



SHARING THE WEALTH

EMPLOYEE SHARE OWNERSHIP PLANS ARE NO LONGER RESERVED JUST FOR LARGE, PUBLICLY LISTED COMPANIES. AS **REBECCA SPICER** DISCOVERS, THEY CAN BE A USEFUL TOOL FOR ANY BUSINESS WANTING TO ATTRACT, RETAIN AND MOTIVATE STAFF

IT'S 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 before.

Employee share ownership plans (ESOPs), or employee share schemes, 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 ESOPs, which generally aim to encourage employees to invest in the business they work in, and to more closely align employee performance with the company's financial and business objectives.

"The whole purpose behind employee share ownership schemes is that the employees have a share in the business, and it's considered that will give them a greater incentive to

perform. And as the business grows, they benefit," explains Gary Addison, senior tax consultant at CPA Australia.

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

Given these potentially positive outcomes, the Federal Government and groups such as the Australian Employee Ownership Association (AEOA) aim to increase the amount of ESOPs offered to Australian employees, and the focus has been towards educating and assisting unlisted organisations (mainly SMEs) to understand the process and benefits.

In 2004, the government announced its target to double employee share ownership in Australia by 2009. And it has since launched initiatives such as the *Employee Share Plans: Getting Started* kit and the share ownership guides on the workplace.gov.au website, as well as a dedicated ESO Development Unit, to get more information on these plans.

It's important to understand immediately that offering ESOPs in your staff remuneration packages won't always mean offering them actual 'shares' in the company. In fact, many SMEs are unlisted and won't have physical shares to offer. But as Gary Fitton, president of the AEOA, reiterates, "It's about sharing in the surplus value of the organisation." And that can be through alternative arrangements that still provide staff with equity in your business.

The type of plan used and how it's applied in a business will greatly depend on each individual business' aims and needs. "It's all part of their attraction, retention and motivational strategy for staff, but it's all linked back to their remuneration strategies," Fitton explains. "And when you look at remuneration, the optimum remuneration strategy has three elements: fixed remuneration (what you're paid to come to work), short-term variables (your profit share, incentives and bonuses), and long-term incentives (usually a share in the capital value of the organisation—an ESOP)."

Fitton says the first step business owners should take when considering ESOPs is to determine the purpose of the plan. Ask yourself: 'Why am I doing this?'. "Some employers might believe their employees have a fundamental right to have shares in their company. But most employers do it because it's pragmatic, it needs to be done or they think it's important for the performance of the company," says Fitton. "If you're trying to attract highly trained and skilled people, you can't attract them unless you can offer them equity. So there's a need to do it, and it's linked to how you run your business."

Once linked to a business purpose, it is then linked back to your remuneration strategies, Fitton adds. Then you need to establish how the equity will be delivered to staff (whether it's in the form of actual shares or alternative methods), and this is where the different types of plans come in. According to the government's Developing an Employee Share Ownership Plan report, there are four broad categories of employee ownership plans operating in Australia:

- **Fully paid plans.** Employees can purchase shares directly from the share market (usually at a discounted rate), or if they don't have the funds to pay for them shares can be issued by the employer and paid for via a loan from employer to employee, funded out of a share of the company's profits or salary sacrifice arrangements.
- **Partly paid plans.** Although not commonly used in Australia, participants in partly paid plans are issued shares at a market or pre-determined price (\$2, for example), but are only required to pay up a small portion of their value (usually one cent). The participants remain liable for any amount unpaid on the shares, even if the market price falls below the value at the date of issue.
- **Options plans.** An option is a contractual right to acquire a share in the future at a set cost. Options are held in a trust set up by the employer until the 'exercise' of the right, at which time fully paid shares are issued to the employee.
- **Replicator plans.** These try to replicate a real employee share plan—but do so without issuing real shares or options. A replicator plan usually offers participants, for little or no cost, an entitlement to receive a cash payment in the future, subject to satisfying predetermined performance levels, for example. These plans are often used where the company doesn't want to use real shares, for reasons such as retaining control, avoiding minority interest problems, or lack of a market.

When Brian Cook and Brett Campbell founded their software services company OBS in 1999, they immediately had the intention to give their staff an opportunity to share in the company's success. However, it was almost five years before they could deliver on that promise, and began implementing ESOPs in their staff remuneration packages two years ago. Now with 50 staff across three interstate offices, OBS offer all staff share options when they join the company, and at performance review time staff are offered a certain amount of share options based on loyalty, and further options based on performance. "We had two choices: we could have issued shares and had everybody as shareholders but we decided on the share option plan, mainly because it gave us more flexibility in key growing years of the company," explains Cook.

"It's a retention strategy, it's a hiring strategy, and it's a wage reduction strategy," he adds. "At pay review time, there are a few people we ask if they'd prefer more options or cash, and they can nominate to weight their package towards options and equity if they

like. So we find that's a good way to curb wage growth, especially in IT, which is a bit explosive at the moment.

"The main benefit is being able to get everyone on board and have them feel like they're owning a part of the company, rather than just being an employee."

Addison believes the costs of ESOPs are always a concern for small businesses, and giving employees equity is another because many small business owners want full ownership and control of the company. But as Fitton explains, the owner decides the degree to which control is retained when designing their plans. "They can set the terms and conditions upon which the equity is offered. They can provide full voting rights, or no voting, set up mechanisms for involvement in decision-making, and then they'll have to decide how far up they want that decision-making to go."

In OBS's case, given staff only have share options, they don't actually have a share yet, so there are no voting rights or power. But once they get the share they'll be like any other shareholder.

Businesses should note, not all staff have to be offered the same ESOP, in fact not all staff need to be offered a plan at all. Employees play different roles within any organisation, and because ESOPs become part of a business's long-term remuneration strategy, it may be necessary to reward some staff differently to others.

TAX ISSUES

When implementing ESOPs there are several tax, legal and accounting issues to consider. Under existing tax law, there are two different share ownership strategies employees can engage in:

- tax exempt: employees can buy up to \$1,000 worth of shares per year, tax exempt, paying capital gains on any growth; or
- tax deferred: employees can purchase a greater amount of shares (or share options) on a 10-year tax-deferred basis without attracting capital gains tax.

Fitton says the tax exempt option is popular for businesses wanting to offer all levels of staff some sort of share in the business. But when it comes to high-income earners, \$1,000 in terms of their remuneration isn't very much, so they would tend to be offered the unlimited tax-deferred option.

While this might sound complex, there is plenty of help available and Fitton advises businesses to seek outside assistance when implementing plans, because it generally won't fall within the expertise of those already working in the business.

Specialist consultants can help throughout the whole process, from designing the most appropriate and rewarding plan for your staff, to arranging plan documentation, implementation, management and accounting. But it's also worth getting a lawyer to check over any plan documentation outlining the rules of the plan or the trust deed to ensure the ESOP complies with all Corporations Act, stock exchange listing rules (if applicable), and tax laws. >



> All ESOP offers must also be assessed (valued) at the time of offer to determine impact on profit and loss. To ensure compliance with corporate governance principles, businesses are advised to use someone other than their accountant or auditor for this valuation, such as a qualified valuer or specialised ESOP consultant.

At OBS, Cook says they had someone internally look at what would be involved in implementing ESOPs, but realised early that they'd need outside help. They sought out a professional ESOP consultant who took them through all their

options, guided them through the rules, including all accounting and legal requirements, and who has since designed and implemented ESOPs for OBS's staff. The consulting firm now also administers the plans on behalf of OBS on an ongoing basis.

When choosing a consultant, Cook's advice is to go with one who's got plenty of experience. A list of consultants can be found on the AEOA website (www.aeoa.org.au).

The main goal for business owners implementing ESOPs will be to get a 100 percent participation rate among those staff offered plans, so the benefits of aligning the interests of management and employees are achieved.

Consequently it's important participants are taken into account at the planning and design stage, that the offer material is clearly understood, and that there is a comprehensive communication strategy in place. "You've got to make sure there's no burden or obstacle to employees taking up shares," explains Fitton. "And you only achieve 100 percent participation when employees are confident that their shares and the valuation of the company are realistic and correct. They've got to be confident that at the end of the day they can convert their shares into realisable cash."

In the case of OBS all staff have an ESOP in their remuneration package. "I believe the team think it's a good thing," says Cook. "It's obviously a challenge with share options that people understand exactly what they are and how they work and so forth, so we have a number of internal videos and training on induction so people can understand what it is and how it works, and then we keep reiterating that."

The time it takes to establish an ESOP will vary depending on whether more than one plan is to be adopted, whether shareholder approval is required, and the degree and complexity of the design and implementation of the plan.

A standard executive option plan could be designed, documented, and implemented in a matter of weeks, whereas a complex ESOP rollout, with multiple plans and offers, may take several months. Fitton says the most time consuming part usually is the company's own decision-making process, and that was certainly the case for OBS.

Cook says it took around six months to roll out their plans to staff, and most of that time was taken up in deciding which plans would best suit, how the share options would be divided, and then

considering how to handle all the different scenarios. And while he admits it could have been completed sooner, there was no hurry. They started exploring the idea in December one year, and only needed it up and running by the time performance reviews came around in the middle of the following year.

While employee share plans might seem complex or costly to implement, the key message to SMEs is that ESOPs 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, ESOPs could be your answer to acquiring and retaining key employees. ●

MORE INFO

Department of Employment & Workplace Relations:
www.workplace.gov.au/eso

ESO Development Unit: 1800 181 088

Australian Employee Ownership Association: www.aeoa.org.au

Australian Tax Office: www.ato.gov.au