GRG Remuneration Insight 115

The Missing Piece

Authors: Denis Godfrey & Nida Khoury

Introduction

If the Royal Banking Commission highlighted anything strategic beyond the obvious issues related to integrity, self-interest and short termism, it would have to be the importance of organisations having an ethical and constructive work culture, taking into account both the short and long term views that benefit customers, shareholders and other stakeholders.

Unsurprisingly, these are attributes that both shareholders and Boards value because they know that they are imperative to sustainably good results. Shareholders and other stakeholders do not benefit when results are short term and not sustained. However, the remuneration systems utilised for most employees concentrate on rewarding the short term only, with a small group of senior executives also receiving long term incentives (usually via equity plans).

While it does make sense to provide equity to executives who formulate the direction and plans for the business on the near and long term, it remains a fact that all the day-to-day execution and monitoring that impact business results are done by middle management and lower level employees.

What Contributed to this Problem

Before the introduction by the Australian Accounting Standards Board of the accounting standard for share based payments (AASB2) in 2005 it was common practice in Australia for employee equity plans to be extended to the majority of employees with the amount of benefit provided related to the impact of the roles held. Prior to that time most equity grants to employees did not involve an accounting charge. Thus, equity could be offered without any expense being recognised in a company's accounts. Equity was widely held, and a culture of mutual ownership and benefit was the result.

When AASB2 came into operation, for the first time companies needed to recognise an accounting expense for equity based benefit plans. Due to the size of the benefits provided and the spread of employees to whom the benefits were offered, the new accounting expense had a significant impact on the reported profitability of many companies.

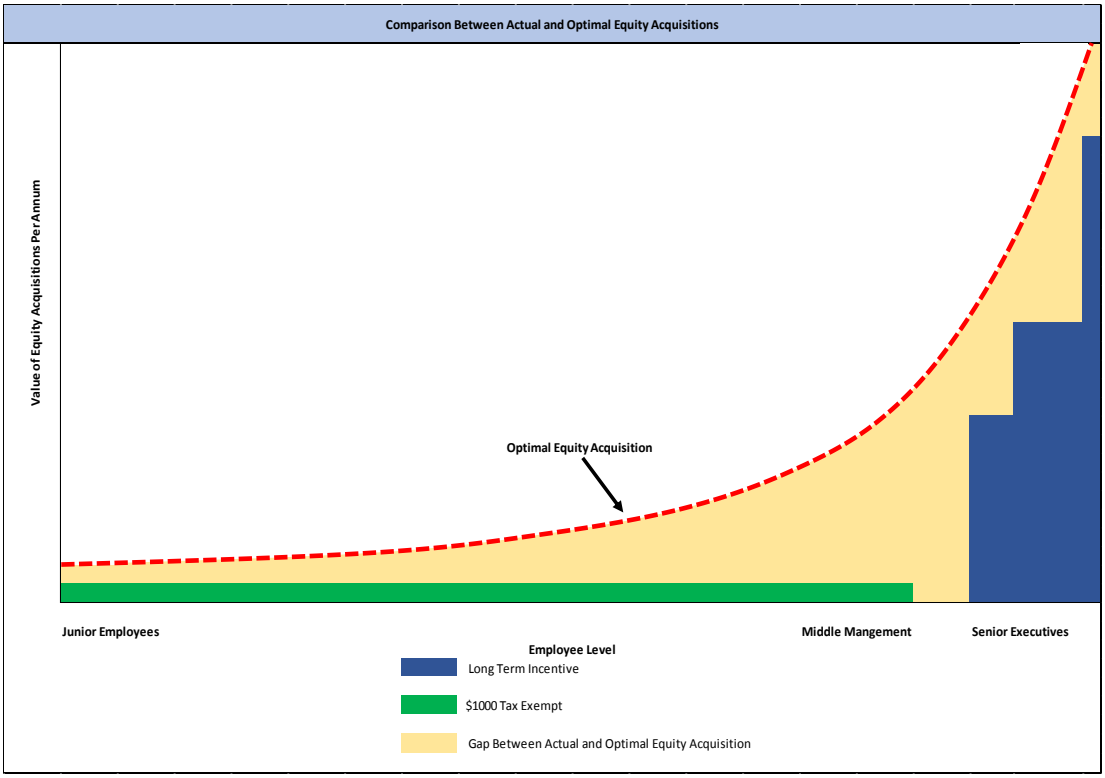
The reaction to this outcome was a major contraction in the spread of employees being offered equity based benefits so as to restore reported profits to prior levels.

As a result, the current practice is for equity participation to be at historically low levels with consequential impacts including poor company cultures and short termism dominating long term prosperity. Naturally the focus became maximising cash benefits, if that is all that is offered.

This GRG Remuneration Insight discusses this problem and provides the solution to overcome it.

Current Practices

Currently the vast majority of equity related remuneration is provided to a small group of senior executives and a token amount is sometimes provided to other employees typically via annual grants of up to $1,000 of "free" shares under a Tax Exempt Plan (participation is typically limited to those earning less than $180,000). The graph below depicts the current practice and compares it to what GRG considers to be optimal equity acquisitions.



The graph indicates that there is a shortfall between actual and optimal practices. What is most disturbing is that the largest gap relates to middle and senior management immediately below the senior executive roles. These are the roles that implement the business plans of senior management and have the most direct and significant impact on corporate culture. The gap can be much larger than depicted here, depending on where $180,000 of income occurs in the organisation.

Clearly, there is currently a missing piece in the mix of remuneration and benefits offered by most companies.

Addressing the "Missing Piece" Problem

In the current environment where many companies are seeking to minimise operating costs, including the costs of remuneration and benefits, it is unlikely that many companies would be prepared to take on additional costs associated with providing equity as a benefit for employees.

An exception may apply where the additional cost can be linked to improved performance (for obvious reasons) and/or employee retention as turnover costs associated with hiring and training new employee can be onerous so programs that minimise turnover can produce cost savings and improve efficiency.

Another way to minimise company cost for funding the equity acquisitions and yet facilitate and encourage it would be via utilising salary sacrifice. In this regard it needs to be remembered that salary sacrifice confers greater advantages for employees compared to investment of after-tax salary into equity. This is depicted in the following simple example overleaf.

Aspect	Variables		After Tax Investment	Salary Sacrifice Investment
Gross Amount			$10,000	$10,000
Tax	47%		$4,700	$0
Investment in Company Shares			**$5,300**	**$10,000**
Value at End/Sale	Share Price Growth	3	$15,900	$30,000
CGT			$2,491	$0
ESS Tax			$0	$14,100
Net Benefit			$13,409	$15,900
Advantage from Share Price Growth - Amount				$2,491
Share Price Growth - %				**19%**
Dividends On			$5,300	$10,000
Additional Base for Dividends				$4,700
Additional Dividends - %				**89%**

Points to note about the above example include:

1. The amount invested in equity is significantly larger ($10,000) under the salary sacrifice approach compared to an after-tax investment ($5,300). This is based on a 47% marginal tax rate and the difference will be smaller at lower tax rates.
2. If equity acquired by salary sacrifice is sold as soon as it becomes taxable, then capital gains tax (CGT) does not apply.
3. The after-tax benefit will always be greater from salary sacrifice equity acquisitions than from after tax investments if there is share price growth. The difference will always be the amount of CGT. In the example the difference is 19% because the value of the shares has been assumed to triple over the holding period, but the amount of the difference will vary depending upon the amount of share price growth.
4. Dividends is where the greatest advantage accrues from salary sacrifice. This is because the value of equity held will be significantly greater under the salary sacrifice approach ($10,000 compared to $5,300 in the example). In the example the dividends are 89% greater under salary sacrifice than for an equivalent after-tax investment.
5. When operated as a dividend reinvestment plan, compounding growth effects can also produce substantial advantages for employees.

Depending upon company circumstances the funding of the 'missing piece' may be via salary sacrifice and/or additional company cost.

Other factors to consider

There are various technical aspects from a regulatory point of view that need to be taken into account when setting up a broad-based equity plan to bridge the 'missing piece'. However, from a plan attractiveness point of view there are several important aspects to consider including:

1. **Unrestricted Access** – During the course of employment employees should be able to access accrued vested equity benefits whenever they have the need for cash, as they cannot predict when and how much they may need to access from the equity plan upfront: this may be influenced by many unforeseen factors that can emerge in the future. Accordingly, the plan should allow employees to access benefits whenever they decide to do so, subject, of course, to the insider trading restrictions of the Corporations Act and the company's securities trading policy.

2. **Company Cost** – There are many configurations as to the timing of the company tax deduction in respect of the salary sacrificed amounts. If the tax deduction timing is delayed and the share price has increased, then the company tax deduction can be larger than the amount of the salary sacrifice. In the previous example, the value of the salary sacrificed equity had grown from $10,000 to $30,000. If the $30,000 qualified as a company tax deduction, then the company would have benefitted from an additional $6,000 tax saving ($20,000 x 30% company tax rate). This saving may offset some or all of the company cost associated with administering the plan (or even matching).
3. **Employee Risk Minimisation** – A possible impediment to employees making salary sacrifice elections is the risk of loss from a fall in the share price. This risk is commonly addressed via a matching company equity component which means that the employee does not lose until the combined value of the employee salary sacrifice component and the matching company component falls below the cost of the employee salary sacrifice component. GRG developed an alternative which, in effect, guarantees that the employee will not receive back less than the amount salary sacrificed for the equity. This new approach does not involve any additional company cost whereas matching does.
4. **Dividend Entitlements** – In the example, the after-tax investment acquired shares attracted dividends. Irrespective of the equity instruments used it would be important for the employees to receive the value of dividends or equivalent value in respect of salary sacrifice equity acquisitions.
5. **Administration** – If significant numbers of employees were to be participants in the equity plan then consideration would need to be given to outsourcing the administration of the plan and to having shares held by a trustee. An advantage of a trustee holding shares is that participation by employees can be simplified. If they wish to sell shares they simply ask the trustee to undertake the transaction and pay the net sale proceeds into their bank accounts (they do not need to have a broker or set up share trading). As indicated above, the tax savings may offset some or all of the company cost associated with administering the plan.

Benefits

Other than the obvious financial benefits to employees, bridging the 'missing piece' gap will transform employees into shareholders, which will result in a more engaged workforce that takes more responsibility for its own work, proactively problem solving and delivering higher levels of productivity, customer care and satisfaction, in a sustainable manner.

The interests of employees will truly become aligned with the interests of other shareholders, and they will certainly become more motivated to deliver the strategic business plan as they stand to share in its near and long term rewards.

Lastly, providing employees with a mechanism for wealth creation will help compensate for stagnant salary increases and lacklustre superannuation that are expected to remain the norm for the foreseeable future.