United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Labor-Management Relations, Committee on Education and Labor, House of Representatives

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EMPLOYEE STOCK OWNERSHIP PLANS

Allocation of Asse[illegible] Selected Plans

GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

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June 5, 1989

The Honorable William L. Clay
Chairman, Subcommittee on Labor-Management Relations
Committee on Education and Labor
House of Representatives

Dear Mr. Chairman:

This report responds to your request regarding Employee Stock Ownership Plans (ESOPS) as employee benefit plans. You asked that we determine (1) how much stock ownership ESOP participants are receiving, (2) what is the value of participants' accounts, and (3) how benefits are allocated among participants. This report expands on information provided to your office on January 12, 1989.

Because of your special interest in ESOPS established after 1984, we focused our analysis on these plans. We reviewed nine ESOPS established in 1985. Only 2 to 3 years of data were available on the operations of these plans. Thus, our analysis does not fully measure the benefits that participants will ultimately receive.

The data obtained on the nine plans showed that:

- ESOP ownership of company stock ranged from 2.2 to 100 percent; five plans owned less than 15 percent and four owned over 50 percent.
- Individual participant account balances ranged from $467 to $38,311.
- All nine plans allocated assets based on participant salaries; one plan gave additional credit for years of service.
- In three plans, the participants with the highest percentage of ESOP assets were company officers who also held company stock that was not in the ESOP. Two plans excluded company officers from participating in the ESOP.

As agreed with your office, we plan to review a sample of ESOPS established between 1979 and 1983 to obtain more complete information on the benefits ESOPS provide over a longer period.

Background

ESOPS are recognized under the Employee Retirement Income Security Act of 1974 (ERISA) as a type of defined contribution plan. The benefits from a defined contribution plan are based on the amount of money accumulated in each participant's account, not on a predetermined

1984, these incentives have been increased by (1) allowing banks and other eligible lending institutions to exclude from their taxable income 50 percent of the interest earned on ESOP loans and (2) allowing companies a deduction from taxable corporate income for dividends paid on stock owned by an ESOP.

Whether ESOPs have accomplished the purposes the Congress intended has been the subject of five GAO reports issued since 1980. (See p. 12.) Previous GAO work found that, in the aggregate, the major benefit of ESOPs to participants appears to be a modest broadening of the base of stock ownership. These reports also showed that, in general, ESOPs have not (1) been used to promote capital formation, (2) improved the productivity or profitability of the sponsoring companies, or (3) led to a high degree of employee control over or participation in corporate management. Our previous work did not examine how stock ownership and plan assets are actually allocated among ESOP participants.

Objectives, Scope, and Methodology

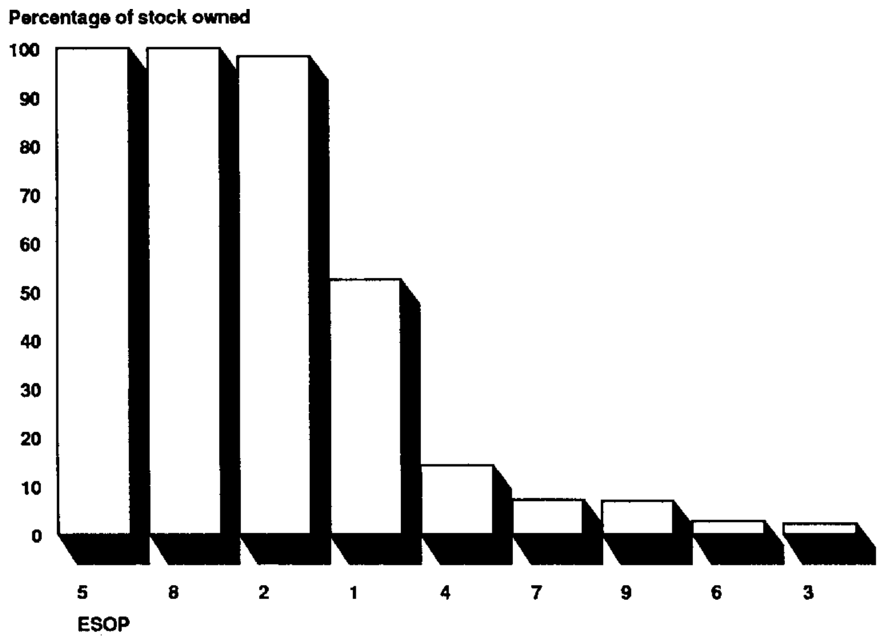
In response to your request regarding ESOPs as employee benefit plans, our objectives were to determine (1) how much stock ownership ESOP participants are receiving, (2) what is the value of participants' accounts,[2] and (3) how benefits are allocated among participants. We reviewed 2 to 3 years' operations of nine leveraged ESOPs established in 1985.

We used ERISA annual reports filed by employee benefit plan trustees to identify plans having "ESOP features".[3] We then surveyed plan sponsors in the four states having the most plans with ESOP features—California, Illinois, New York, and Texas—to identify leveraged ESOPs. We judgmentally selected nine leveraged ESOPs for on-site review. Of the nine, five operated in Texas; four, in California. Six were sponsored by closely held companies, while three were sponsored by publicly traded firms. The number of workers at the nine companies ranged from 10 to 12,352. Participation in the ESOPs ranged from about 32 percent to 100 percent of employees.

[2]Contributions to participants' accounts may be made in cash or employer securities. Any dividends on the stock may be paid in cash to participants or may be used as additional contributions to buy more shares to be added to participants' accounts.

[3]ERISA requires most employee benefit plans to file annual reports with the Internal Revenue Service showing various financial, actuarial, and demographic data. Plans report using the Form 5500 series, Annual Return/Report of Employee Benefit Plan. Before 1988, the Form 5500 asked if the plan had ESOP features; not all plans with ESOP features are ESOPs. Beginning in 1988, the Form 5500 asks if the plan is an ESOP.

Figure 1: Percentage of Company Stock Owned by Nine ESOPs GAO Reviewed



held in a suspense account as collateral for the loan. If the plan is terminated, participants immediately become vested in those assets already allocated; however, they are not entitled to shares of stock held in the suspense account.

The total value of assets allocated to participants' accounts in eight of the nine ESOPS[5] ranged from $24,771 to $2.4 million, with average assets per participant ranging from $467 to $38,311, as shown in table 1. However, because these data are based on only 2 to 3 years of plan operations, they do not fully measure what participants will ultimately receive.

[5]Total asset data on the largest plan were not available at the time of our review.

allocated assets based on participants' annual salaries; one plan gave additional credit for years of service.

To measure how assets are concentrated among ESOP participants, we ranked all participants by salary and divided them into five groups, each containing 20 percent of total participants. The top group consists of the 20 percent of participants with the highest salaries; the bottom group consists of the 20 percent with the lowest salaries. We performed this analysis on seven of the nine plans.[6]

As shown in table 2, in one plan, the top salaried group of participants held 66.7 percent of total assets allocated; in another plan, the top group held 29.4 percent. The differences between the amount of assets held by the top and bottom groups also varied among the plans. For example, in one plan, the 20 percent of participants with the lowest salaries had an average balance of $292, or about 4.4 percent of the asset value of the highest group, which had an average balance of $6,672. In another plan, the lowest salaried group had an average balance of $3,392, or over 41 percent of the value held by the highest group, which had an average balance of $8,222.

Table 2: ESOP Assets Held by Participants When Ranked by Salary[a]

Figures in percent

Participant group	ESOP 1	2	3	4	5	6	7
Top 20%	29.4	40.3	50.0	66.7	34.7	46.0	61.5
Second 20%	21.9	19.6	17.6	14.2	13.4	20.3	16.7
Middle 20%	22.0	16.0	13.2	8.5	26.0	17.8	16.1
Fourth 20%	19.5	14.6	10.7	6.2	11.7	9.4	3.0
Bottom 20%	8.0	9.6	8.5	4.4	14.3	6.6	2.7

[a]Based on data for the most current plan year available: 1987 data for plans 3, 4, and 6; 1986 data for all other plans.

In some plans, a few participants held a relatively large portion of the allocated assets. In four of the seven plans, the top two participants were officers in the company. In three plans, at least one of the officers was also an owner, holding over 5 percent of outstanding company stock in addition to the ESOP allocation. Two officers in one plan were also the principal owners of the company, holding 92.8 percent of outstanding shares of company stock outside the ESOP. Once the ESOP loan is repaid, ESOP participants will hold the remaining 7.2 percent of outstanding

[6]We did not obtain information on participants' salaries from two companies.

Because plan data were based on only 2 to 3 years of plan operations, we were not able to fully measure the stock ownership and income participants will ultimately receive. For this reason, we plan to review a sample of ESOPs established between 1979 and 1983 to obtain more complete information on the benefits ESOPs provide.

Copies of this report will be made available to interested parties on request. The major contributors to this report are listed in appendix I.

Sincerely yours,

for Edward A Densmore

Joseph F. Delfico
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Employee Stock Ownership Plans: Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership (GAO/PEMD-87-8, Dec. 29, 1986).

Employee Stock Ownership Plans: Interim Report on a Survey and Related Economic Trends (GAO/PEMD-86-4BR, Feb. 7, 1986).

Initial Results of a Survey on Employee Stock Ownership Plans and Information on Related Economic Trends (GAO/PEMD-85-11, Sept. 30, 1985).

Employee Stock Ownership Plans: Who Benefits Most in Closely Held Companies? (GAO/HRD-80-88, June 20, 1980).

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company stock. As of plan year 1986, these two officers had been allocated 25.8 percent of ESOP assets. The two plans with assets least highly concentrated among any one group of participants excluded officers from participating in the plans.

Nonvested Assets Forfeited to Remaining Participants

Under ERISA, participants who terminate employment as active workers are entitled to pension fund assets allocated to them only to the extent they are vested in those assets. If participants leave the company before they are fully vested, they forfeit the nonvested portion of their accounts. In defined contribution plans, these forfeited amounts are reallocated to the remaining plan participants. The plans we reviewed had not been in existence long enough for us to determine the impact of vesting schedules and turnover rates on participants' benefits.

Minimum vesting standards in effect at the time of our review included 10-year cliff and 5- to 15-year graded vesting. Using a cliff schedule, participants move from nonvested to fully vested status after a specified length of service. Using a graded schedule, vesting begins after a specified length of service and increases by a fixed percentage each year until full vesting is achieved.

Under the Tax Reform Act of 1986, the Congress changed the rules to require quicker vesting. The new minimum vesting schedules provide 5-year cliff or 3- to 7-year graded vesting. Participants are fully vested after 5 years using the cliff schedule, and after 7 years using the graded schedule. Although the nine plans we reviewed were not required to comply with the shorter vesting requirements until after December 1988, five of them had already adopted vesting provisions that met or exceeded the new requirements at the time of our review. The other four plans required 10 or more years of participation for 100-percent vesting credit.

GAO's ESOP data base from its 1985 surveys showed that about 6 percent of ESOP sponsors granted 100-percent vesting credit at the time an employee became a participant. While none of the nine plans we reviewed provided for immediate vesting, eight did give ESOP participants credit for years of service with the company before the ESOP was established. In one plan, this policy resulted in 33 percent of the participants being fully vested 1 year after the plan was established. In contrast, another plan required that participants remain in the ESOP for 3 years before receiving 30-percent vesting credit; participants became fully vested after 10 years.

Table 1: Total ESOP Assets and Average Assets Per Participant

ESOP	Number of participants	Total assets[a]	Average per participant
1	40	$195,775	$4,894
2	48	664,624	13,846
3	53	24,771	467
4	249	580,761	2,332
5	8	49,118	6,140
6	123	232,977	1,894
7	37	82,080	2,218
8	62	2,375,259	38,311

[a]Based on data for the most current plan year available: 1987 data for plans 3, 4, and 6; 1986 data for all other plans.

The stock held by four of the ESOPs increased in value from the time they were established in 1985 through the end of 1986; one company that went from closely held to publicly traded had a stock appreciation of 457 percent. The value of stock held by two ESOPs was unchanged. The value of stock held by three ESOPs declined, including one where the value dropped almost 50 percent in one year.

The risks associated with ESOPs were demonstrated in the case of one of the plans we reviewed. The company that established this plan was experiencing financial difficulties and was considering either suspending or terminating the ESOP. Company officials told us the stock owned by the ESOP was probably worthless, given the company's poor financial condition. They said they were unable to pay the balance of the loan made by the ESOP to buy the stock, and while the company had not declared bankruptcy, it was struggling to make ends meet.

Allocation of Benefits

Average account balances do not provide a complete picture of the benefits participants are receiving through the ESOP, because employers rarely allocate the same dollar amount to each employee account. Generally, pension benefits are based on employees' salaries; some employers give additional credit for years of service. Using benefit formulas based on salary, higher paid participants will receive a higher percentage of plan assets than lower paid participants.

GAO's ESOP data base from its 1985 surveys showed that over 90 percent of the plans allocated shares of stock based on salaries, or on salaries adjusted for years of service; less than 1 percent allocated an equal number of shares to each participant. All nine of the ESOPs we reviewed

We reviewed pertinent sections of the authorizing plan documents and trust agreements, participant account data, and stock valuation reports and related data for each of the nine ESOPs. In addition, we reviewed the sponsoring companies' annual financial reports for 1984 through 1987, when available. We also met with company officials to obtain their views on ESOPs and discuss plan operations. Our analysis was limited to the benefits provided through ESOPs. We did not consider benefits employees may be receiving through other types of retirement or deferred income plans. Four of the companies we reviewed had plans in addition to the ESOP; two of the nine companies had terminated a defined benefit plan when they established the ESOP.

We supplemented information on the nine plans with data on ESOPs developed from surveys GAO conducted in 1985 of a statistical sample of 1,113 ESOPs established between 1979 and 1983. We also met with ESOP experts and reviewed private sector reports on ESOPs and pertinent legislation and regulations to gain a better understanding of ESOP requirements and operations.

Our fieldwork was performed primarily from January through June 1988, with follow-up work in February 1989. Data presented on benefit levels and allocations cannot be generalized beyond the nine plans we surveyed.

ESOP Stock Ownership and Total Assets

The percentage of company stock owned by the nine ESOPs varied considerably. Ownership of outstanding company stock ranged from 2.2 to 100 percent, with an average of 42.6 percent. Four of the nine ESOPs owned from 52 to 100 percent of outstanding company stock; the other five owned less than 15 percent, as shown in figure 1. In a previous study,[4] we reported that few ESOPs owned a large share of the outstanding stock of their sponsoring corporations.

Because leveraged ESOPs borrow funds to purchase employer securities, participants do not receive stock ownership immediately. Rather, shares of stock are allocated to participants' accounts as the loans are repaid; repayment periods ranged from 1 to 10 years. The sponsoring company must make yearly contributions to the ESOP trust sufficient to cover loan interest and principal payments. The stock purchased with the loan is

[4]Employee Stock Ownership Plans: Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership (GAO/PEMD-87-8, Dec. 29, 1986).

formula as in defined benefit plans. Defined contribution plans place the risk of investment performance of plan assets on the participant, not the employer. ESOPs may present an even greater investment risk to participants than other types of defined contribution plans because plan assets are not diversified. Defined contribution plans, including ESOPs, are generally not restricted from investing in employer securities, but only ESOPs are designed to invest primarily in the securities of the sponsoring company. Defined benefit plans are generally not permitted to acquire or hold employer securities in excess of 10 percent of plan assets.

To help protect participants' pension benefits, the Congress established minimum standards in ERISA for ensuring that (1) employees had an opportunity to become eligible for pension benefits (participation standards), (2) employees did not have to work an unreasonable number of years before having a nonforfeitable right to pension benefits accrued (vesting standards), and (3) pension plans are operated in the best interest of their participants (fiduciary standards). To encourage employers to establish pension and deferred income plans, employer contributions to plans, including contributions to leveraged ESOPs[1] to meet annual principal and interest payments, are generally tax deductible; earnings on contributions held by pension plans are not taxed until they are disbursed in the form of benefits; and employees do not pay taxes on their benefits until they are received. Plans qualifying for these tax savings must meet numerous requirements of the Internal Revenue Code.

Unlike other types of defined contribution plans, ESOPs have multiple purposes. In addition to providing retirement or deferred income to participants, ESOP objectives include (1) improving productivity by giving workers an owner's stake in the success of the company, (2) broadening stock ownership and transferring company ownership to employees, and (3) providing a way to finance company operations or buy out existing owners.

To encourage the establishment of ESOPs, the Congress enacted legislation that exempts ESOPs from some of the requirements ERISA imposes on other defined contribution plans and that gives ESOPs tax incentives greater than those afforded other defined contribution plans. Since

[1]Leveraged ESOPs permit the plan trust to borrow funds to purchase employer securities, usually company stock. The sponsoring company can use the money raised through this stock sale to finance capital formation, pay off loans, or meet other financial obligations. The company makes contributions to the trust sufficient to meet annual principal and interest payments on the loan. The funds used to repay the debt are treated as contributions to an employee plan and are deductible from pretax corporate income.