company may find that the non-qualifying loan participation plan and replicator plans are suitable for their employees. This is especially relevant, given the recent changes to

the accounting standards, which will apply to all Australian companies, which require full disclosure and expensing of employee share benefits. Such changes will have the effect of creating a more neutral, 'level playing field' between the different plans.

#### **4. Prerequisites for EPP's**

In order to create the necessary structure for effective delivery of equity benefits, it is important to recognise the important pre-requisites of an EPP. These are:

- Determination of the type of equity (e.g. shares, options or participation units);
- Valuation of the equity;
- Allocation of the equity; and
- Utilisation of a plan trustee for the implementations, administration, and marketing of the employees' equity.

Employee equity can be provided under a number of methods and structures. These may involve such things as option contracts or unit trust structures, which are appropriate for the circumstances of the particular employer organisation and its employees.

It is important that employees are secure in the knowledge that their participation delivers a fair share in the capital growth and profitability of the company, without jeopardising their fixed pay entitlements, nor exposing them or their families to unnecessary downside risk of the value of shares, being the subject of the options happens to fall.

And, ideally, the ability to claim a tax deduction when required to "expense" the equity benefit, also designed so that the employees only pay tax when they have the CASH IN HAND, and ideally they are taxed as a Capital Gains Tax Benefit (if the equity is held for more than 12 months).

Also the taxation outcomes of the EPP's chosen should be confirmed by an appropriate Ruling from the Australian Taxation Office.

#### **5. The broad range of plans include:**

- Qualifying Exempt Plans;
- Qualifying Deferred Plan;
- Non-Qualifying Employee Loan Plans; and
- Non-Qualifying Replicator Plans.

These plans can be broken down further into:

- Qualifying Exempt Plan
  - Exempt Share Plan
  - Exempt Option Plan
- Qualifying Deferred Plan
  - Deferred Share Plan
  - Deferred Option Plan



- Non-Qualifying Employee Plans
  - Loan Share Plan
  - Loan Participation Plan
  - Employee Option Plans
  - Geared Employee Share Trust
- Non-Qualifying Replicator Plans
  - Unfunded Replicator Plan
  - Funded Replicator Plan

While not all of these plans will enable employees to become long-term holders of shares in their employer, all of the plans will enable employees to share in the growth and prosperity arising from their work with their employer.

## **6. Employee Equity**

The employee equity can be provided under a number of methods and structures. These may involve such things as option contracts or share trust structures, which are appropriate for the circumstances of the employer organisation and its employees.

Until the late 1980s, employee share plans were typified by loan plans and partly paid share plans, and supplemented in the executive arena by the provision of executive options.

Since the late 1980s, due to a number of factors including changes to the superannuation requirements restricting the ability of superannuation plans to invest back into shares of the employer, a series of corporate crashes, a recession on the Australian share markets and the adoption of New Pay strategies highlighting the need to more directly integrate employee share plan strategies with employee strategic remuneration, there was a steady move away from loan plans and partly paid plans.

Loan plans and the partly-paid plans (for example, shares issued, called and paid to one cent) were seen as inflexible, separate from the remuneration strategies of the organisation and difficult to impose performance-based vesting conditions upon.

Options were popular at the executive levels but had little acceptance or relevance at the lower ends of the corporate hierarchy.

## **7. Employee Share Option Plans**

Increasingly, employees and non-employee contractors are asked by the company offering them a job, to receive a substantial part of their remuneration in the form of share options in the company. These options may have a life of 5 (five) to 10 (ten) years and are usually subject to vesting conditions or a non-exercise period extending two (2) to five (5) years. They may also be subject to other conditions such as performance hurdles or a growth in shareholder value (i.e. by issuing options with a premium exercise price).

Options as a substantial part of professional remuneration packages are becoming increasingly popular, especially for start-up companies in their early growth phases. In industries such as the mining industry, options fulfil an indispensable role as a means of attracting, retaining and motivating key staff.

However, those participating in option allocation programs need to be confident that the options are valued properly, administered correctly and can be exercised into marketable shares or the cash equivalent at some time in the future.

The valuation of options has become more reliable and consistent because of new accounting rules, which have been introduced recently in Australian and most other advanced western economies.

## **8. Restricted Shares**

Restricted shares provide the employee with the benefit of a whole share, which includes the acquisition price of the share plus any growth of the share that has occurred over the holding and vesting period.

Exactly the same vesting and performance conditions can be applied to restricted shares as applied to option shares. Restricted shares provide a more effective and efficient provision of share benefits, because employees receive the benefit of the whole share. This means that less share capital is required to provide benefits to employees under a restricted share plan than an option plan. Furthermore, a restricted share plan preserves the efficacy of the employer's long-term incentive structure as share benefits can be provided effectively in "crab" and "bear" market conditions, under which the shares may be experiencing nil or minimal capital growth.

## **9. Earmarking Equity for Staff**

Companies often earmark or set aside a percentage of the issued share capital in the company to be provided in the form of share options. This percentage may range from 5% to 20%, depending on the size and type of company, its maturity, its business circumstances and the remuneration strategies of the company.

## **10. Plans for Unlisted Companies**

For unlisted companies, there are 4 main methods of providing both real and notional equity to the employees:

- \$1,000 per annum worth of qualifying tax exempt shares or share options;
- a replicator plan which does not utilise shares at all, but communicates formula-based performance rights and is ultimately paid out as ordinary salary and wages;
- a special purpose employee share trust, which allows selected employees to invest in shares or other securities of the employer and ultimately acquire those investments funded by an interest-free, non-recourse, loan facility; and
- a special purpose Employee Option Plan, which allows selected employees to acquire options to shares of the employer, or receive the equivalent in cash.

The 5 requirements for an employee share plan, utilising unlisted shares are as follows.

The plan must involve available shares or their substitutes (for example, shares, units, rights, options or other entitlements).

There must be an acceptable valuation basis for the shares (for example, multiples of earnings before interest and tax or net asset values).

There must be a reliable warehouse for shares, investments to ensure shares are retained within the plan (for example, a share trust, share company or option contracts).

There must be an effective market for shares (that is, usually funded by the employer and participating employees).

There cannot be any obstacle to employee participation (for example, no drain on employees' cash resources and deferring tax until disposal of entitlements).

### **11. Plans for Listed Companies**

Listed Companies can also provide these plans to their employees but also in addition to the Qualifying Tax Exempt Plans, Listed Companies are able to offer Qualifying Deferred Plans. However, the application of Qualifying Deferred Plans (e.g. as restricted share or option plans) will become limited to delivery of Executive Long-Term Incentives, which readily incorporate "real" risk of forfeiture now required under the proposed Division 83A ITAA 1997 and which are short term and will encourage more short term risk taking by participants. Consequently, there will be a trend for listed companies to adopt long term incentive based employee equity strategies outside of the provisions of the proposed Division 83A ITAA 97.

## **E. EPP ROADMAP**

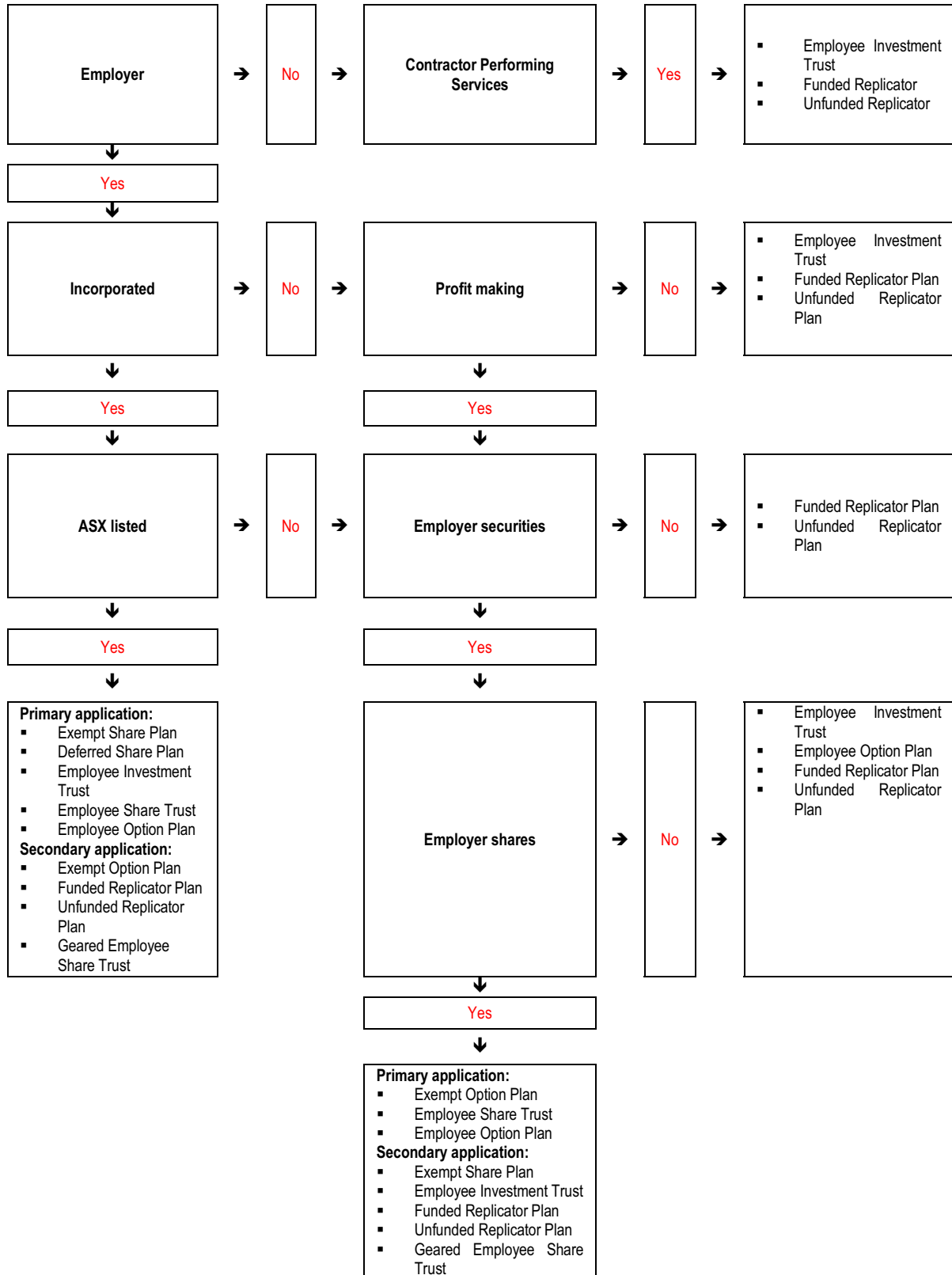
### **1. Introduction**

Set out below is the RSG Employee Share Plan Roadmap (see diagram on following page) to assist an organisation with charting the course of best plan selection for the circumstances of the organisation. To chart the roadmap, you simply begin from the top left hand corner and chart the flow of the roadmap according to the Yes or No answers to the factual circumstances presented. You should end up with the plan or plans that suit the particular circumstances of the organisation.

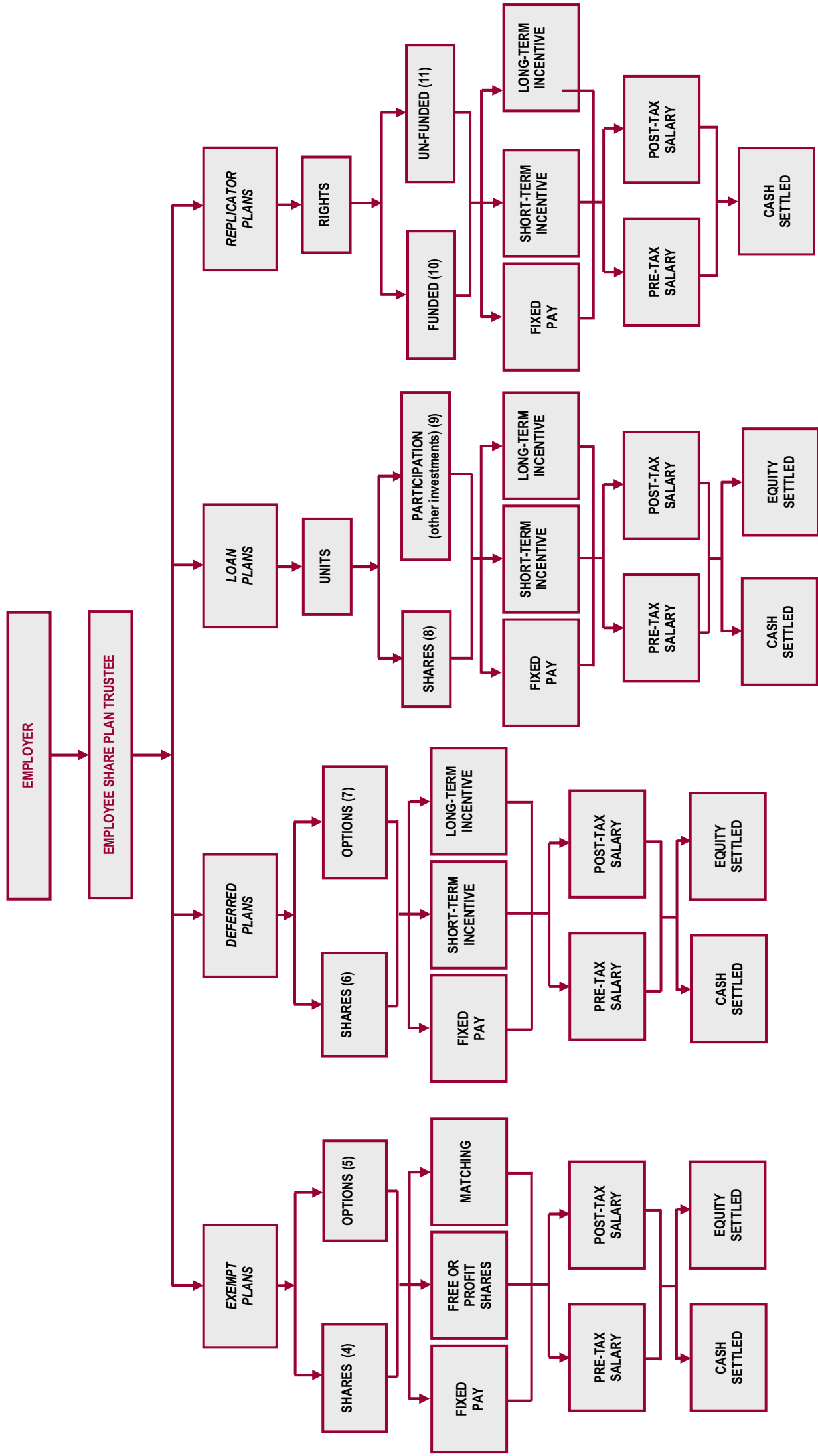
The following plan outlines includes successful design features that have been confirmed as a viable, working model capable of implementation in Australia based on international "best practice" and the actual experience of successful employee share plans implemented for Australian companies of all types and sizes.

The taxation consequences of the various plans are in accordance with private binding rulings obtained from the Australian Taxation Office.

## 2. Employee Share Plan Decision Tree - 'Roadmap'



### 3. RSG ESOP Framework



## **F. EPP's AND COMPANY PERFORMANCE**

### **1. Overview**

Over the past 25 years a wide range of research projects has established that employee ownership, especially when combined with participative management, is linked to significantly improved corporate performance. The research findings have been unusually consistent.

Among the studies already completed, the following are considered the most significant on the connection between ESOP's and company performance. Most of the studies summarised below examined and compared company performance both before and after employee share plans were introduced.

### **2. The 2000 Rutgers Study**

In this study Douglas Kruse and Joseph Blasi of Rutgers University compared the performance of more than 250 ESOP companies that adopted plans between 1988 and 1994 and a similar number of non-ESOP companies. It found that these companies increased sales, employment and sales per employee by 2.3% to 2.4% per year over what would have been expected without and ESOP. Although at first glance the relative growth numbers may seem small. Projected out over 10 years and ESOP company with these differentials would be a third larger than a company without and ESOP.

### **3. The 2000 NCEO Stock Options Study**

In this study Blasi, Kruse and Hames Sesil of Rutgers University, and Maya Kroumove of the New York Institute of Technology, studied 490 companies including a survey of 105 companies with broad-based stock option plans and 385 additional companies that offered broad-based stock options to a majority of their full-time employees.

Among a number of findings, the key one related to a comparison of the performance of broad-based stock option companies with non-broad-based stock option companies both before and after they had implemented their option plans. The results showed that broad-based stock option companies had 6.3% higher productivity levels than non-broad-based companies before option plans were implemented, and 14% higher productivity levels than non-broad-based companies after the implementation of option plans. The researchers considered the 7.7% difference as statistically significant.

### **4. The 1986 NCEO Study**

This study by Michael Quarrey and Corey Rosen of the US National Centre for Employee Ownership (NCEO) was the first to show special causal linkage between employee ownership and corporate performance. It found that ESOP companies had sales growth rates 5.4% per year higher in the post ESOP period than would have been expected based on pre ESOP performance. ESOP companies with highly participative management structures showed by far the biggest gains, growing three to four times faster than ESOP companies without such structures. Other studies suggest the worker ownership without participation can be short-lived or ambiguous. Ownership appears to provide "the cultural glue" to keep participation going.

## **5. *The New York and Washington Studies***

In 1997 economist Gorm Winther and Colleagues followed up the NCEO study with a study of 25 employee ownership firms in New York and 28 in Washington State. In both studies, employee ownership per se had little or no impact on corporate performance, but substantial impact when combined with participative management. In Washington State, ESOP companies grew in employment by 10.9%, and in sales by 6% per year more than would have been expected. The New York results were similar. In Washington State, majority employee-owned firms that were participatively managed did even better.

## **6. *The GAO Study***

In 1987 the US General Accounting Office (GAO) studied 110 firms focusing on productivity and profitability. The study found that, while ESOP's had no impact on profits, participatively managed employee ownership firms increased their productivity growth rate by 52% per year. In other words, if a company's productivity growth rate were 3.0% per year, it would be 4.5% percent after an ESOP. Due to the particular methodology used these results were are considered conservative.

## **7. *The 1998 Employee Compensation Study***

Carried out by Peter Kardas and Jim Keogh of the Washington Department of Community, Trade and Economic Development, and Adria Scharf of the University of Washing, this study matched 102 ESOP companies with 499 comparison companies. It found that employees in the ESOP companies were "significantly better compensated". In terms of wages, the median hourly wage in the ESOP firms was 5% to 12% higher than the median hourly wage in comparison companies. The study also found the average value of retirement benefits in ESOP companies was equal to \$32,213, with an average value in the comparison companies of about \$12,735.

## **8. *The 1998 Hewitt Associates Study***

This study by Professor Hamid Mehran, formerly of Northwestern University J.L. Kellogg Graduate School of Management, in partnership with Hewitt Associates, found that ESOP's in 382 publicly traded companies increased the return on assets (ROA) 2.7% over what would otherwise have been expected. Mehran also found that for the 303 ESOP companies surviving the entire four year, post ESOP study period, ROA was 14% higher than the comparison group scores. He also found that while for the 382 companies as a group, ROA was 6.9% higher for the four year period. Over 60% of the companies surveyed experienced and increase in their stock price, averaging 1.6%, in the two day period following public announcement of the ESOP, illustrating that the stock market now reacts positively to ESOP's, instead of concluding that the company is trying to prevent a hostile takeover.

## **9. *The 1998 Study of Stability of Public Companies***

Margaret Blair, Douglas Kruse, and Joseph Blasi found that publicly traded companies that are 20% or more owned by an ESOP are more organisationally stable. Looking at companies between 1983 and 1996, the study found that 74.1% of the ESOP companies remained as independent operations while only 37.8% of the comparison companies did. None of the ESOP companies went bankrupt, but 25% of the comparison companies did.

## **10. The 1990 Michigan Study**

The Michigan Centre for Employee Ownership and Gainsharing and Michigan State University asked executives to indicate if employee ownership had had an impact on sales, profits, productivity and other measures. The results were most positive in companies that scored high on participative management measures. The study also found that the incidence of employee participation programs increased 50% to 100% after an employee ownership plan was set up.

This pattern of dramatic increase in participation after ESOP's are set up was confirmed by a 1993 Ohio Employee Ownership Centre study.

## **11. Oxera Study**

Oxera was commissioned by HM Revenue & Customs (formerly the Inland Revenue of United Kingdom) to examine the impact of tax-advantaged share schemes on UK company performance (whereby companies' reward their employees by granting them shares, or share options, as part of their remuneration package).



## **Initial Findings**

- Larger companies, as measured by number of employees (but also turnover and amount of capital employed) are more likely to operate schemes. Large companies are also more likely to operate multiple schemes.
- Analysis of schemes by industry sector reveals that around 80% of all share schemes are concentrated in four industry sectors (being manufacturing; real estate, renting and business activities; wholesale and retail trade; and financial intermediation). When taking into account the total size of each industry, companies belonging to the electricity, gas and water supply, mining and quarrying, financial intermediation, and manufacturing sectors are shown to be most likely to operate a share scheme.
- Companies in any industry are more likely to operate a discretionary CSOP scheme than either a SAYE or APS all-employee scheme.
- On average, across all industries and years examined, 36% of companies with schemes are listed. The number of companies with a scheme that are listed has increased over time to almost 50% in 2001/2002. Between 38% (mining and quarrying) and 74% (manufacturing) of all listed companies across industries operate a share scheme.
- Companies in the electricity, gas and water sector are most likely to operate any type of share scheme. When focusing the analysis on listed companies, the sector in which companies are most likely to operate a share scheme is manufacturing (74%).
- Listed companies with schemes tend to have the same or higher levels of productivity (capital or labour) and profitability as listed companies without schemes.
- Additional modelling shows that companies are more likely to operate schemes the more capital-intensive they are. The analysis also indicated that companies are more likely to have share schemes under favourable economic conditions.

## **Key Findings**

However, this only paints a partial picture and more complex analysis (namely econometric modelling) is required to examine the impact of share schemes, controlling for other factors. This econometric analysis therefore provides a more definitive assessment of share schemes and their impact. Using dynamic panel data modelling, Oxera identified the following key points at the aggregate level (i.e. across all firms).

- On average, across the whole sample, the effect of tax-advantaged share schemes is significant and increases productivity by 2.5% in the long run.
- However, when the schemes are analysed on a disaggregated basis, there is a 4.1% long-run improvement in performance for companies using SAYE schemes, but no significant improvement for CSOP or APS schemes.
- Critically, there are further benefits to be gained from operating several types of scheme – when companies have both CSOP and SAYE schemes, productivity increases by 4.4% (i.e., a greater increase than the effect of operating only SAYE).

## **12 General Social Survey**

New data from the General Social Survey show that 20 million American workers own stock in their company through a 401(k) plan, ESOP, direct stock grant, or similar plan, while 10.6 million hold stock options. That means that 17% of the total workforce, but 34.9% of those who

work for companies that have stock, own stock through some kind of benefit plan, while 9.3% of the workforce, but 18.6% of those in companies with stock, hold options.

Confirming this data, an online survey of 2,373 US adults conducted by Harris Interactive between April 11 and 13, 2007 for The Wall Street Journal Online found that 13% of those surveyed said that their company provided stock as a benefit (presumably primarily through ESOP's or 401(k) plans), while 9% said they received stock options.

### **Employee Involvement**

A striking finding of the study is that sharing ownership (as well as profit sharing and gainsharing) is correlated with increased employee involvement in work-level decisions. Cause and effect here are uncertain. It could be that the companies likely to set up participation programs, for instance, are more likely to share rewards, or the causality could go the other way (or both ways). In any event, about 41.6% of employees with options and 43% of those owning company stock are on an employee involvement team, compared to 30.2% for the sample, while 38.6% of those owning stock and 44.0% of those with option are on self directed work teams companies to 33.3% for the entire sample. These numbers understate the difference, however, because roughly 20% of the sample owns stock or options. If these were excluded, the comparisons would be even more significant.

### **13 Pricewaterhouse Coopers 2007 Global Equity Incentives Survey<sup>4</sup>**

Perhaps the most striking of the themes in the survey results relates to the reported value of equity compensation plans. Since 2003, the majority of survey participants have reported that the benefits to be gained from equity compensation are worth the costs. This year, however, when the "costs" have become more visible than ever before, survey participants almost unanimously (97%) reported that the benefits outweigh the costs, up to 75-80% during the period 2003-2006. When people at all organizational levels are responsible for bringing the company to life, it makes sense that now more than ever stock in the company is viewed as key to the architecture bridging company, customer and shareholder. This is especially the case in those companies where equity compensation continues to be granted beyond the upper management level. This is particularly apparent with plain vanilla stock options, which have value for the employee only when the company stock price increases from the grant date.

The overwhelmingly positive attitude toward equity compensation in today's market is paired with increasing sophistication and movement toward cross-functional alignment reported in the design, valuation, oversight, administration and communication of such plans. Additional key findings of the 2007 Global Equity Incentive Survey include:

- Despite continuing decline in the use of stock options, options continue to be the most popular equity compensation vehicle in virtually all industries and among companies based in every country surveyed. However, participants in this year's survey were only half as likely to grant stock options as those in the 2003 survey.
- Performance ("operating" and "market") based equity compensation plans continue to increase in prevalence.
- The "pay for performance" mantra is resonating both CEO and broader employee populations: over 40% of participants indicate executive pay will change based on

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<sup>4</sup> Pricewaterhouse Coopers  
harnessing the reqrd 2007 Global Equity Incentives Survey

performance over the next 12 months and 5 years, and nearly 30% report similar relationship between employee pay and performance.

- There is evidence that cuts in stock option grant sizes were made at all levels of the organisation, not just among the rank and file.
- Companies are willing to modify some of the most basic design features in stock option plans, including lowering contractual term and service requirements (87% of participants in 2003 reported granting options with a 10-year contractual term, compared with 58% in 2007), and incorporating publicly traded options in developing volatility assumption.
- Market based benchmarking is almost universally employed as a tool to analyse and track compensation plans. As alluded to earlier, multinational companies are keenly focused on market competitiveness, and a significant portion (33% of participants) are bolstering their “toolbox” for granting a full picture of the total rewards package, including equity compensation. The use of analytical tools such as tally sheets in addition to benchmarking is strong among our “All Participants” group than among companies based in Europe, perhaps reflecting the impact of the recent Securities and Exchange Commission’s requirement to provide detailed tables of executive compensation in the Proxy statement, or perhaps in response to shareholder feedback.
- Despite the continuing trend indicating that shareholders generally approve equity compensation plans submitted to them, a larger percentage of participants report “no” votes in 2007 than in 2006.
- Companies continue to seek ways to reduce the after-tax cost of providing equity compensation through the use of cost recharge arrangements between corporate headquarters and local subsidiaries. Under such agreements, local employers must reimburse the parent for the value of the equity delivered to their employees, thereby securing local tax deductions for equity awards.
- On a similar theme, there has been an increase in the prevalence of locally tax qualified plans. The evidence suggests that this is particularly true in countries with high social taxes and where qualified plans are particularly prevalent.
- Plan compliance continues to be a challenge, particularly outside the country where the company headquarters is located. Less than half of participants in 2007 report having conducted a review of the compliance of their equity compensation plans in all countries where equity is granted. However, as the number of countries in which tax authorities have undertaken programs to audit equity compensation plans offered in their country increases, we expect to see companies shift from somewhat reactive, headquarters’ country focus to a more proactive, all-inclusive approach to internal compliance reviews in all countries where the plans are offered.

#### **14 ESO Research Findings of the DEWR End Unit 2006**

The key findings of the research are structured around three key areas:

- Awareness and incidence;
- Attitudes and endorsements; and
- Increasing take-up.

## **Awareness and Incidence**

The research confirmed that ESO is a complex area and that while general awareness of the concept among businesses is high, there is a lack of depth of understanding of issues related to design, implementation and management of ESO plans. This lack of knowledge also extends to some advisors, for whom the complexity of specific tax and legal issues can be overwhelming.

Awareness of broad based schemes (*'share plans that are open to all employees'*) was highest among:

- Public companies listed overseas (87%);
- Companies with over 100 Employees (85%);
- Companies with an annual turnover of over \$50 million (81%); and
- Companies with mostly white collar workers (79%).

Lack of familiarity of ESO was reported most often among businesses:

- In the Health and Community Services industry (70%);
- In the Transport and Storage industry (73%);
- Who rated their organisational culture on a range of measures as Good (65%) or Average (64%) but not Excellent; and
- With mostly blue collar workers (60%).

The incidence of ESO reported in the survey was low, with one in ten businesses (10% having a plan. Only 4% of all businesses had a broad based plan which was open to at least 75% of employees. Industries with higher incidences of ESO were:

- Manufacturing (22%);
- Finance and Insurance (19%); and
- Communication Services (15%).

While there was some variation in take-up by industry, differences across other company characteristics were more prevalent. Larger businesses, for example, were far more likely to have plans, as were publicly listed companies and companies listed overseas. From the qualitative research it was clear that the size of the company was important, if not the most important, influence on the take-up of the ESO rather than the industry of the business or other company characteristics. Smaller businesses often felt ESO was not relevant, too hard and too costly.

Table 1 – Companies Most Likely and Least Likely to have an ESOP

<b><i>Most Likely to have an ESOP</i></b>	<b><i>Least Likely to have an ESOP</i></b>
<ul style="list-style-type: none"> <li>▪ Publicly listed companies (52%)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Private companies (8%)</li> </ul>
<ul style="list-style-type: none"> <li>▪ Companies with offices overseas (32%)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Companies with only one office in Australia (10%)</li> </ul>
<ul style="list-style-type: none"> <li>▪ Large Businesses: <ul style="list-style-type: none"> <li>○ 100 or more employees (30%)</li> <li>○ More than 50 offices in Australia (39%)</li> <li>○ Annual turnover of over %50 million (32%)</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Small Businesses: <ul style="list-style-type: none"> <li>○ 5-19 employees (9%)</li> </ul> </li> </ul>

Narrow or executive plans were the most common types of ESO plans reported in the survey. However, the majority of plans implemented in the last year (63%) were open for all employees, indicating a move towards broad based plans over the last 12 months. Of businesses with plans, 40% (4% of all businesses) had a broad based plan which was open to at least 75% of employees. Among businesses with an ESO plan, most (62%) used shares as the main form of equity.

### ***Attitudes and Endorsement***

The research found a high level of endorsement for the notion of ESO among businesses with plans and those without plans. Overall, businesses with plans rated ESO more positively than those without, indicating high endorsement of the concept as a productive human resources strategy for those with practical experience.

#### ***Rational for implementing ESO***

The findings show that the initial rationale for implementing an ESO plan may vary considerably. The key rationales for action can be broadly grouped into three categories:

- (1) Businesses and workplace relations strategy;
- (2) Facilitating organisational change; and
- (3) Employee benefit/market competition.

Each of these is outlined in turn below;

#### (1) *Business and workplace relations strategy*

Some businesses described the rationale for implementing an ESO plan as a business strategy providing benefit to the bottom line and directly implementing employee productivity. While seen as an effective workplace relations strategy, businesses were quick to outline the separateness of the scheme from any formal wage setting arrangements, preferring to view the schemes as a benefit offered over and above any salary agreements.

ESO plans were also used by some to promote an identity or affinity with the business for employees with the intention of influencing productivity and performance, i.e. building a sense of ownership and belonging, focusing and motivating employees. ESO plans were also seen as a means of fostering **two way commitment** between the business and the employee, particularly where the plan asked the employee to contribute (“buy-in”). This was both rewarding for the employee and the business, also working towards achieving long term loyalty from key employees who were seen as vital to the success of the business.

Employee share ownership plans were generally seen as contributing to **improving business performance**. While companies found it difficult to establish a clear (and quantifiable) link between ESO and absolute increase in productivity, some proponents were adamant that their plan had positively impacted on their bottom line and would recommend ESO as an effective business strategy as a result. Other companies saw the main benefit of options in particular as a long term incentive related to **retention and loyalty**, that is, as a powerful human resource strategy to retain key performers given the restrictions on length of service before options could be exercised – a “golden handcuff”.

(2) Organisational change:

The literature review revealed the possibility of ESO being a core tool for achieving or supporting organisational change, a view supported by interviews with businesses. This may include, for example, integrating and unifying different parts of a business after a merger or acquisition which was commonly reported among larger businesses in the study.

ESO was also used as a way of achieving a smooth transition of ownership/succession planning for owner operators in smaller family businesses. Particularly in regional areas or specialist areas where sale of the business is not guaranteed due to lack of buyers when owners choose to retire, ESO provided a way of owners to spend less time in the business and ease into retirement.

Schemes were seen as increasing the interest in company performance, and positively impacting on the culture of the company. Share plans were also reported to create a “vibe” about the office, particularly when employees could track the share price. Business also reported that share plans can align the work of employees with company goals or a changing direction for the business; and/or encourage cultural change in organisations, for example, towards a more customer (or share holder) focused mode of operations.

*‘We have been doing considerable work over a considerable period of time to try and develop some sort of an ongoing reward scheme for our award staff. That’s an area where we believe there is much to be gained for the organisation... primarily from the point of view from driving a workplace culture which values performance and also... aligning individual goals with corporate goals’*  
(Workplace Relations Manager)

(3) Employee benefits

ESO was used by some businesses as a way of attracting and retaining employees in a competitive labour market. For some industries, the decision to include shares

and/or options in a remuneration package was driven by competitor behaviour and the need to match the marketplace as part of being an employer of choice. This was of course, dependant on the capabilities and skills of 'potential' employee shareholders including consideration of their capacity to earn and be 'poached' by other employers. One employer who did not currently have an ESO plan was keen to investigate the possibilities:

*'We have done quite a lot of work in relation to salary structure for executive staff and... when you look at total employee reward we come out significantly behind the market and that is basically because of the extent of shares and options which exist in the private sector at these executive levels...this area of employee share ownership is one I have been conscious of for some time'*  
(Workplace Relations Manager)

#### Received benefits of ESO

The key benefit recognised most frequently among all businesses (with and without plans) (agreement rated 7.3 out of 10) is the recognition of a dual benefit of the plan, that is, ESO benefits both the business and the employee.

The two key findings are:

- Businesses were more likely to agree with benefits related to organisational culture and workplace relations/human resource strategies; and
- Agreement was lower when considering elements such as the relationship between ESO and effective performance, a better working environment, and competitive salary packaging and tax benefits.

#### Negative Perceptions and Barriers

The main barriers to increased implementation of ESO plans related to a perception of a lack of relevance of ESO to their business, practical issues regarding legal and tax complexities, and employee resistance. There was also a range of legislative/taxation issues raised in particular by advisors who saw these issues as significant barriers for business. These key issues included:

- Limited tax incentives and/or unattractive and complicated tax treatments depending on the plan type or transfer of ownership (capital gains tax issues);
- Burdensome corporations law disclosure requirements; and
- Annual valuation requirements which can be expensive, complex and difficult for unlisted companies.

The research highlighted the key concerns of **cost and complexity** for businesses wanted implement and ESO plan. The four main negative perceptions emerging from the survey were:

- Businesses without share plans believe that share plans are not applicable to their organisation;
- Employees would prefer other types of benefits, do not/would not understand ESO and some could not afford to take part of a plan;
- Set up and maintenance costs are expensive; and
- Legal requirements are too difficult.

## Employee Perspectives

As noted above, employee resistance was one of the most frequently reported concerns for businesses (with and without ESO plans). Qualitative research with employees found that while in many cases understanding was low, perceptions varied even within organisations. The views of employees towards ESO plans appeared to be driven by a range of factors, including:

- The performance of the share price – share volatility was not well received by some employees and a declining share price was seen as demotivating;
- The size and age of the company – different views for those in smaller or start up phases (i.e. employees can be part of a business growth and development) as opposed to an established or larger business;
- The value and type of shares (needs to be significant/worthwhile);
- Previous experiences (positive and negative) with share schemes;
- Life stage and current financial position – younger employees looking for different types of investments or cash flow compared to those closer to retirement;
- Understanding of share ownership generally and an openness to this type of remuneration as part of a wealth creation strategy; and
- Existing employee relations and trust of management.

Well designed communication materials and strategies to educate employees and counter resistance were identified as key elements for successful implementation of an ESO plan.

## Effectiveness of Plans

The success of an ESO plan is related to the objectives of the scheme which varied across organisations. Considering most plans aimed at impacting such broad areas as organisational culture and employee attitudes, precisely measuring the success of an ESO plan is somewhat difficult. The survey asked respondents to recall the reason why their plan was implemented and rate the effectiveness of their plan against those objectives.

Around half of all respondents rated their plans as being effective, with more than one in ten rating plans as extremely effective. Plans which provided units were the most effective plan types, with a quarter (24%) rating them very highly, and the vast majority (86% rating them 7 or higher out of 10 for effectiveness. Shares plans also rated favourably with 71% of businesses rating them as 7 or higher out of 10.

Businesses that rather their plans as extremely effective (rating or 9 or 10) reported the following specific benefits: *share plans*

- Provide benefits to both the business and employees (mean rating 9.6);
- Are a good way to reward and recognise performance (mean rating 9.4);
- Increase loyalty and retention (mean rating 9.2); and
- Mean we can provide better remuneration packages (mean rating 9.1).

The survey found that many businesses were linking their plans to performance hurdles and the majority of these were for executive plans and option plans. The very



large majority of these businesses believed that the share plans were positively affecting performance and/or that ESO was a good way to reward and recognise performance. Of those who used performance or recommendation from a manager as a criterion to decide which employees were eligible to participate in an ESO plan, 95% agreed that share plans are a good way to reward and recognise good performance (54% rating 10 out of 10). Almost all these businesses (94%) agreed that employees perform more effectively when they have a share plan.

One of the reasons cited for less successful plans was the volatility of the share price. Common problems also reported by businesses related to plans being difficult to manage and maintenance costs being too expensive. Employees not understanding or preferring other types of benefits, and ESO plans not really being suitable for their organisation were also reported as reasons for plans being less successful.

#### Additional or alternative strategies to ESO

ESO plans are one of many choices open to businesses wanted to reward, recognise and motivate employees. Of those businesses interviewed, many had in place a variety of reward schemes including gifts, prizes and cash bonuses for both short and long term incentive programs. Alternative forms of financial participation might also include commission schemes, profit sharing or gain sharing. Often those businesses with ESO were also using other strategies:

*'ESOP's...are only one plank in a whole range of HR initiatives and so usually companies that have strong share plans and responsive employees probably are doing 30 other things very well as well...if you have a highly motivated work force that is well paid, working in a good work environment being encouraged to participate on every level and they have got a share plan... does that mean it's the share plan that's one the trick or all these other things?' (Advisor).*

The research also shows that many businesses simply prefer alternative (more conventional) employee benefits such as profit sharing and often businesses believe that employees would also prefer cash. The survey found that 54% of all businesses agreed (rated 7 or higher out of 10) that there are better ways of rewarding employees and 67% felt that employees would prefer other benefits. Of those who preferred other means of reward, 80% were offering at least some employees' cash bonuses.

## **G. LTI COMMUNICATION AND EXPENSING**

### **1. Expensing**

"Worldwide" accounting standards now require employee share and option benefits to be valued and expensed in the profit and loss accounts.

Though there was in some quarters concerns about the requirement to expense equity offerings, it has been universally accepted and implemented.

### **2. Communication**

What has not been universally adopted is the communication of the "equity" benefits to employees as part of their Total Employment Cost.

The provision of LTI benefits are a cost of employment the same as Salary and Wages, Superannuation and so on, and employees for the purposes of communication and transparency, let alone retention should be aware of the annual value of their LTI benefits.

### **3. Valuation**

RSG has developed an employee equity valuation calculator (i.e. the RSG Employee Equity Calculator), in conjunction with a noted academic from a leading university, who specialises in the valuation of options and other equity. The valuation of the employee share options and all forms of employee equity needs to be based on the methods outlined in the AASB 2, which is the Black and Scholes model or a binominal model, with a careful and detailed calculation of the valuation volatility factors.

The RSG Equity Calculator incorporates a 250 step, binominal tree structure, which allows for inclusion of employee vesting conditions, employee turnover rates and early exercise as required by the accounting standards.

It is the determination of the volatility factor that is one of the keys to accurately value share options and other equity. Volatility represents the potential for the option and share benefits to grown in value over the period the employees hold the equity. Accurate determination of the appropriate volatility requires careful analysis of the fluctuations in the company's share prices.

Where a company has little in the way of historical valuation data, it is understood ASIC is applying the arbitrary volatility factor of 65%. Most mature companies exhibit a volatility factor of around 20-30%. However, newly established, more speculative mining or hi-tech companies can exhibit unsustainable volatility factors in excess of 100%.

It should be emphasised that the valuation of share-based payments are not limited to employee option plans. For example, many companies have loan share plans (i.e. employees are given an interest free loan by their employer to invest in the company's shares) and they will also need to disclose and expense the value of this equity. Generally speaking, the value of employee loan plans can be determined on a similar basis to employee option plans.

Also it is not limited to public companies, the requirement to expense LTI benefits applies to all employers who are offering "equity" benefits.