

THOUGHTS ON SHARE OPTIONS FOR EMPLOYEES

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Options to purchase company shares at a fixed price at a future date can be created for a variety of reasons and take a number of different forms. They may be associated with fixed interest borrowings as convertible notes or detachable warrants, they may be issued as a sop to shareholders in capital reconstructions or as a benefit to promoters or initial supporters of new flotations, and they may be granted to particular interests either to facilitate their control of a company or to provide a reward or incentive for their endeavours. Experience has shown the possibilities in the use, and abuse, of share options to be very wide indeed.

Share Options Generally

These notes are primarily intended to discuss those share options ostensibly granted to employees as an incentive, but it is desirable to look first at options generally. Abuses have been very great in the past and, particularly in the U.S.A., the history of "stock options" or "stock warrants" has not been a very happy one. Graham, Dodd & Cottle in the 4th Edition of "Security Analysis" quote the case of American and Foreign Power Company, whose listed option warrants attained a market valuation of over \$1,000 million in the boom of 1928-29 and which were eliminated for nil in a later capital reconstruction.

No matter in what way share options may be created, so long as they — and the company itself — continue in existence two propositions are self-evident:

1. The options have some value even though the company's shares may currently be selling at less than the exercise price.

The market price may rise above the exercise price during the remaining life of the option; the holder of the option cannot lose but may gain.

2. The value of existing shares is reduced even though the company's shares may currently be selling at less than the exercise price. Part of the present market value is based upon the right to benefit from future improvement, and this benefit is being subjected to possible dilution.

Shareholders tend to view the issue of share options with indifference, failing to realize that part of their equity is being taken from them. Sound security analysis must take the existence of share options into account as, to quote Graham, Dodd & Cottle: "Neither the past nor the future earnings can be said to belong unqualifiedly to the outstanding common shares in the same way as they would if there were no dilution through option warrants." Net asset backing and earnings per share require adjustment, allowance having to be made for any funds (and their conjectural earnings) introduced on exercise of the options.

It may not be easy to decide when and in what way such adjustments should be made. At the very least, however, the existence of share options should be noted and due attention drawn to their possible effect. Any statement of a company's share capital must include reference to any share options or convertible notes on issue, or whose

issue has been approved, and in this regard the Australian Associated Stock Exchanges could give a stronger lead. It is important, for example, that capitalization columns of the Sydney Stock Exchange Gazette be compiled with rigorous accuracy as at the end of each month and that net asset backing figures quoted in company reviews be appropriately qualified where options exist in any form.

Employees' Plans in the U.S.A.

Current Australian interest in share option plans for employees appears to have arisen out of their development in the U.S.A. as a means of remunerating important employees of companies in a manner involving them in lower taxation than would otherwise have been the case. At one time gains made through exercise of options and sale of shares thereby acquired were subject to normal progressive rates of personal income tax, but tax legislation in 1950 made such gains liable only for capital gains tax if they fell within the pattern of restrictions set out in the legislation.

This led to the inauguration of many plans but subsequent abuses caused much public criticism. Within the restrictions an employee had the chance of making a substantial profit—really at the expense of the shareholders generally but with the incidence and extent of the benefit well disguised. Serious articles in media such as the Harvard Business Review drew attention to the drawbacks of share options as a method of executive remuneration — they were said to be uncertain and hazardous in application, with a large element of lottery. Finally tax legislation in 1964 imposed much more severe restrictions upon the issue of

new share options to employees, without disturbing those already issued under binding contracts although some existing plans were discontinued by the companies concerned.

It is not possible in the U.S.A. to obtain tax-free benefits — the very best that an executive or other employee can hope for out of a share option plan is that he will be subjected to tax at capital gains rates on the whole of any realised profit. To gain this **maximum** benefit the following conditions must be fulfilled:

1. The option price must be not less than 100% of the market price of the stock at the time of grant.
2. The option must expire within 5 years of grant, and the grantee must be an employee of the company continuously from grant until 3 months prior to exercise.
3. The stock must be retained for at least 3 years after it is acquired.
4. When the option is granted the employee must not own, directly or indirectly, more than 5% of the company's stock either in voting power or in value.

Lesser benefits may still be available where there is some departure from these standards. The 1964 amendments made it mandatory to obtain stockholders' approval for a plan, and also limited opportunities for option prices to be reduced to meet adverse movements in market prices.

Taxation in Australia

It seems that many Australian companies have considered the idea of introducing a share option plan for employees, but only a small number of schemes have actually been inaugurated. Perhaps publicity given to abuses in the U.S.A. has made some companies hesitant to become involved in what may possibly become an area of controversy, yet others have proceeded confidently. One writer—M. C. Wells, is an

article on "Executive Stock Options" in The Australian Accountant of March 1968 — has expressed the view that they will be widely adopted in Australia, although it is significant that his later article in the August issue was largely devoted to seeking solutions to practical problems not considered previously.

A simple copying of U.S. precedents is not possible even if it were thought to be desirable. An important consideration is that there is no distinct capital gains tax in Australia — no doubt many people would regard the absence of such a tax as an advantage, but one effect is that there is no "half-way house" into which specified income could be placed by statutory definition. Basically one would expect in Australia that remuneration paid in the form of grant of share options would attract income tax on the whole of any realised profits at progressive personal rates. Views have been expressed to the contrary, but it seems likely that because of conditions precedent to exercise of options (such as continuance in service) and therefore an absence of contractual right, tax liability would not arise in the year of grant but in the year of exercise, and that tax would be levied on the difference between the option price and market value at date of exercise. For this purpose the market value may not be that of the stock exchange for existing shares but contain adjustment to compensate for restrictions on subsequent sale as well as for different dividend ranking.

Whatever the present Australian taxation situation may really be, it is possible that personal tax may be avoided in either of two ways:

1. An arrangement may be made with the Australian taxation authorities, involving conditions as to grant of share options to employees but resulting in an admission that personal income tax would not be payable at time of grant, exercise or sale. It is understood that this has

occurred in at least two cases, and presumably this course would be open to other companies prepared to accept restrictions that are actually less rigorous than those applicable in the U.S.A. for lesser benefits.

2. The use of an artifice may change the apparent nature of the arrangement so that, whilst not technically a share option plan at all, the same result is achieved. On the recommendation of a tax adviser one company issued convertible notes paid up to a nominal amount only — a course which also avoided company law provisions as to publication of names and amounts of holdings of share options and as to the 5-year limit on their lifetime.

If these courses continue to be effective, Australian recipients would be better off than their U.S. counterparts in that they would pay no personal income tax at all on realised (or unrealised) profits.

Other Considerations

Whatever advice is received there could remain some doubt as to the taxation position in Australia, and in any case special legislation could be expected to follow any great increase in the granting of share options to employees selected by employers. Most of the companies that have inaugurated plans are keen supporters of the idea of granting share options to employees; however, amongst companies in general, it seems to be felt that there are better ways of providing incentives in Australia than such a relatively long-term one involving the future behaviour of stock exchange prices and under which an employee, to be rewarded, has to produce and place at risk a considerable amount of money—his own or borrowed.

This was one of the areas of criticism in the U.S.A.—that the employees rewarded were those that not only had substantial incomes by

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virtue of their positions in their companies but also had substantial assets to enable them to take up, at the appropriate time, the shares to which they were entitled. Probably share option plans served a useful purpose in the U.S.A., where high turnover of executive staff is traditional, in enabling companies to secure and hold valuable employees, although it is not known to what extent their development up to 1964 was merely a response to competition once the movement towards their inauguration had got under way. To go even further, was that development a symptom of mass psychology and, after all that has happened in the U.S.A., would a corresponding development in Australia now be indicative of a state of euphoria rather than of detached reasoning as to what is best for companies, their shareholders and their senior employees?

The Future

Have share option plans for em-

COMPUTERS

(From previous page)

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ployees a future in Australia? If so, in what form and to what extent? Are we likely to see a great increase in their number and a consequential cycle of:

1. Abuse until we have what Erwin N. Griswold (Harvard Business Review, November - December 1960) described in the U.S.A. as a "fairyland" where "the ground is strewn with quite a bit of gold" for influential executives of companies,
2. Concern on the part of security analysts and then of stock exchanges as to the real nature of what is happening, and finally
3. Aid to ineffective shareholders through changes in company and/or tax laws to lay down frameworks, impose restrictions and ensure adequate publicity?

In the ultimate the case for a share option plan for employees must not rest on its effectiveness or otherwise as a vehicle for getting tax-free remuneration into the hands of senior employees, however much this aspect may appeal to those concerned. The real point is effectiveness in providing an incentive whereby the interests of shareholders and senior employees are made to coincide. To do this the plan must not only be specifically designed to function as an incentive

scheme but it must be demonstrated that it provides a more effective incentive scheme than any available alternatives — taking into account such aspects as real burden of cost through dilution of equity on the one hand and the need for substantial personal financial participation by employees on the other.

It has yet to be shown that the great majority of Australian senior employees would not prefer to receive immediate cash rewards on good results—and if company results are good the shareholders should benefit. Perhaps share option plans are only really appropriate for companies whose share prices are depressed and which are too illiquid to finance a share **purchase** plan for their employees.

Further Reading

Apart from the U.S. and Australian publications mentioned previously, it is suggested that reference be made to other articles that have appeared over the years in the Harvard Business Review. Many U.S. text-books on financial management refer in some measure to share option plans for employees, but "The Financial Manager" by Cohen & Robbins is particularly recommended for its historical summary and discussion of the recent position in the U.S.A.

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Working Parties as listed below are at present conducting studies on the following companies:

Company
Thomas Nationwide Transport Ltd.
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Members
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R. A. C. Keene
J. J. Jago

A survey of the paper industry is being conducted by:

J. Troy
T. V. Davies
W. Hawkins.
