THOMSON

Weekly Tax Bulletin

THOMSON ATP WEEKLY TAX BULLETIN

2 June 2006, Issue 23

[955] **Pay and share options in the new world**
by Gary Fitton, Director, Remuneration Strategies Group, Melbourne

[*Gary Fitton is author of the "Salary packaging and remuneration strategies" and "FBT and financial planning" chapters of Thomson's Australian Financial Planning Handbook*.]

In 2004, the Federal Government 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% of the workforce over a 5-year period. Currently (that is, 2006), the level of employee equity participation in Australia businesses stands at a rate of 5.9% of the workforce.

The Federal Government realised that, in order to achieve its target levels of equity participation, it needed to encourage equity participation in all its forms (i.e. real and replicated options and shares), for application in all types of Australian employer organisations, for all categories of staff.

Prerequisites for effective employee share plans

In order to create the necessary structure for effective delivery of equity benefits, it is important to recognise the 3 pre-requisites of an employee share plan. These are:

- determination of the type of equity (eg shares or options);
- valuation of the equity; and
- utilisation of a plan trustee for the implementation, 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 if the value of the shares, being the subject of the options, happens to fall.

Why use an employee share plan?

The Federal Government believes that it is in the public interest to promote employee share plans. Employee share plans are seen as providing a means to:

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

This article is about share options, which many companies offer as a part of employees' and contractors' remuneration arrangements.

Employers like to provide options to selected employees and contractors as they enable them to attract, retain and motivate staff, which they may not have otherwise been able to do. Employees and contractors may choose to accept options so as to enhance their remuneration packages, by accepting a share of the growth and profitability of the business (ie its "surplus value"), rather than seek a higher fixed pay with no share in the company's future surplus value.

Options as a part of remuneration

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 to 10 years and are usually subject to vesting conditions or a non-exercise period extending over 2 to 5 years. They may also be subject to other conditions such as performance hurdles or a growth in shareholder value (ie 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 fulfill 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 Australia and most other advanced western economies.

Options: a quick picture

Options are rights to shares. They may be:

- put options - whereby the option holder has the right to sell shares at a set price; or
- call options - whereby the option holder has the right to buy shares at a set price.

Options issued to employees and contractors are usually call options, whereby the employee, after achieving certain vesting conditions, has the right to have the company sell shares to them or be paid a cash equivalent.

Traditionally, options are composed of 5 steps:

- the grant and issue of options;
- the price of options - usually nil or a nominal amount;
- the exercise price of options, being the amount to be paid to acquire the shares - often, the prevailing market price of the shares at the time of option grant, but may be issued at a discount or a premium, depending on the purpose of the option allocation;
- the vesting of options, when the performance or time-based conditions precedent are achieved and options are capable of being exercised - over the exercise period; and
- the exercise of options, when the employee elects to pay the exercise price and acquire the shares or receive a cash equivalent.

New accounting standards

Under the new international accounting standards, which have been encapsulated in the Australian Accounting Standards Board's AASB 2, options must be valued at the date they are granted, and *expensed* in the profit and loss account of the company in the accounting year they are granted, or spread over the vesting period.

This valuation should also be used to measure and communicate the value of the options to be included in the participating employees' or contractors' respective remuneration packages.

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 business circumstances and the remuneration strategies of the company.

Philosophy and methodology

The components of an optimal remuneration strategy are:

- Fixed Pay;
- Short-Term Incentive (STI); and
- Long-Term Incentive (LTI).

Given the application of the remuneration strategies underpinning staff pay in the company, the levels of option allocations making up the total remuneration should be consistent with the options allocated to others within the corporate hierarchy.

Given the nature of businesses and the early positioning in their business growth development phase, it may be appropriate that the STI and LTI should be combined and paid in the form of options for shares. Such options which are determined and approved by the Board may be provided with an exercise price subject to substantial premium on share price, at the date of allocation of the options.

Fixed Remuneration is represented by salary, superannuation and other benefits. The STI represents Short-Term Incentives which are normally paid as bonuses, or incentives based on key performance indicators, which have revenue or profit linked bases.

Certain organisations are "cash poor" but "asset rich" and cannot afford to pay cash bonuses, and may not yet be in a position to reflect realistic profit figures. In these organisations, the STI may be integrated into allocations of share options.

Issues for participants

The main issues for employees and contractors deciding whether or not to participate in an option plan are:

- the valuation of the options;

- the integrity of the options (eg are they protected by a plan trustee?);

- having a dependable market for the options enabling the equity to be redeemed for its cash value; and

- downside risk protection - options have an inherent downside risk protection, so if options are "not in the money", participants can simply allow them to lapse without further detriment.

Valuation

The valuation of options is the area that has experienced the greatest development over the last couple of years. While options in the past have often been offered to selected staff, the valuation of the options tended to be vague, imprecise and inconsistent. This is no longer the case, given the new accounting standards, to which all companies must have adhered since 1 January 2005.

Most option valuation methodology has its genesis in the pioneering work of Black and Scholes. Fisher Black and Myron Scholes were Chicago-based academic "boffins", who won a Nobel Prize for developing a methodology for valuing so-called European Options. European Options are fixed-term options that are traded, but which have no vesting conditions.

The Black and Scholes methodology is said to be responsible for the creation of the multi-billion dollar Chicago derivatives exchange market, because once options could be reliably valued, they could be traded on a market. However, to introduce vesting and other conditions into the option valuation calculation, which is typical in grants of employee options, it was necessary to build a binomial tree into the basic Black and Scholes framework.

Remuneration Strategies Group, with the assistance of a Professor of Commerce at one of Australia's leading universities, has developed a computerised equity valuation calculator based on the Black Scholes methodology with the 250-step binomial variation, which will soon be published and distributed by Thomson (see para [1019] of this *Bulletin*).

This amended Black and Scholes methodology is encapsulated in the Australian Accounting Standards Board's published standard AASB 2, concerning Share-Based Payments. AASB 2 generally encapsulates the valuation methodology set by the London-based International Accounting Standards Board, and is initially based on 6 factors. Those 6 factors are:

1. the exercise price of the option;

2. the life of the option;

3. the current price of the underlying securities;

4. the expected volatility of the share price;
5. the dividends expected on the shares; and
6. the risk-free interest rate for the life of the option.

As well as the AASB, this methodology has been generally accepted by ASIC and the Australian Stock Exchange.

This option valuation performs 2 roles:

- it determines the value of the options which should be included in participants' remuneration packages;
- it determines the value to be expensed in the company's profit and loss accounts.

The Short and Long-Term Incentives may be provided by way of options, subject to performance criteria. The appropriate performance criteria depends on the incentive purpose of the option allocation. Where the purpose of the option allocation is to increase share value, it may be appropriate to subject the options to time-based vesting conditions and to subject the exercise price to a substantial premium.

An example

Here is an example of a package including options as an integral part of the remuneration package for a Head Geologist of a mining company.

This position is one of the most important technical managerial positions involved in the exploration programs undertaken by the company. The company and the employee negotiated a reasonable fixed remuneration, supplemented by options to shares in the company to be included in a total remuneration package.

STI and LTI benefits have been combined and focus purely on options which are subject to performance criteria, based on a share price premium set at 25% of the share price at the date of grant of the options. The incentive function of the options is to encourage the maximisation of the company's share value.

It is proposed that 800,000 such options be issued, with an option life of 5 years and a vesting period of 3 years.

With the options valued at 4 cents each, this means that the Head Geologist will be granted options with a total value of $32,000 (ie $800,000 x 4 cents).

The composition of the total remuneration package is:

- Fixed Remuneration Excluding STI and LTI - $128,000;
- Short and Long-Term Incentives (Option) - $32,000;
- Total Remuneration - $160,000.

Conclusion

The employee has negotiated a reasonable fixed remuneration, supplemented by a substantial allocation of options, which lifts the value of his or her pay from $128,000 to $160,000. While the growth in the value of the shares in the company cannot be guaranteed, the expectations are that the company has a bright future and the options enable the employee to share in that future.

[1019] Equity Based Remuneration Toolkit - COMING SOON

With this soon-to-be-released CD toolkit from Thomson, enhance the efficiency and reliability of your equity-based remuneration calculations.

Demystify AASB 2 calculations with this user-friendly **Equity Based Remuneration Toolkit**:

- Meet stringent new standards regarding the value of equity based payments.
- Simplify a complex calculation, accessing straightforward, practical help.
- Streamline your process.

Perform complex calculations in a time-efficient, cost-effective way.

THOMSON

Equity Based Remuneration Toolkit

Enhance the efficiency and reliability of your equity based remuneration calculations with this user-friendly electronic calculator:

- Meet stringent new standards regarding the value of equity based payments
- Access straightforward, practical help, simplifying a difficult calculation
- Use simple, step-by-step input screens to streamline the process
- Avoid involving an auditor/valuer
- Generate a complete audit trail of your calculations

Equity Based Remuneration Toolkit applies a 250-step binomial model that complies with AASB 2 Share Based Payments legislation. This CD resource allows you to negotiate a complex new calculation in a time-efficient, cost-effective way.

Authored by
Remuneration Strategies Group
RSG

Available late June.

Calculate with confidence under AASB 2 Share Based Payments

The countdown is over. It's time to take control.
Save time — Make difficult calculations easy and comply with regulation.

www.thomson.com.au