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Unlocking the Power of Ownership

Understanding ESOS

in Malaysia

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I. WHAT'S ESOS AND WHO NEEDS IT?

In the vibrant tapestry of the Malaysian business landscape, Employee Stock Option Schemes (ESOS) emerge as a strategic cornerstone for companies aspiring to not only attract but retain top-tier talent. This chapter delves into the fundamental essence of ESOS and identifies the two distinct categories of companies that stand to gain the most from its implementation.

1. Fast-Growing Startups for Attracting Top Talent

Fast-growing startups embody the spirit of innovation and agility. In this context, ESOS becomes a potent tool, offering these dynamic enterprises a competitive advantage in the race for top talent. By weaving a culture into their DNA, startups can captivate the attention of ambitious professionals seeking more than just a job; they seek a stake in the company's journey. ESOS, with its inherent allure of shared success, not only attracts but deeply engages individuals who crave a sense of belonging and contribution. Through this lens, startups can position ESOS as a beacon that not only attracts top talent but also cultivates a workforce deeply invested in the company's success.

2. Listed Companies for Retaining Top Talent

For established listed companies in Malaysia, the narrative shifts towards the retention of invaluable talent. ESOS, in this context, transforms into a linchpin in the strategic arsenal for talent management. By aligning the interests of employees with the long-term goals of the organization, ESOS becomes a powerful mechanism for retaining top-tier talent. The allure of shared ownership not only instils loyalty but also reinforces a commitment to the company's enduring success. In this arena, ESOS serves as a dynamic force in cultivating a work environment where employees perceive themselves as stakeholders, fostering a culture where longevity and loyalty are reciprocated through shared prosperity.

In essence, this chapter establishes the foundation for understanding the pivotal role of ESOS in the Malaysian business landscape. Whether for the agile startups seeking to entice the brightest minds or the established corporations aiming to fortify their human capital, ESOS emerges as a versatile and indispensable tool for businesses on the path to sustained growth and success.

II. TYPES OF ESOS (AND OTHER LTIPS): PROS & CONS

In the realm of Employee Stock Option Scheme (ESOS) and Long-Term Incentive Programs (LTIPs), understanding the various types and their associated pros and cons is essential for businesses in Malaysia seeking to craft effective strategies for talent management. This chapter embarks on a detailed exploration of the distinct types of ESOS and LTIPs, shedding light on their advantages and challenges.

1. ESOS / ESOP

Employee Stock Option Schemes (ESOS) or Employee Stock Option Plans (ESOP) are foundational instruments in fostering a sense of ownership among employees.

Out of the total shares (or ownership) of a company, a percentage is allocated for employees. However, ESOP is not directly converted into shares immediately — instead, it is an option for the employee to buy shares at a price determined on the date of grant. Employees can decide whether they want to buy it (exercise) or not. If they decide not to buy it, their entitled ESOPs may become expired.

ESOPs serve mainly as a form of employee benefit, aiming to align the interests of employees with the success of the company. By giving employees a stake in the organization, ESOPs can foster employee engagement, motivation and loyalty, which in turn can lead to increased productivity and a stronger company culture.

The pros include enhanced employee motivation and loyalty, but challenges may arise in terms of valuation complexities and potential dilution of ownership.

2. RSU (Restricted Stock Units)

Companies reward their top-performing employees in various ways. While some resort to cash bonuses, others prefer to give ownership rights to their employees. One way to imbibe a sense of ownership in the employees is by offering restricted stock units (RSUs). RSU offers a unique approach by providing employees with a stake in the company without requiring an upfront financial commitment.

A restricted stock unit is a type of employee compensation in which employees are given company shares at a future date if they fulfil certain conditions. These conditions can be performance-based, time-based, or a combination of both.

Usually, companies launch RSU programs to incentivise employees to perform. If the` employees achieve the defined targets, their units vest. As they fulfil the obligation, they get ownership of the shares. Unlike in an ESOP scheme, they need not purchase the shares post the vesting period or get a deep discount.

Restricted stock units offer both employees and employers various advantages. Employees get benefits like no or very low upfront payment at the time of vesting, while the employer gets a way to incentivise employees for retention and performance.

There are some disadvantages of RSUs as well, such as no dividend payment, market standoff, automatic forfeiting of unvested RSUs, etc. RSUs convert to common shares after employees exercise them. So, they are subject to market risks. As the share value can decrease, so is the amount employees can make selling it. RSUs holders don't get dividends or voting rights. However, once RSUs get vested, the employees get both, just like common shareholders.

Another disadvantage is that RSUs don't vest until conditions (restrictions) are fulfilled. Unvested units get forfeited if the employees leave the organisation or fail to achieve the target.

Suppose there is a market standoff provision in the RSU policy. In that case, employees can't sell the vested RSUs for a limited period after the initial public offerings, usually for 90 to 180 days. This stabilises the stock price of the company and prevents a big sell out.

3. SARs/Phantom Plans (Stock Appreciation Rights)

While ESOPs are an excellent employee benefits scheme that has worked for many companies, some companies are hesitant about the idea of diluting ownership rights and sharing equity with their employees. We have seen many founders be wary of getting employees on their cap table. Though they want to reward employees for their contribution to the startup's growth, they want it primarily in the form of monetary benefits.

This is one of the significant regards in which SARs comes out as a viable and feasible alternative for both employers and employees. SARs allow employers to share the benefits of company value appreciation with their employees either monetarily (cash-settled SARs) or in equity (Equity-settled SARs), without sharing control aspects like ownership stakes or voting rights.

The cash pay-out for a unit of vested Phantom stock is equal to the full aggregate value of a stock unit in the company at the time the pay-out event is announced. To illustrate, if an employee is issued phantom stock when your stock is valued at $10 and the award vests when your stock is valued at $50, the cash pay-out will be $50 per unit. In the same vein, if your stock's value declines in the interim to $5 at vesting – the cash payout would be $5 per unit.

The pros include flexibility and reduced dilution, but challenges may arise in communicating the concept effectively to employees and aligning performance with phantom share values.

Understanding the nuances of these ESOS and LTIP types empowers Malaysian businesses to tailor their incentive programs to meet specific organizational objectives. By weighing the pros and cons, companies can choose the most suitable plan that aligns with their corporate culture, engages employees, and contributes to long-term success in the competitive Malaysian business landscape.

4. PSP (Performance Share Plans)

Performance Share Plans (PSPs) tie rewards directly to the company's performance.
By aligning employee incentives with organizational goals, PSPs motivate employees to

contribute to the company's success. The pros include a clear link between performance and rewards, but challenges may emerge in defining measurable performance metrics and maintaining employee morale during periods of underperformance.

III. IMPLEMENTATION OF ESOS

Efficient implementation lies at the heart of unlocking the full potential of Employee Stock Option Plans (ESOS) in Malaysia. This chapter is a navigational guide through the key considerations, documentation essentials, approval processes, and the critical aspect of employee communication.

1. Key Considerations

Designing an effective ESOS program requires a meticulous examination of various factors. Firstly, understanding the organizational culture and objectives is paramount. The plan must align with the company's mission and values, ensuring that it resonates with both leadership and employees.

Additionally, consideration should be given to the financial implications, striking a balance between incentivizing employees and maintaining fiscal responsibility. Balancing short-term goals with long-term sustainability ensures a well-rounded ESOS program that stands the test of time.

What is the best time to create an ESOP pool?

It is recommended to create an ESOP pool as early as possible. Ideally, an ESOP pool should be created on Day 1. However, if the same is not created at the time of incorporation / commencement of business, the same should be created before any fund raise.

What should be the size of the ESOP pool?

While there is no fixed formula to determine the size of the ESOP pool for a Company, a pool size of 10-15% is usually reasonable, and a Company can look to expand the pool size during future rounds of funding. The size of the pool depends on the investment stage, company objectives, market position, valuation, etc.

Determining the most suitable instrument for your LTIP

It is important that a Company select the desired plan - Employee Stock Option Scheme ("ESOS"), Employee Stock Purchase Plans ("ESPP"), Restricted Stock Units ("RSUs"), Stock Appreciation Rights ("SARs"), and Phantom Stock Options; based on the needs and commercial objectives of the Company. The most commonly used option plan by start-ups/ private companies is the ESOS or ESPP. Where stock options are offered by a foreign parent, generally RSUs are preferred as they can be linked to occurrence of a specified event or fulfilment of specified conditions.

Phantom stocks, or SARs are the best choice where a Company wishes to offer employees with rewards that are based on merit or some other discretionary basis – the benefit being since they are given in cash for the shares and no ownership control is given to the employees, handling of these options becomes easy for the owners.

What happens when an employee leaves the organisation?

Exit situations are to be kept in mind while designing the ESOP scheme, as this will help to decide how to structure the rights of the employees over exercising the options which are already vested or unvested at the time of their exit. The ESOP scheme should clearly state what happens when an employee leaves the company – the unvested options are generally forfeited while the outgoing employee retains the vested options until a short period (say 30 or 60 days) of time as specified in the scheme.

2. Documentation

Transparency and accountability are the bedrocks of successful ESOS implementation. Comprehensive documentation is essential for legal compliance and to provide clarity to all stakeholders. This includes outlining the terms and conditions of the ESOS, specifying eligibility criteria, and detailing the mechanisms for share valuation. Well-documented plans not only mitigate legal risks but also serve as a crucial reference point for both current and future participants, fostering trust and confidence in the program.

3. Approval Process

Navigating the approval process is a critical phase in implementing ESOS. Obtaining necessary approvals involves engaging with relevant stakeholders, including the board of directors and hareholders. Clearly articulating the benefits, risks, and long-term impact of the ESOS program is imperative during this stage. Effective communication with decision-makers ensures a smoother approval process, paving the way for the successful launch of the program.

4. Employee Communications

Communication is the linchpin of successful ESOS implementation. Ensuring that employees not only understand the intricacies of the plan but also appreciate its value is crucial. This involves clear and transparent communication about the benefits, eligibility criteria, and potential risks. Establishing channels for ongoing communication, such as regular updates and Q&A sessions, fosters a culture of openness and engagement.

Employees who are well-informed and understand the impact of ESOS on their financial well-being are more likely to actively participate and contribute to the overall success of the program.

In conclusion, effective implementation of ESOS in Malaysia hinges on a thoughtful approach that considers organizational nuances, embraces transparency through documentation, navigates the approval process with finesse, and prioritizes clear and ongoing communication with employees. By carefully addressing these aspects, businesses can ensure that their ESOS program not only complies with regulations but also becomes a catalyst for employee engagement, loyalty, and organizational success.

IV.TAX & COMPLIANCE IN ESOS IMPLEMENTATION

Navigating the intricate landscape of tax and compliance is an essential aspect of implementing Employee Stock Option Plans (ESOS) in Malaysia. In this chapter, we explore the nuanced considerations surrounding company expenses under MFRS 2, the concepts of Fair Market Value (FMV), and Fair Value (FV).

1. Company: MFRS 2 Expense

The implementation of ESOS requires a thorough understanding of the accounting standards outlined in the Malaysian Financial Reporting Standards (MFRS) 2. This standard governs the accounting treatment of share-based payment transactions, including ESOS. Recognizing the expenses associated with ESOS is critical for financial transparency and compliance. Businesses must adhere to the guidelines provided by MFRS 2 to accurately report and disclose the expenses related to share-based payments, ensuring alignment with regulatory requirements and fostering trust among stakeholders.

I. Fair Market Value (FMV)

Determining the Fair Market Value (FMV) of shares is a pivotal element in ESOS implementation. FMV represents the price at which the shares would exchange between knowledgeable and willing parties in an arm's length transaction. Ensuring a robust and defensible methodology for valuing shares is crucial for compliance and fairness. Companies must establish clear procedures for regularly assessing FMV, considering factors such as financial performance, industry trends, and other relevant market conditions. Accurate valuation not only aligns with regulatory expectations but also enhances the credibility and perceived fairness of the ESOS program.

II. Fair Value (FV)

Distinct from FMV, Fair Value (FV) encompasses a broader concept that extends beyond the stock price. FV considers various factors, such as the volatility of the stock, expected dividends, and the duration until the option is exercisable. Understanding and applying the concept of FV is essential for recognizing the true economic value of ESOS and aligning financial reporting with the economic substance of the transactions. Businesses must employ reliable methods for estimating FV, ensuring compliance with accounting standards, and providing stakeholders with a comprehensive understanding of the financial impact of ESOS on the company.

V.PAYROLL AND INCOME TAX CONSIDERATIONS IN MALAYSIA

1. Payroll

In Malaysia, payroll obligations encompass a comprehensive set of responsibilities for employers. The salary package, inclusive of Basic Salary, allowances, Overtime (if applicable), perquisites/Benefit-In-Kind (BIK), and the Value of Living Accommodation (VOLA), must be accurately structured and documented. Employers are mandated to adhere to statutory deductions, identifying which types of wages are subject to obligatory deductions and contributions. It is essential to stay informed about available exemptions to ensure compliance. Monthly payslips play a crucial role, necessitating employers to provide a valid document that includes essential items such as employee details, earnings, and deductions. The payment of salaries and statutory contributions involves a diligent process, with attention to how payments are made, and the information required for accurate remittance.

2. Income tax for Employees

In Malaysia, employees are subject to income tax obligations governed by the Inland Revenue Board of Malaysia (LHDN). By the end of February each year, employees are required to obtain their EA form from their employers, summarizing the previous year's income details. The submission of Form BE, whether through the online platform myTax or paper form submission at LHDN offices, is mandatory for employees to fulfil their income tax obligations. This form declares the total income earned and allows employees to claim eligible deductions. In the event of any shortfall in taxes, employees are obligated to pay the outstanding amount. Adhering to these processes ensures compliance with Malaysia's income tax regulations and facilitates a transparent and accountable financial system.

3. LHDN documents/Forms submission

Submitting documents to the Inland Revenue Board of Malaysia (LHDN) is essential for tax compliance. Employers submit monthly forms, including CP22A, CP22, and CP21, detailing employees' income and deductions. These forms contribute to accurate monthly tax assessments. At the end of the financial year, employers must submit Form E, summarizing the company's annual statutory income and employment details. Timely and precise submissions are crucial for maintaining transparency and adherence to Malaysia's tax regulations.