

# **The Employee Share Ownership Plan: what value has it for Australia?**

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## **ABSTRACT**

The Australian government is currently committed to the goal of increasing organisational participation in employee share ownership plans (ESOP) from 4% of all companies to 11% by 2009. The Nelson Report into ESOPs commissioned by the Honourable Brendan Nelson highlighted the lack of comprehensive information on the nature and extent of ESO plans in Australia. ” (Nelson 2000). This paper places the program in context by reviewing overseas experiences and considers the viewpoints of both employers and employees. The preliminary investigation concludes by highlighting the need for further thorough research before success for all types of businesses can be confidently predicted. ”

*Keyword: Employee Share Ownership, Australia, Implications*

## **INTRODUCTION**

An employee share ownership plan (ESOP) is a scheme that provides employees with a financial share in the business in which they work. ESOPs allow employees to gain shares (or options to shares) in the company in which they work so that the employees benefit financially when the business performs well (Nelson 2000). Employee share ownership plans are used throughout many democratic countries and go back to the 1930s when the US Congress legislated for the Employee Stock Ownership Plan (ESOP) to provide a mechanism for employees to acquire equity in their places of employment (Pugh, Jahera Jr. Oswald. 1999). More recently, the Australian Federal government has set benchmarks in increasing participation from 4% of all companies to 11%. This has created debate as to its value for both employers and employees and also to its relevance in all industries. This paper presents the current situation regarding ESOPs and proffers research questions which highlight the multifaceted nature of ESOPs.

## **BACKGROUND**

Employee share plans have operated in Australia since the early 1950s as part of the philosophy of Prime Minister Robert Menzies for the “encouragement and introduction of profit sharing schemes wherever possible” Under specially enacted legislation in 1974 the gradual evolution of the legislation arrangement has attempted to foster employee share plans and participation in them, whilst at the same time limiting their use as vehicles for aggressive tax planning (Nelson 2000).

Many employers were keen on the introduction of employee share plan legislation brought in by the Whitlam Labour Government in 1974 and a year later, the Company Directors Association sponsored the American Economist, Lawyer and ESOP expert Louis Kelso to address their National Conference. Kelso was instrumental in establishing the first ESOPs schemes in the USA in the early 1950s (ESEO 2006). He had proposed the widespread use of Employee Share Ownership Trusts (ESOTs) as a means of restructuring wealth and income patterns with a view to establishing a more viable form of capitalism for the future (Sheehan 1981). Under the Kelso Plan, a company wishing to raise a loan for the purchase of the stock for distribution to employees establishes an Employee Stock Ownership Trust (ESOT) as a tax qualified employee retirement fund. The ESOT borrows the money and passes the money onto the company for exchange for stock. The company guarantees the loan, but the ESOP carries the loan as a liability. The company makes annual tax deductible contributions to the ESOP allowing them to pay the loan interest and distribute dividends (Kelso, 1975 as cited in Sheenan 1981 pg15). This trust structure in a modified form to suit Australian laws is available to employers today. It is a little used instrument that many family and medium to large private companies should examine when contemplating ESOP opportunities or if they are thinking of selling their company to its employees or management.

Australia compares unfavourably with the USA and UK in the take up of ESOPs, but is on a par with Germany and with other OECD countries (Ausgov 2000). The USA is the volume leader in ESOPs and has 11,500 ESOPs operating with at least 10 million employees (3.5% of total population) and an asset value of over US\$500 Billion. The USA also has other employee share schemes that account for another 15 million employees (5.1%) (NCEO 2006). More than 2,000 companies operate all-employee share schemes in the UK, most of them larger publicly listed companies. These schemes are estimated to cover more than three million employees (5% of total population) (ESEO 2006). In the last census Australia had ESOPs covering over 400,000 employees and between A\$9-12 Billion (DEWR 2005). This

only involves 2% of the total Australian population, but the Australian Government has set a ambitious target of increasing this to be in line with the UK figures by 2009.

## **TYPES OF ESOPs**

Employee share ownership plans can take many forms, depending on the business size and type, and the aim for introducing the plan (Nelson 2000). There are many different types of ESOPs for Publicly listed and Private Companies, the most common being the Fully Paid Voting Share. However, Fully Paid Non-Voting Shares are also very popular in cases where the controllers of the company (especially family firms) who may have the largest block of shares and do not want to dilute their power. Partly paid voting or non-voting shares are common in cases where the cost of purchasing a share is spread over a number of years or the full price does not have to be paid until some future time. This often removes an element of risk from the employees, because if the company does not perform to expectations then only the small initial payment is at risk

Options are very popular in ESOPs especially amongst senior management as part of performance targets. Usually the executives are given these share options free of charge or as part of their salary package. The exercise price of the option is set at a price that reflects the performance target for the executives. If the company wishes to achieve an increase in their share price in two years of at least twenty percent (20%) then the exercise price of the option would usually be today's share price plus 20%. This method, although widely used does have some flaws. The former Minister for Education and Workplace Relations Brendan Nelson believed that some of these option schemes and some executive equity and salary packaging arrangements were out of step with community expectations. He thought that properly regulated ESOPs available to all workers would negate or make transparent excessive senior executive option schemes (Nelson 2000). Recently it was reported that many of Australia's top companies are using cosy hedging schemes and financial instruments for executive options circumventing Australian Securities and Investment Commission (ASIC) rules. These schemes allegedly allow executives to sell or hedge options during the vesting period without telling shareholders and in effect turning something that had been sold to the shareholders as performance pay into guaranteed pay and ensuring the executives were getting shares with no downside risk." (Gettler 2006 pg B1).

Examples like this are not uncommon and can spoil the perception of ESOPs by existing shareholders. “Regan (1991) (as cited in Bowden 1997) had chronicled the progress of events at Ralsston Purina, an American domiciled company. In 1986, with the stock trading at \$50, the Board allocated to top management the right to receive [half] million shares if the stock closed for 10 consecutive days at \$100 or above. In the ensuing years, the managers leveraged the balance sheet from 1:1 to 3:1, using debt and cash flow in a massive buyback operation, in the process retiring a third of the outstanding shares. While the return on total funds held steady at 17%, the return on shareholders funds doubled to 60%. Corporate profit rose 54% over the period, while earnings per share doubled and the share price went above the targeted \$100. The revenue to top management via the stock incentive scheme was \$50 million dollars” (Bowden 1997). Thus rewarding management manipulation, not exceptional performance, as intended.

Share buybacks in Australia have been very common in recent years. Excess Franking Credits that are not listed as assets in the balance sheet are used as the incentive for low taxed individuals and superannuation companies to sell their shareholding for less than the current share price minus a discount of usually 14%. This results in a capital loss and a tax deduction for the seller. The super funds are taxed at 15% and the tax paid on franking credits is 30%. Thus the super fund gets a rebate of half of the tax paid on the dividend. With fewer shares in the company, even if overall profit stays the same the share price will rise. Research needs to be carried out to determine whether Australian executives have benefited from similar option incentives that operated at Ralston Purina and through the repurchase of shares using Franking Credits.

Employee share ownership plans in Australia were used in the 1990s for very aggressive tax planning. In 1999 in its submission to the ‘Enquiry into employee share ownership in Australia’, the Australian Tax Office (ATO) stated, “The picture that has been built to date is one that indicates that a small, but aggressive segment of the legal, financial planning and accounting professions have moved to exploit government initiatives in relation to employee share ownership, incentives to increase productivity in the work place, and provision for retirement through superannuation” (Nelson 2000). Many family owned companies had acted on the advice of the financial advisors mentioned and introduced ESOPs in to their companies solely because of the promised taxation benefits. Unfortunately for them, the Australian Taxation Department charged Fringe Benefit Tax on the shares or disallowed tax deductibility

on the ESOPs. This ATO ruling negated any taxation benefit on issuing shares to family member employees and in many cases huge tax and legal liabilities resulted. Most of the ESOPs were later disbanded when the Howard government asked the ATO to offer the companies involved an opportunity to go back to the status quo, without imposing heavy fines, providing they paid the taxation due, plus interest.

The primary taxation concessions provided for in the taxation legislation (in 2006) is the tax exempt benefit of up to \$1000 per employee per year (DEWR 2005). Based on 2006 company tax rates this would give employers a tax saving of \$300 per employee, however they would get the same concession if they paid the \$1000 as a bonus or as part of wages. In the employer's case, tax savings in its self does not provide a sufficient motivation to implement an ESOP. Especially when the establishment of an ESOP involves the expense of publishing a formal prospectus, setting up a trust company and the costs associated with the on going administration of the scheme. This could be part of the reason that while general awareness of the ESOP concept among Australian businesses is high, only 4% of all Australian non government businesses had a broad based plan which was open to at least 75% of employees (DEWR 2005).

## **VALUE TO THE EMPLOYERS**

In Australia it would appear that taxation benefits would not be the major reason to commence a ESOPs within a company. Employee motivation, employee rewards, worker participation and changing the organisation culture are more likely to be some of the reasons why employers establish ESOPs (Conte 2005).

Employee share ownership plans are introduced for a variety of reasons. A common goal in introducing an ESOP is to “align employee/employer interests to motivate and retain valued employees ” (Nelson 2000) employee share ownership (ESO) is a human resource strategy or workplace relations strategy that can be used to motivate employees by giving them a stake/share in the company's success (DEWR 2005)

Generally, employers choose to introduce an employee share ownership plan (ESOP) for one or more of the following major reasons (Stradwick 1992):

- to improve organisational competitiveness, productivity and efficiency;
- as a form of employee participation

- as a form of employee reward;
- as a form of defence against takeovers
- as a rescue operation
- to enable employee 'buy outs' or privatise a government business entity.
- to foster the free enterprise system

ESOPs can also be used as a tool to improve employer/employee relations or to foster a cultural change. ESOPs can also be used as part of a remuneration plan as an employee performance incentive component in workplace agreements. In addition, ESOPs may be used as a method of succession planning or employee buy-outs in SMEs (DEWR 2005).

In Australia there does not appear to be any quantitative research studies that effectively measure the improvement of a company's competitive position or its efficiency after the introduction of an ESOP. However, strong anecdotal evidence suggests that there is an improvement in efficiency (Stradwick 1992).

Brian Sheehan (1981) completed a study of Australian companies that operated schemes of financial participation using employee share ownership plans. It is interesting to note that of the following companies studied: W.L.Allen Foundry Co. Pty. Ltd.; C.M.V. Group; Dynavac Pty. Ltd.; Fletcher Jones & Staff Pty. Ltd.; Lend Lease Ltd.; Siddons Industries Ltd.; Walter Reid & Co Ltd.; Waltons Ltd. and Western Hart Ltd. ... only Lend Lease Ltd. and C.M.V. Group survive today.

Data collection and analysis of four United Kingdom bus companies that used ESOPs suggests similar results and that, in the UK at least, employee ownership of the ESOP variety may be a transient phenomenon. In 1994 three of the four companies were sold by their employees to other bus companies, while the fourth underwent a flotation followed by a merger which substantially reduced the employee share (Pendleton 1998).

Extensive research has been conducted in America. Brady in 1995 pointed out that deeper commitment improves companies' possibilities to create sustainable competitive advantage (Brady 1995), whereas others have found that the positive impacts are only short term unless combined with participation (Pugh et al. 2000).

The largest and most significant study to date of the performance of ESOPs in closely held American companies by Douglas Kruse and Joseph Blasi of Rutgers University in 2000,

found that ESOPs increase sales, employment, and sales/employee by about 2.3% to 2.4% per year over what would have been expected without an ESOP. They also found that ESOP companies are also somewhat more likely to still be in business several years later (NCEO 2002). Douglas Kruse, Joseph Blasi and Michael Conte, tracked from 1992 through 1997 the average percentage increase in stock price of all publicly traded companies with a public record of 10% or more employee ownership and more than \$50 million in market value. ESOP companies grew 193%, while the Dow was up 145% and the S&P 500 140% (NCEO 2002). There appears to be a strong correlation between employee 'ownership' and corporate profitability (Hays 1999).

In 1987, the U.S. General Accounting Office (GAO) did a 'before and after' study. The GAO study found that ESOPs had no impact on profits, but that participatively managed employee ownership firms increased their productivity growth rate by 52% per year. In other words, if a company's productivity growth rate were 3.0% per year, it would be 4.5% after an ESOP (NCEO 2002). "It gives people something to be excited about," says Susan H. Marcille, partner in Ernst & Young Human Resources Consulting Group of Atlanta, Georgia. "They're motivated to work harder because they're sharing in the eventual success of the business." (Hays 1999).

It would appear that researchers in America now agree that 'when ownership and participative management are combined, substantial gains result. Ownership alone and participation alone, however, have, at best, spotty or short-lived results' (NCEO 2002).

The Nelson Report (2000) found similar results in their analysis of ESOPs and concluded that "It may be that companies with employee share plans are better performing enterprises, but that firms with such plans tend to exhibit more progressive management practices and a progressive organisational culture. On the whole, this leads to better performing enterprises".(Nelson 2000)

## **VALUE FOR THE EMPLOYEES**

How do employees benefit? From an employees point of view even the words ownership can have many different meanings. Most would be positive, but some employees could be suspicious and see ESOPs as a means of switching hard earned performance gains from cash payments into bogus share schemes. Loren Rodgers (2001) using his Ownership Culture Survey™ (OCS), a survey-based approach to measuring the psychology of ownership. Based

on work with USA employee ownership companies over 15 years, identified five major meanings of ownership for most employees. The findings are:

- Financial Payoff: ownership as a financial benefit--as owners, people expect at some point to receive cash value.
- Participation: owners being included in the decisions that affect their day-to-day work; wanting to have a say over the issues that affect their working conditions.
- Influence: having a part in broader, company-wide decisions. Owners want a degree of influence over strategic issues.
- Community: a bond with their fellow owners; they want to feel that the whole company is "in this together."
- Fairness: being treated fairly by the company; owners want sensible rules and they do not want "special treatment" for specific individuals (Rodgers 2001).

The above meanings with the exception of 'Participation' could be categorised using the Hersberg's 'Motivation Theory' as Hygiene factors and if an effective ESOP was introduced it could act to minimise dissatisfaction, but an ESOP alone would not be a motivator. To employees, the 'Participation' meaning of share ownership is more likely to be the factor that results in employee motivation and higher performance (Hersberg 1968). Thus it is possible that the introduction of a broad ESOP with out combining an employee participation program is unlikely to achieve the outstanding success and benefits sought. Those employees who feel like owners are those with higher relative levels of share ownership and perceptions of participation, and this feeling is significantly related to relatively high levels of commitment and satisfaction with the organization. This approach suggests, therefore, that ownership does make a difference (Pendleton 1998). Participation may also be one of the factors that contribute to the success of Executive ESOPs because unlike the normal employee, executives do participate in the decisions that affect their day-to-day work. A comparison of an employee-owned and a 'conventional' firm found that employee participation was higher in the employee-owned firm, and that, the greater the perceived extent of participation, the higher the level of organizational commitment (Rhodes and Steers 1981).

Employees benefit from employee share ownership plans (ESOPs) in a number of ways. Some of the main benefits include:



- a feeling of 'ownership' of the company –
- a degree of participation in the company and a voice in the business as a shareholder;
- greater job satisfaction through receiving tangible rewards for their performance;
- a tax efficient way of acquiring shares and the opportunity to earn a substantial capital sum.
- increased flexibility and choice when negotiating workplace arrangements;
- a sense of commitment and a stronger relationship with their workplace;

In effect, the average employee who receives shares through an ESOP gets a tax concession on the first \$1000 of shares amounting to about \$300 in actual saving in their pocket. However, full capital gains taxation is applicable at the time of sale on any profit. There is an alternative tax deferred share benefit scheme that will be available if the share plan offered meets certain conditions (Nelson 2000). These conditions are now quite stringent, due to the aggressive tax planning mentioned above.

Perhaps more importantly, employees may also gain a greater understanding of the stock market and factors that influence the performance and prosperity of the business (Nelson 2000). This may appear on the surface that this would foster the free enterprise capitalistic system, but further research would need to be carried out to determine if this was the case.

## **IMPLICATIONS FOR AUSTRALIAN ORGANISATIONS**

The Family Business sector in Australia is extensive, for example. It is the largest form of business ownership in Australia and represents 83% of all business enterprises (Waddell 2005), "the wealth of family and private businesses is estimated at \$3.6 trillion" (Smyrios and Walker 2003). If you take the definition of a Family Business to be: "a business that is governed and/or managed with the intention to shape and pursue the vision of the business held by a dominant coalition that is controlled by members of the same family or a small number of families in a manner that is potentially sustainable across generations of the family or families". (Glassop, Waddell, Ho. 2005)

The success of ESOPs found by Douglas Kruse and Joseph Blasi was in 'closely held' American companies, many of these are what we would term 'Family Businesses'. If the Australian Government's target of 11% of all companies having ESOPs by 2009 is to be achieved (double what it is 2005) then medium to large Family Businesses must play a big role in the establishment of ESOPs in the next three years.

Then one would see that some of our largest companies are indeed Family Businesses. The Murdochs of News Corp., Packers of PBL, Pratts of Visy, Lowrys of Westfield, Harveys of Harvey Norman and Smorgons of Smorgon Industries are just a few of the many Family Businesses that are listed on the Australia Stock Exchange (ASX). The majority of our large private companies such as Tenix Defence Systems owned and managed by the Salteris and Linfox by the Foxs are also family businesses. Australian Democrats ex senators, John Siddons and Sid Spindler also operated ESOPs in their respective larger private family businesses. What most of the above have in common apart from being very tough competitors in their respective industries is: they are nearly all noted for their benevolence. Although many of the above and other family businesses already operate ESOPs in their companies, most Family Businesses, because of a variety of reasons do not.

According to the House of Representatives Inquiry into Employee Share Ownership, “[a] very low number of unlisted companies have employee share plans (data on this is not reliable, but estimates range from negligible, through 3 per cent to about 20 per cent)., the main reasons for employers not putting plans in place are cumbersome administration, cost implications, difficulties with approval and corporate structure not considered to be appropriate” (Nelson 2000)

In the Australian Government’s favour, they are trying to address these issues about the ‘red tape’ costs. However, Family Businesses also have other business issues that the introduction of ESOPs into their businesses may help address. In a 2005 Survey of Family Business Needs study by Linda Glassop, Dianne Waddell and Ho Yuen Ching of Deakin University in conjunction with KPMG and Family Business Australia they discovered that the main three ‘Business Issues’ were; balancing short-term and long-term business decisions, maintaining loyalty of non-family members and the availability of willing and able successors (Glassop, Waddell, Ho. 2005).

Combining ESOPs with employee participation could address the issue of balancing short-term and long-term business decisions, employees would be very interested in short term goals, but more so in working towards their long term security. ESOPs could also be an excellent way to achieve and maintain loyalty of non-family member employees and research suggests that executives are reluctant to join family businesses because of the perception that promotion and benefits will always go to family members, ESOPs may be a way of alleviating this fear. Thus ESOPs may be able to ‘align the interests of the employee with the

employer' and increase the perception by employees that their financial interests coincide with that of their employer (DEWR 2005). When employees gain a financial interest in the company for which they work, this motivates employees to 'think like owners' leading to a conscious choice to actively enhance performance by working longer hours, lower absenteeism, and better productivity (Nelson 2000).

Are ESOPs effective in Australia? Anecdotally yes, but faced with a paucity of qualitative research into ESO schemes in Australian workplaces, particularly in relation to the nature of the link between ESO schemes and enterprise performance, it is very difficult to judge their value or effectiveness. (Barnes, Josev Marshall, Mitchell, Lenne, Ramsay, Rider, 2006)

Quantitative research can be carried out on listed companies using the resources available from the ASX but these must be combined using qualitative research on listed and non- listed family businesses as well as companies using employee participation methods.

## **CONCLUSION**

It would appear that the Australian Government's target of a 175% increase in the amount of employees involved in ESOPs by 2009 is very ambitious, but possible. The public companies with diverse shareholder bases may be receptive to establishing ESOPs, however family controlled public and private companies may resist ESOPs because of the dilution of their shareholding. The costs of establishing and maintaining an ESOP in Australia against the possible benefits to existing shareholders and employees needs to be fully analysed, together with research on what further incentives companies will need to introduce ESOPs. The proposed 'No Tax on Superannuation Benefits after sixty' or better use of Franking Credits may provide the catalyst to pursue ESOPs.

Research also needs to be carried out to determine whether Australian executives have benefited from option incentives based on rises in share prices and they repurchase shares especially using Franking Credits and hedging methods.

The literature on ESOPs strongly suggests that without Employee Participation, employee ownership is likely to be a waste of time and effort. The success of ESOPs in the USA may also be culturally unique to that country and research is needed to assess whether Australians have similar attitudes towards ESOPs.

*When you plunder a countryside, let the spoil be divided amongst your men; when you capture a new territory, cut it up into allotments for the benefit of the soldiery. (Sun Tsu -512 as cited in Clavell 1981))*

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