

## ABSTRACT

### AN EVALUATION OF THE EMPLOYEE SAVINGS PLAN AS AN EQUITY CAPITAL SOURCE

by Frederick G. Davis

The research was directed toward expanding the knowledge of the capital supply sources available to the firm. Equity supply sources traditionally considered are rights issues to existing stockholders and cash issues to the general public. The research focuses on a third source, employee stock-purchase programs. Specifically, the investigation concerned the employee savings plan, the most widely adopted form of stock-purchase plan since its ruling as a qualified deferred compensation program by the Internal Revenue Service in 1951. The problem was to define the characteristics of the savings plan as an equity capital source and to examine the implications of the availability of this new capital source on financial planning.

The research design consisted of three stages: a review of relevant literature, a theoretical inquiry of possible implications on financial planning, and an empirical field investigation of savings plans in operation. The review of literature revealed the problem had not been

adequately identified nor investigated as prior studies had examined the plans exclusively as employee benefit programs and not as possible sources of new equity capital for the company.

The theoretical inquiry was undertaken to provide the basis for the empirical research and was organized into three phases: (1) a summary of existing financial theory applicable to the inflow of funds into a firm; (2) an identification of the unique characteristics of the savings plan as a source of equity capital; and (3) the effects on financial planning that might occur. From this analytical inquiry, several concepts were developed which were envisioned as being present in financial decisions involving new equity financing and which could be tested empirically.

Using all companies on the New York Stock Exchange as a universe, 126 companies were identified that had active savings plans which allowed the plan trustee to purchase the common stock of the sponsoring company during the study period 1962-66. Each company was requested to provide a description of the plan, financial statements of the plan, and to complete a questionnaire. Additionally, interviews were conducted with financial officers of a number of firms having savings plans.

The first major finding for the companies studied was that the funds available through the savings plans could have provided substantially all of the resources

normally obtained through issuing new stock. A comparison of funds available through the plans to actual funds raised during the study period indicated that for the majority of the companies the amount available was greater than that historically obtained by new equity issues.

The second general finding was that during the study period only a few of the financial managers considered their savings plan as a potential source of new equity capital. The majority of the respondents rejected this source because the available funds at any one time were not sufficient when compared to their requirements. Additionally, the extra administrative requirements and the risk of creating unfavorable employee or stockholder relations were considered to outweigh the savings in flotation costs. However, a minority of the respondents considered the savings plan as a superior equity capital source when planning was expanded to incorporate the gradual accumulation of funds. The advantages cited were the predictability of available funds, the easy access, and the absence of initial cost.

In summary, the results of the research imply that an additional equity capital source with certain advantages exists in companies sponsoring savings plans. However, more careful financial planning is required when the equity funds are raised from the savings plans over an extended time period than when obtained in a single, discrete amount through traditional sources.

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AS AN EQUITY CAPITAL SOURCE

By

Frederick G. Davis

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CHAPTER ONE

RESEARCH DESIGN AND ORGANIZATION  
OF THE DISSERTATION

- 1.1 Background
- 1.2 Purpose of the Research
- 1.3 The Problem
- 1.4 Terminology
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- 1.6 Research Design and Organization of the Dissertation
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## CHAPTER ONE

### 1.1 Background

The broad objective of this study was to contribute to the body of knowledge concerning the financial management of the firm. Financial management is involved in three main functions: financial planning and control; raising funds; and investing funds. This research was directed toward the function of raising funds.

The primary source of funds for many firms is through the earnings generated by the operations of the business.<sup>1</sup> In planning for raising and investing funds, the financial manager compares the forecast of funds expected from earnings with the projected outflow. If there is a deficiency, it is necessary to obtain funds from outside the business. The rational financial manager,

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<sup>1</sup>This concept is expressed by Hunt, Williams, and Donaldson as follows: ". . . in a going and profitable concern the primary continuing source of funds is the net cash flow from operations - the cash remaining after all current expenditures have been provided for, including the customary disbursement to the owners in the form of cash dividends. Indeed, many companies operate for years entirely on retained earnings and quite independently of negotiated sources." Pearson Hunt et al, Basic Business Finance (Homewood, Illinois, 1961), p. 345.

attempting to maximize the market value of the company, seeks outside funds guided by the objective to provide the firm with the optimum capital structure at the minimum cost. To accomplish this, the optimum capital structure of a particular firm must be determined and all available sources of capital and their costs must be known. The capital structure and sources and costs of capital are dynamic factors that are constantly changing and must be reevaluated frequently in light of present and predicted firm and market conditions. This research investigated a relatively new source of equity capital which may come under consideration by financial managers seeking outside funds. This new source of equity funds is the sale of stock to the firm's employees through an existing employee benefit program.

The sale of stock to the firm's employees is not in itself a new source of capital as employee stock purchase plans and employee stock option plans have existed for some time and have been utilized to a limited degree to raise new equity funds for the firm. However, due to certain advantageous income tax provisions and other reasons presented in Chapter Two, a new form of employee benefit program has emerged in the last fifteen years. This program goes under many titles such as thrift plan, savings plan, stock bonus plan, stock purchase plan, and even profit sharing plan. Throughout this dissertation

an employee savings plan, as subsequently defined, is implied by the terms "savings plan" and "plan." Substantial amounts of money are now being channeled through these employee savings plans into stock of the sponsoring company.

A brief description of the employee benefit program will clarify how savings plans can be used as a source of capital. The funds utilized by the plans to invest in the company stock come from three sources, all of which are administered by an independent tax-free trust. The first source is the employees' voluntary contributions (an essential characteristic of the savings plan) which are withheld by the employer and periodically turned over to the trustee. The second source of funds is the company contribution to the plan which likewise is paid periodically to the trustee. The company contribution is considered as an expense and usually appears in the financial statements of the firm combined with the more common forms of employee compensation such as salaries and wages. The two contributions, the employees' and the employer's, are invested by the trustee in accordance with the provisions of the plan and the directions of the participants. In most plans at least a part of the funds must be invested in the stock of the contributing company. The various securities purchased are held in trust a minimum period of two years (due to tax regulations) before

the company contributed portion is vested (ownership transferred to the employee). To obtain full tax advantages, the invested funds must remain in the trust until termination of employment by the participating employee. The earnings on the invested funds provide the third source of funds invested in company stock. The earnings are reinvested in the security which produced them. Thus, there is a constant flow of funds into the trust fund from the contributions of the employees and the employer plus periodic funds from cash dividends which must be invested by the trustee in the stock of the company.

In those companies where a savings plan is in operation, a constant, steady, predictable purchaser for the firm's equity securities exists. To utilize this internal market as a source of new equity funds, the company has only to direct that the trustee purchases be made from the company rather than in the open market. Since the administrative costs of the savings plan are considered as expenses of the employee benefit program, no distribution or flotation costs are involved. Therefore, the savings plan provides an external source of equity capital at the same cost of capital as internal equity capital (retained earnings). To protect the employee and to insure an arm's length transaction, the stock is sold to the trustee at current market value.



## 1.2 Purpose of the Research

As described above, the savings plan provides a potential source of equity capital. The primary purpose of this study was to examine the implications of this new equity source on the financial planning of the firm. The research was designed to answer the following questions: Are the funds available through the plans large enough to warrant consideration as a source of capital? Do the plans, as presently designed, allow the trustee to purchase stock from the company? How many firms have utilized the savings plan as a source of capital? What are the advantages of this source and what problems are involved? When a savings plan is not used as an equity capital source how is financial management affected?

## 1.3 The Problem

A widely accepted goal of financial management is to maximize the value of the existing holders of equity interest. To achieve this goal the financial manager must have knowledge of the characteristics of the supply functions of funds available to the firm and the characteristics of the demand functions for funds. The two are interdependent in financial planning, for the supply functions that are open help determine the choice of projects that will receive funds, just as the analysis of the demand for resources affects the decision to select a particular supply source.

This research was directed toward expanding the knowledge of the supply functions available to the financial manager. One of the sources of funds available to the firm is new outside equity capital. This source of capital may be viewed as composed of several supply functions of differing characteristics. The equity supply functions traditionally considered in financial planning are the supply of funds from existing shareholders (right issues) and the supply of funds from new shareholders (open market cash issues). This research introduces and evaluates another source of equity capital which has become significant only in the last fifteen years. This source is the employee incentive plan that encourages the employees to invest in the firm's stock. Specifically, this research is directed toward those employee incentive plans usually referred to as savings plans (see definition in section 1.4).

The sources of supply of funds available to financial managers have been referred to as supply functions. The variables of these supply functions have been called characteristics. The financial manager needs to know the characteristics of each supply function available to him. One of the most important characteristics is the cost of the funds. The financial manager must also have knowledge of the other characteristics of every supply function if the goal of maximizing the shareholders'





wealth is to be achieved. The other characteristics for equity capital supply functions include the amount of resources offered, the time period they will be supplied, the ease of access, and the influences on other supply functions.

The problem then, was to define the characteristics of this new equity capital supply function and to determine how these characteristics could affect financial planning.

#### 1.4 Terminology

A clarification of terminology between similar terms used frequently throughout this dissertation is necessary for complete understanding of the following chapters. The terms are employee stock ownership plans (also called employee stock purchase plans) and employee savings plans. Employee stock ownership plans, as used herein, applies to all plans which meet the following criteria:

1. The plan must cover rank-and-file employees (stock option plans to key employees are excluded).
2. An employee must acquire stock by voluntary commitment of his own funds (excludes stock awards to employees as bonuses or long-service awards).

The employee stock ownership plans include a variety of arrangements whereby the company assists its employees in acquiring company stock. Also included in this definition are those plans which enable the employee to acquire stock

in companies other than his own company, such as the New York Stock Exchange members' monthly investment plans.

The employee savings plan, as used herein, is one type of employee stock ownership plan and is defined as meeting the following criteria:

1. Voluntary employee savings, within a specified range, are made through payroll deductions.
2. Company contributions are primarily a function of the level of employee savings (excludes contributory deferred profit-sharing plans).
3. The combined funds are put into a tax "qualified" employee trust for deferred distribution. This trust is qualified under Section 401 (a) of the Internal Revenue Code of 1954 which allows the company contributions to the plan to be deducted from corporate gross income in the year in which they are made, but these contributions are not taxable income to a participating employee until distributed to him.
4. Company stock and government securities are the predominant form of investment.

These definitions are substantially identical to those used by the National Industrial Conference Board in their research in these areas.<sup>2</sup>

### 1.5 Scope

The research was limited to the analysis of only those employee stock ownership plans defined as employee

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<sup>2</sup>Harlan Fox, "Combining Short and Long Term Employee Savings Plans," Management Record, XXIII, No. 5 (May 1961), p. 4.

savings plans. Other stock ownership plans were excluded for several reasons. First of all, the savings plan appeared to be the type of ownership plan gaining the widest acceptance. Secondly, the savings plan was the easiest type of stock ownership plan to isolate as a separate semi-homogeneous group for purposes of analysis. Finally, since the primary purpose of this research was to examine the implications of these plans as a source of capital, it is important that the flow of funds be such that reasonable predictions can be made of the amounts available. The funds available from profit sharing and stock option types of stock ownership plans are not subject to as constant flow, and thus prediction, as those funds available from the savings plans. The profit sharing and stock option types of stock ownership plans were therefore excluded from the research.

By definition of the problem, the scope of the research was further limited to the funds of the savings plan directed by the trustee into stock of the company in question. The funds invested in government bonds, common stock of other companies, or stock of investment companies were not considered. Likewise, those savings plans where no funds were invested in company stock were excluded.

This study was further limited in scope by avoiding, except as related to the problem as described, the following issues:

1. Attempts to measure the effectiveness of savings plans (or other fringe benefits) in terms of increased production, employee satisfaction, and lower turn-over rate.
2. The effect of using company stock for compensation on employee loyalties and the new concerns introduced by this form of savings with unpredictable future value.
3. The question of business ethics involved through using employee savings plans to perpetuate existing management by placing ownership in the hands of those over which management has direct control and the power of discontinuing employment.
4. The theoretical soundness of the Internal Revenue Code definition of a "qualified" savings plan.

## 1.6 Research Design and Organization of the Dissertation

The research design consisted of three distinct stages: (1) a thorough survey of the literature and previous related research; (2) a theoretical inquiry of possible implications on financial planning; and (3) empirical field investigation of savings plans in operation.

### 1.6.1 Review of Literature and Related Research

Most of the research and literature pertaining to the plans contained little information that could be directly applied to this study because of the relatively recent development of the savings plan. Likewise, the literature and previous research on equity capital sources seldom considered sale of stock to the employees as a source of capital; however, certain information was found to have an indirect bearing and is summarized in Chapter

Two. This information is divided into three sections: history of the savings plan (2.2), the savings plan as an employee benefit (2.3), and a survey of previous studies of savings plans (2.4).

The survey of previous studies was additionally utilized to identify the companies making up the empirical research population. The description of the population and the sources of the names of the companies are presented in Chapter Four (4.2).

#### 1.6.2 Theory

Due to the limited previous research related to this study that could be used as a foundation, and in order to define the areas of investigation for the field work, a theoretical inquiry was prepared. To allow for a systematic analysis, the inquiry was organized into three separate sections which comprise Chapter Three of the dissertation. The first step, presented in section 3.2, was to prepare a theoretical framework from which the impact of any source of capital could be evaluated. This framework or model is a distillation of existing financial theory relating to the financing decisions of the firm.

The second step in the theoretical analysis was to examine the general characteristics of external equity capital and the unique characteristics of new equity

capital acquired through employee savings plans. These characteristics are presented in section 3.3 of Chapter Three.

The final step of the theoretical inquiry was to combine the characteristics of employee savings plans as a capital source into the theoretical framework. The possible effects on financial planning from this combination are presented in section 3.4 of Chapter Three.

This theoretical analysis was presented prior to any interviewing or data gathering by questionnaire. The questionnaire used in the pretest and the early interviews was prepared to examine empirically the possibilities developed in theory.

#### 1.6.3 Empirical Investigation

The review of the literature and related research and the analytical preparation of a theoretical model were undertaken primarily to provide a foundation for an empirical survey of the savings plans that were in operation. From the theoretical inquiry, two broad areas were defined for investigation through analysis of the savings plans and the financial operations of the companies sponsoring these plans. The two areas are entitled phase one and phase two of the field research.

In the theoretical inquiry, the savings plan was envisioned as having certain unique characteristics which were predicted to cause changes in financial planning



when the savings plan was considered as a source of capital. Phase one of the field investigation was conducted to test the existence of the unique characteristics of the savings plan as an equity capital source and to completely describe them. The financial reports of the plans' operations and the plans' descriptions provided the primary information for the analysis. The financial reports and plan descriptions were supplemented by information obtained from filings with the Securities and Exchange Commission and from responses to the questionnaire. A detailed description of the procedures followed to collect the information and the responses obtained are presented in a separate chapter (Four). The analyses conducted and the results obtained in the empirical research directed toward the characteristics of the savings plan as an equity capital source are reported in Chapter Five.

Phase two of the field research involved an investigation into the effects on financial planning caused by the existence of a savings plan as a potential source of capital. The areas of financial planning that were anticipated to be affected were identified in the theoretical inquiry which is described in Chapter Three. The primary sources of information for the investigation into financial planning were the responses to the questionnaires and the interviews conducted. The questionnaire was designed to obtain the desired information without





influencing the responses. Accordingly, the questions posed were broad in nature and did not explicitly identify the areas of financial planning postulated to be affected by the existence of an employee savings plan in the financial environment. The response rate to the questionnaire is presented in Chapter Four and a copy of the questionnaire used is included in an appendix to that chapter. The responses to the questionnaire and the information obtained through interviews, organized as they apply to the anticipated effects on financial planning, are presented in Chapter Six. The final chapter of the dissertation is a summary of the research conducted, the results obtained, and the conclusions that can be drawn.

The following subsections describe the parameters of the empirical research and the sources of information utilized:

(a) Universe: The universe for the empirical study was all corporations listed continuously on the New York Stock Exchange from December 31, 1962 through December 31, 1966. This universe was selected for two reasons. First, corporations listed on the exchange are required to make public certain information on their savings plan to the Securities and Exchange Commission. These filings and annual reports were originally intended as a primary research source; however, for reasons presented subsequently, they were insufficient. Second, previous studies of employee savings

plans could be used to identify the companies in the research universe that had savings plans that qualified for this study. These previous studies also provided some comparative data. Additionally, the information necessary for the measurement of funds available from savings plans was more accessible from public sources for the companies listed on a national stock exchange. The exact procedure followed to identify the companies from this universe to test through the questionnaire is described in Chapter Four (4.2).

(b) Study period: The period of study was the years 1962 through 1966. Every attempt was made to obtain financial statements on the plans composing the research population for this period or that portion of this period for which the plans were in effect. The information for the five years was considered necessary for several reasons. A sufficient time period was necessary to observe how consistent, and thus predictable, the flow of funds was into these plans. Information covering several years was necessary to analyze the growth of the reinvested dividend elements of these funds and the growth in the shares subject to trustee voting. Finally, five years was desirable to smooth the actual sources of funds of the firm which were used as a measurement criterion.

(c) Information from Securities and Exchange Commission filings: The original research design was to obtain all

financial information on the plans in the population through registration statements and required annual reports filed with the Securities and Exchange Commission. The SEC requirements for registration and reporting are presented in Appendix B to Chapter Two. After the research population was defined, considerable time was spent in Washington, D.C. gathering the financial statements of the plans for the study period before this was abandoned as a primary source of the financial information. The SEC filings pertaining to the savings plans were difficult to locate as no listing is maintained by the SEC of this type of registration. At times the required annual reports on the plans were filed with the annual reports on the company operations and at other times they were filed separately. The annual reports that could be located were found to be inadequate for the purposes of this research. The trust operations were frequently reported in total with no separation of funds by investment media, therefore it was impossible to establish exactly the amount of funds invested in company stock. There was no information in the annual reports specifying the source of company stock purchased by the plan trustee, i.e. open market, company held treasury shares, or newly issued shares from the company. Accordingly, inquiry into the sources of company stock purchased for the plans was incorporated as a part of the questionnaire and the companies were requested to



send financial statements on their savings plans for the study period.

The financial information gathered from the SEC filings on seventeen companies was utilized to supplement the responses to the questionnaire where such responses were incomplete. In addition, certain of the SEC information was used for those companies that did not respond to the questionnaire.

(d) Questionnaire: The primary objective of the questionnaire was to determine how this source of capital was involved in the financial planning of the firm. The questionnaire was designed to ascertain which companies had used their savings plan as a capital source, i.e. sold newly issued stock to their plan. For these companies, questions were asked regarding the decision to sell stock to the trustee and the effect these funds had on capital budgeting. For the companies that had not utilized the plans as a capital source, the questionnaire was designed to determine if the company could sell stock to the plan's trustee under the provisions of the plan and if management would use this source if new equity capital were needed. The financial executives of all companies were asked to list the primary advantages and disadvantages of this source of capital. A sample of the questionnaire used is contained in Appendix A of Chapter Four.

A pilot study was made pretesting the questionnaire on ten companies. These companies had been eliminated from the research population because their stock was not traded on the New York Stock Exchange or because the company contribution was based on profits and not on employee savings. The responses (five) were analyzed as projected for the study to determine if the information was complete and if the proposed tests could be performed. In addition, the questionnaire was evaluated through interviews with several treasurers of companies having savings plans. The purpose of the interviews was to determine the clarity of the questions and the ability and willingness of the financial officers to respond. As a result of the pilot study and the interviews, several changes were made in the questionnaire.

(e) Interviews: Two companies known to have used their savings plan as a source of capital were analyzed for the entire life of the plans (over ten years in both cases). Extensive interviews were conducted with several financial executives of each firm. In addition, extensive interviews were conducted with the treasurers of three companies that had not sold newly issued stock to their savings plans. In these interviews all the questions contained in the mail questionnaire were asked and additional areas were discussed. The effect on financial planning of using this source of capital was explored and the problems encountered were examined.

## CHAPTER TWO

### REVIEW OF THE LITERATURE

#### 2.1 Introduction

#### 2.2 History

##### 2.2.1 Employee Ownership of Stock

##### 2.2.2 Fringe Benefits

#### 2.3 The Savings Plan as an Employee Benefit

##### 2.3.1 The Benefits of Having Employee Stockholders

##### 2.3.2 The Thrift Benefit

##### 2.3.3 Disadvantages

#### 2.4 Previous Studies of Savings Plans

##### 2.4.1 Description of Previous Savings Plans

- (a) NICB No. 133-1953
- (b) NICB No. 184-1960
- (c) BTC-1963
- (d) NICB-1965
- (e) NICB No. 206-1966
- (f) BTC-1967

##### 2.4.2 Relevant Findings of Previous Studies

- (a) Participation of eligible employees
- (b) Maximum allowable employee contribution rate
- (c) Company contribution rate
- (d) Investment of contributions
- (e) Forfeitures of company contributions
- (f) Voting of trustee held company stock

#### 2.5 Summary



Appendix II A Internal Revenue Code Provisions

Appendix II B Securities and Exchange Requirements Con-  
cerning Employee Savings Plans

## CHAPTER TWO

### 2.1 Introduction

The employee benefit program, defined as the employee savings plan in Chapter One, is a relatively new benefit sponsored by American companies. Consequently, the literature referring to these plans has been published in recent years and is not very extensive. Most of what has been written about savings plans was prepared considering these plans solely as an employee benefit. Only occasional mention was made of the possibility of these plans having value to the firm as a source of capital.

The purpose of this chapter is to summarize the information in the existing body of literature on savings plans that is relevant to this research. The first section (2.2) describes the historical development in the United States of two areas in personnel administration: (1) the various plans leading to stock ownership by the employees; and (2) the development of supplemental compensation payments (fringe benefits). Due to the unique combination of an employee stock ownership program and a deferred compensation thrift program found in the savings plan, the history of both of these areas contributed to the structure and growing acceptance of these plans.

The second section of this chapter (2.3) is a summary of the major advantages and disadvantages of the employee savings plan as an employee benefit. Since these plans were adopted by companies primarily for reasons of their incentive value for prospective and existing employees, an understanding of this side of the savings plan is a prerequisite to investigating the plans as an equity capital source.

Several rather extensive surveys have been made of the features and operations of the savings plans offered by various companies. These past surveys were directed almost exclusively at describing existing characteristics of the plans. Accordingly, there is little information presented in the studies that can be directly utilized in this research investigating the significance of the plans as an equity capital source. However, certain information has an indirect bearing and this material is presented in section 2.4.

Following this chapter are two appendices containing technical information. Appendix A is a summary of the Internal Revenue Service requirements to qualify a plan for the deferred compensation tax advantages, with appropriate references to the tax law and regulations. The Securities and Exchange requirements pertaining to savings plans utilizing stock of the sponsoring company for investment of funds are explained in Appendix B.



## 2.2 History

The following brief history of the evolution of the employee savings plan will aid in understanding why the plans are such a dynamically growing type of employee benefit and in explaining the current form of the plans. The present status of the plans is the result of the historical development of two separate phenomena in American business: the stock ownership by employees and supplemental compensation programs (fringe benefits). These will be explained in turn to establish how they have affected the acceptance of employee savings plans.

### 2.2.1 Employee Ownership of Stock

The plans offering ownership of stock by companies to their employees have had a cyclical history in the United States.<sup>1</sup> The first plans were established before 1900, but development was slow until after World War I. Between 1919 and 1929 the first great wave of employee stock ownership plans occurred in the United States. The growth of employee ownership plans during this period was the result of many favorable factors. Employees had been encouraged to save during World War I by purchasing Liberty

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<sup>1</sup>The source of this history unless otherwise noted is Bruce Stewart and Walter J. Cooper, Profit Sharing and Stock Ownership for Wage Earners and Executives (New York, 1945). This book also contains surveys of major findings of former studies of employee stock ownership published from 1917 to 1942.



Bonds. With the discontinuance of the sale of Liberty Bonds and a further rise in wage rates and earnings after the war, an increasing number of employees eligible under the plans began to buy stock. About this time, many managers decided that stock ownership was a better incentive vehicle than profit sharing because the rewards were more immediate and a complicated formula, seldom understood by the employees, was not necessary. Also many managers hoped that stock ownership would make trade unionism less attractive to their employees. Post war optimism considered fluctuations of the business cycles a thing of the past and for both employee and employer the climate was favorable for the expansion and development of employee stock ownership plans. Thus, the practice of offering these plans became widespread during this period. One study identified 389 companies with an employee stock purchase program in 1928.<sup>2</sup> The typical plan allowed the employee to contract for a given number of shares, frequently below market price, to be paid for through monthly installments over a year or more. The company rarely contributed toward the price of the stock, but some companies paid employees a bonus for the

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<sup>2</sup>National Industrial Conference Board, Studies in Personnel Policy, No. 206, Employee Stock Purchase Plans (New York, 1967).

retention of stock to prevent them from selling their shares when the price was attractive. The companies wanted to encourage the employees to hold their stock so that they would become more interested in the long range success of the company and not consider the stock a speculative investment to be sold for short term gains.

The contraction in earnings and employment and the decline in the stock market during the depression of the Thirties were disastrous to these plans. At the time wages were being reduced and workers laid off, employees found that their savings were tied up in stock of depleted value and some employees were still obligated to continue payments or forfeit their savings. The magnitude of this decrease in the value of the employees' savings invested in company stock is revealed by a study of prices of stocks held before and after the crash. This study of seventeen common stocks and eighteen preferred stocks sold to employees using an index of median quotations and taking July 1, 1926 as 100, found the median price level had dropped to 15 on July 1, 1932. This study also found that in 1933 of a sample of fifty plans, thirty-one (over sixty percent) had been discontinued or offerings under them postponed.<sup>3</sup>

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<sup>3</sup>Eleanor Davis, Employee Stock Ownership and the Depression (Princeton, New Jersey, 1933), pp. 7-39.



The employees were embittered and the companies offering such plans were embarrassed. Several costly forms of settlement were made by a few companies. The bonuses designed to encourage retention had the effect of inducing employees to retain their holdings during a period of exceptionally high prices only to be forced to sell when prices were exceptionally low. This experience caused most corporate executives to view employee stock ownership plans with disfavor for years.

Following World War II, and especially in the decade of the 1950's, there was a renewed interest in stock purchase plans for all employees. The general economic conditions were favorable and many of the factors that prompted the adoption of the plans during the 1920's were again prevalent. However, the experiences of the depression with these plans forced company managers to design stock purchase plans to protect against a recurrence of the loss of employees' savings. The form of the stock purchase plan defined in this study as the employee savings plan emerged as the most popular type of the new plans because it offered protection for employee savings in several ways.

The first and most obvious protection was the introduction of the company contribution. This contribution to the employee's account, on a partially matching basis, acted as a cushion against falling market prices of the



stock. Since the typical company contribution was fifty percent of the employee's savings, if all funds were invested in stock, the stock would have to fall thirty-three and one-third percent before the employee's own savings would be endangered.

Another feature that improved protection of the employee's savings was the elimination of the subscription practice found in the plans of the 1920's. The 1950 plans were designed so that there was no advanced commitment (subscription) to purchase stock at a fixed price. The stock was purchased only when the funds were actually available, and then most commonly, at the going market price. Many plans required the employee to have a portion of his savings invested in government securities, further protecting his savings from a drop in the stock market. In addition, all savings plans limited the amount the employee could have withheld from his wages as savings, typically a maximum of six percent of base compensation. Finally, a few companies guaranteed that the employee's portion contributed to the plan would not be lost regardless of the level of the stock market prices; employee portions were guaranteed to time of vesting of the company portion or to time of withdrawal. In addition to these safety features, there were several other significant reasons for the growth of the savings plans.

In 1951 the employee savings plan (as defined in Chapter One) first qualified for the deferred compensation tax advantages that the Internal Revenue Code had previously granted to pension and profit sharing plans.<sup>4</sup> The tax advantages of the savings plan will be presented in detail later in this chapter and in the first appendix to this chapter. The essence of this tax provision was that the company contributions to the savings plan could be deducted from corporate gross income for the year in which they were made, but these contributions were not taxable to a participating employee until distributed to him. This favorable tax status encouraged many companies to adopt the savings plan.

In 1955 the United Auto Workers' Union began a concerted drive for a Guaranteed Annual Wage. In actuality, this union proposal was an unemployment compensation plan to be funded by the company to supplement the state and federal plans. The automobile companies countered with a three part program that included: (1) a savings-stock purchase plan in which the companies would put in fifty cents for each dollar saved by the employee; (2) a loan plan; and (3) a separation pay plan. The union turned

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<sup>4</sup>Bankers Trust Company, 1963 Study Savings and Thrift Plans Profit Sharing Plans Stock Purchase Plans (New York, 1963), p. 2.



down the companies' program and settled for the supplemental unemployment plan.<sup>5</sup> Following the 1955 negotiations with the union, the automobile companies made available to their salaried employees a savings-stock purchase program (savings plan) similar in design to that offered to the hourly-rate employees. This pattern was followed by steel and related industries where most savings plans covered only salaried or non-bargaining employees. The plans took the place of supplemental unemployment benefit plans negotiated with hourly employees.

Similarly, in union negotiations in 1958, General Electric and Westinghouse stated that they would oppose any form of supplemental unemployment benefits and in turn, offered savings plans. The unions rejected the savings plans, but the salaried employees of General Electric were given the opportunity to participate in such a plan. After one year, ninety-four percent of the eligible salaried employees were participating.<sup>6</sup>

In summary, the recurring interest in programs to give the employee an opportunity to be an owner in the

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<sup>5</sup>There was much speculation during this time that the workers would have been better off if the company offer had been accepted. For example, see "If Ford Workers Had Bought Stock," U.S. News and World Report, February 3, 1956, p. 97.

<sup>6</sup>"G.E. Savings Plan," Business Week, April 16, 1960, p. 138.



company in which he worked coupled with the tragic experiences of the stock market crash of 1929 gave impetus to the introduction of the savings plan. The tax qualification as a deferred compensation plan and the involvement in collective bargaining added momentum to the number of companies adopting employee savings plans as a form of stock purchase. Concurrent with the growing interest in employee stock ownership plans was the expansion of supplemental wage payments. The growth of the nonwage benefits offered by increasing numbers of employers provided further impetus to the adoption of employee savings plans.

#### 2.2.2 Fringe Benefits

Prior to 1940 there had been little in the way of fringe benefits for general employees beyond paid vacations. During World War II wage controls were imposed which limited wage increases. However, within limits, indirect increases were sanctioned in the form of "fringe adjustments." During this period many companies adopted wage supplements such as paid vacations and holidays, shift differentials, employer financed life insurance, accident insurance, hospitalization, health plans, severance pay plans, and Christmas bonuses. These wage supplements became known generally as "fringe benefits."



The growth of these benefit plans continued in the postwar period, particularly the health and pension plans.<sup>7</sup>

Each of these fringe benefits was designed to protect the employee and his dependents in some specific situation. It was on this foundation of existing benefit programs for specific purposes that the multipurpose savings plan was welcomed as fulfilling a need. The savings plan was seen as a fringe benefit to supplement the other plans that were sharply focused on particular types of emergencies. Because it is impossible to have a plan to meet every type of emergency, the savings plan permitted flexibility by encouraging the employee to build a reserve which could be used for a variety of needs.

The benefit package offered by most companies has been criticized as dictating to the employee how and where he must spend his income. The parental attitude of many companies toward provisions for emergencies has been especially attacked.<sup>8</sup> The individual reserves of self-protection accumulated under the savings plan offered an answer to such criticism.

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<sup>7</sup>United States Department of Labor, Employee Expenditures for Selected Supplementary Renumeration Practices for Production Workers in Manufacturing Industries (Washington, D.C., 1959), p. 1.

<sup>8</sup>Arthur M. Ross, "Do We Have a New Industrial Feudalism?" The American Economic Review, XLVIII No. 5 (Dec. 1958), p. 904.

The existence of the many other fringe benefit programs in most companies offering a savings plan gave stability to these plans as vehicles for the employee to purchase stock. The employee was less likely to have to sacrifice his savings at depressed stock prices to meet some emergency. On the other hand, the fringe benefit aspects of the savings plan complimented the existing specialized benefit package. The development of the many fringe benefits now accepted as part of employee compensation thus accounted in part for the current popularity of the employee savings plan.

From various sources and previous studies it is possible to establish the growth of this special type of stock purchase plan called the savings or thrift plan. In Stewart's study of twenty-seven stock purchase plans in 1945, only two plans were found to contain the one feature that sets the savings plan apart from all other stock purchase plans.<sup>9</sup> This feature is an employer contribution in proportion to the employee's earnings or contributions.

Beginning in 1950, the present form of the savings plan emerged in the petroleum industry. In this industry payrolls were comparatively low compared to overall sales

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<sup>9</sup>Steward and Cooper, p. 72.

and profit and fringe benefits were extensive, therefore the extra amount for a savings plan was comparatively minor.<sup>10</sup> In 1953 the National Conference Board recognized a growing interest in this area by publishing a separate study on savings plans (Studies in Personnel Policy No. 133) as a companion to a study on stock purchase plans (Studies in Personnel Policy No. 132). The study summarized the features of all known savings plans with stock ownership features. Fourteen of the eighteen summarized plans were offered by companies in the petroleum industry.

Since the 1953 studies, approximately ten new savings plans have been adopted each year up to the present in a variety of other businesses. The latest National Industrial Conference Board Study found that by mid-1966, 149 U.S. Corporations with securities listed on the New York Stock Exchange had adopted a savings plan.<sup>11</sup> The prevalence of the plans among the larger corporations may be further illustrated by the fact that in early 1967, of the top 100 industrial corporations as ranked by sales, 42 had savings plans with 11 of the 42 companies adopting plans since 1963.<sup>12</sup> The growth in acceptance of savings

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<sup>10</sup>National Industrial Conference Board, Employee Stock Purchase Plans, p. 48.

<sup>11</sup>Ibid.

<sup>12</sup>Bankers Trust Company, 1967 Study of Employee Savings Plans (New York, 1967), p. 3.



plans is due in part to the unique advantages of the savings plans as an employee benefit. The aspects of these plans as employee benefits are presented in the next section.

### 2.3 The Savings Plan as an Employee Benefit

While the purpose of this research was to examine the employee savings plan as an equity capital source, it must be acknowledged that the primary justification for establishing and continuing the plans was their value as employee incentives. The possible use of the plans as an equity source is mentioned rarely in the literature pertaining to savings plans, and then only as a secondary consideration. The existence of the employee savings plan solely for reasons of its value as an employee benefit does not diminish the potential value of the plan as an equity capital source, even if it is not used by financial managers for this purpose. In fact, all expenses in connection with the savings plan are usually accounted for as compensation costs which means any capital raised by the plans is secured without flotation cost. This absence of initial cost in raising capital is presented in more detail in Chapter Three (section 3.4.2) and Chapter Five (section 5.4). Recognizing that the savings plan was adopted and retained because of its value as an employee incentive, this research would not be complete

without some comment on this aspect. Accordingly, the following is intended to provide background for understanding why firms have turned to this employee benefit in increasing numbers.

The broad objective of all supplementary compensation methods or fringe benefits is to maintain a stable, highly-motivated, productive work force. These indirect incentives help recruit high-caliber people and to convince them that working for a particular company will bring special rewards. The retention of existing employees is increased by these benefits that convince present employees to make a career in the company, rather than to move to some other organization. The economic security provided by the various fringe benefits leads to improvement in general attitudes and job performance.

The employee savings plans further these broad objectives through two distinct characteristics; they encourage the employees to become stockholders and they promote thrift among the employees. These two factors are examined to establish how the company and the employee receive mutual benefit.

The material for the following two sections (2.3.1 and 2.3.2) is a summary of the benefits attributed to employee savings plans by numerous writers in personnel management and industrial relations publications. Each of the alleged favorable effects on employee relations was

mentioned by numerous writers. References, when provided, indicate the source considered as best expressing the concept. When analyzed, the material in the articles must be classified as predominately subjective. Research studies supporting the contentions presented in the following two sections have been limited to surveys of management's and employees' opinions. The following should therefore be considered as the effects on employee relations management hopes to achieve by sponsoring a savings plan. (A limited survey of management's opinion of the areas of employee relations affected was conducted as part of the research for this dissertation and is presented in Chapter Six, section 6.7.2.)

### 2.3.1 The Benefits of Having Employee Stockholders

There are numerous reasons why management desires to create a large group of company stockholders among the work force. The most frequently mentioned reason from the company point of view is to prompt the employee to consider himself a partner in the enterprise and a member of the working team. The employee who identifies more closely with the company and its management is expected to be more interested in the elimination of waste and in increased productivity.<sup>13</sup>

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<sup>13</sup>Adolph Langsner and Herbert G. Zollitsch, Wage and Salary Administration (Cincinnati, Ohio, 1961), p. 630.

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Another reason given for encouraging employee stockholders is the attempt to teach the employees in a tangible and easily understood manner the economic facts of business.<sup>14</sup> The plans expose the employees to the concepts of reward and risk amidst the increasing complications of economic action, corporate reaction, and government regulation. In particular, the ownership of stock helps the employees to understand that the company must earn a profit substantial enough to compensate its stockholders.

The ownership of stock by the employees also provides a form of profit sharing.<sup>15</sup> Being a stockholder allows the employee to participate in the growth and prosperity of the company without the complicated formula found in most profit sharing plans. Having employees own stock not only is expected to produce better employees, but also to create better stockholders. As a group, the employee shareholders should be more interested in the long-run success of the company than the public investors.

From the viewpoint of the employee, the savings plan offers the lower level employee an opportunity to acquire common stock. Many employees watching the rising

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<sup>14</sup>"Most Flexible Fringe Benefits You Can Offer," Business Management, XXVII, No. 5 (Feb. 1965), p. 44.

<sup>15</sup>"The New Fringe: Savings Plans," Business Week Sept. 6, 1958, p. 54.



stock market of the past few years and the record earnings of their companies are showing increased interest in acquiring their company's stock.<sup>16</sup> For the employee, there are several advantages to acquiring this stock through a savings plan instead of through other types of employer-sponsored stock purchase plans or individual purchases. The primary advantage to the employee of acquiring stock through the savings plan is the cushion against the risk of falling stock prices which is provided by the company contributions to the plan. With the company, in effect, paying one third to one half of the price of the stock, and the dividends being reinvested while the stock is in trust, the employee's own investment is protected.

The savings plan also allows the employee to terminate his participation at any time. The employee does not commit himself in advance to purchase a fixed amount of stock in a limited period of time and he need not continue installment payments on stock that has declined below the purchase price. The stock is purchased at current prices out of current contributions on a dollar-cost-averaging basis. By investing the same amount each month, regardless of the short-run fluctuations in the price of the stock, the employee purchases more shares when the price is low

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<sup>16</sup>Harland Fox and Mitchell Meyer, "Employee Stock Purchase Plans," The Conference Board Record, III, No. 9 (Sept. 1966), p. 23.

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and fewer when the price is high. In addition, through volume buying by the trustee, the broker's fees and commissions are lower than those that would ordinarily be paid in comparable individual purchases. If the stock is purchased by the trustee from the company, the broker's fees are completely eliminated.

### 2.3.2 The Thrift Benefit

The thrift benefit of the savings plan is dependent upon the deferred compensation aspects of these plans and the tax shelter given the savings. To a degree, the savings plan extends the advantages of the deferred payment plans and stock options so popular with corporate officers to employees far below the levels at which such plans usually apply.<sup>17</sup> The traditional advantages to the company claimed for deferred stock options apply to some extent for the savings plan. The savings plan, in essence, provides for bonus payments by the company as a reward for establishing a personal savings program rather than a reward for job performance, and in many plans, receipt of this bonus is deferred until termination of employment.

From the company point of view, the thrift aspects of the savings plan provide an attractive supplement to the standard package of benefits to attract and retain

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<sup>17</sup>Harland Fox and Mitchell Meyer, Employee Savings Plans in the United States (New York, 1960), p. 10.

desirable personnel. The plans are geared to the active employee in that the rewards are much more apparent than those of the standard pension plan. The active involvement through the employee's own savings and the periodic reports from the trustee make the employee more cognizant of this benefit than many other more costly programs. The savings plan compliments the basic pension plan by providing funds for the initial adjustment upon retirement to meet rising medical costs and also, where common stock is held, as a hedge against inflation.<sup>18</sup>

For the employee, the savings plan provides a relatively painless method through payroll deductions to accumulate an emergency fund. However, the big advantage to the employee is the favorable tax treatment accorded the plans. This tax treatment is an important, if not the major consideration in favor of adopting the plans. The historic growth of the plans dating from the time the Internal Revenue Service ruled they were qualified deferred payment plans (1951), as presented in the previous section (2.2.1), is ample evidence of the importance of this feature. The basic tax advantages of a "qualified" plan may be summarized as follows:

1. The company contributions to the savings plan

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<sup>18</sup>National Industrial Conference Board, Employee Stock Purchase Plans, p. 8.

are an allowable expense to be deducted from corporate gross income for the year in which the contributions are made.

2. The company contributions to the plan are not taxable to an employee participant until distributed to him.
3. The income of the trust fund is exempt from taxation so that the earnings on securities held in trust are not taxable until distributed to the participant.
4. If all of the holdings in the participant's account are distributed within one taxable year after termination of employment, the excess of the cost of such securities over the participant's contributions are allowed the long-term capital gains treatment. Note, neither the unrealized appreciation (increase in market value) on the securities purchased with the employee's savings nor the unrealized appreciation on the securities purchased with the company contribution are taxed at the time of distribution.
5. If the funds are distributed while the participant is still an employee, the market value of the shares distributed in excess of the market value of the shares purchased with the

participant's own contributions is taxed as ordinary income. Note, not only is the capital gains treatment lost, but the unrealized appreciation on all but that portion purchased with the employee's own savings is taxable.

This deferred compensation treatment provides a shelter for the employee's savings while he is working and defers payment of taxes on a portion of his compensation until he is retired when his income and tax bracket are lower. Furthermore, by electing to receive within one year after retiring the entire amount of securities held in trust, this deferred compensation is subject to long-term capital gains treatment. This treatment means that the total amount from the contributions to the plan by the company and the reinvested dividends are reduced by fifty percent before being taken into taxable income for that year (and further, the marginal tax rate applied to this amount cannot exceed twenty-five percent). The tax consequences of having the funds distributed while still employed strongly encourage the employee to leave the accumulated funds in trust until termination of employment. A more complete explanation of the income tax regulations is presented in Appendix A to this chapter.

### 2.3.3 Disadvantages

The employee savings plan as an employee benefit is not without certain disadvantages. Some companies state



that the plans cost more to maintain than the improvement in morale justifies.<sup>19</sup> The main determinants of the company contribution, and thus, the cost of the savings plan are: the savings rate by the employees (percent of salary withheld), the company contribution rate (percent of employee contributions), and the participation rate of the eligible employees. Obviously, the higher any or all of these rates, the more costly the plan. It should also be noted that fundamental to the cost is the salary levels of the participating employees. In addition, there are certain administrative costs such as trustee fees and other general expenses connected with the operation of the plan that add to the cost. However, these administrative costs are minor when compared to the company contribution. One study that requested companies to estimate the level of administrative costs of employee savings plans found that the median estimate was only 4.3% of the total cost of the plans.<sup>20</sup>

Since the determinants of the company contribution vary considerably among the plans, the costs likewise vary. In a 1960 study, the estimates of annual cost per

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<sup>19</sup>Lawrence Stessin, "Managing Your Manpower," Dun's Review and Modern Industry, LXXIV, No. 3 (Sept. 1959), p. 150.

<sup>20</sup>Fox and Meyer, Employee Savings Plans in the United States, p. 36.

participant by seventy-eight companies replying to a survey ranged from \$25 to \$818, with the median estimate approximately \$167.<sup>21</sup> In another study made in 1966, the estimates of annual cost per participant ranged from \$58 to \$370, with the median somewhat over \$210.<sup>22</sup>

A comparison of the cost of the employee savings plan relative to other benefit plans can be made from cost estimates published by the Chamber of Commerce of the United States. The tabulation below, compiled in 1965 and involving 1,181 companies, shows the average fringe benefit cost as a percent of the total payroll for those companies offering the fringe benefit.<sup>23</sup>

	Of Total Payroll
Pension plan payments	4.4%
Life, health, disability, insurance, etc.	3.0%
Paid rest periods, wash up time, etc.	4.0%
Profit sharing plans	5.5%
Contribution to savings plans	1.6%

These plans are costly, although they are generally considered less costly than profit sharing plans, and the impact on employee relations is difficult to measure.

The predominance of common stock as the investment for the funds of the savings plans has disadvantages as

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<sup>21</sup>Ibid.

<sup>22</sup>National Industrial Conference Board, Employee Stock Purchase Plans, p. 53.

<sup>23</sup>Chamber of Commerce of the United States, Fringe Benefits 1965 (Washington, D.C., 1966), Table 15.

well as advantages. While the long-run trend of stock market prices has been up, thus providing a hedge against inflation, there are short-run fluctuations that appear especially ominous to the neophyte investor. When the stock market takes a down turn, the employees are likely to become disenchanted. The fact that in most plans the only stock held is that of the sponsoring company is seen as a further disadvantage.

First of all, holding only one stock violates the cardinal rule of investing; diversifying to reduce your investment risks. No knowledgable investor desiring to minimize his risk would put all of his savings into the securities of only one company, therefore, why should the company encourage its employees to invest their savings this way? Secondly, the employee is further compounding his risks because both his savings and job are dependent upon the company's success. In spite of all the safeguards previously mentioned, this double jeopardy for the employee is the major disadvantage of the savings plan as an employee benefit, and the reason given most often by corporations for not adopting these plans.<sup>24</sup>

There are also certain administrative problems that accompany employee savings plans. To be fully effective, the plans call for a communications program which can become

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<sup>24</sup>Stessin, p. 150.

elaborate and costly. Most savings plans come under the Welfare and Pension Disclosure Act of 1958 which requires the filing of a plan description and annual reports to the Department of Labor. Most plans also come under the regulations of the Securities and Exchange Commission which considers employee savings plans which allow investment in company stock as if the plan itself was a securities offering. The SEC regulations require a formal registration if: (a) the plans invest in the securities of the employer company to a level exceeding the employer's contribution; or (b) if the employee can direct his own contribution to be invested in the company stock. The SEC requirements for registering employee savings plans and for reporting are covered in more detail in Appendix B to this chapter. Complying with these SEC requirements can be costly and time consuming. The procedure necessary to insure the plan is qualified in accordance with the Internal Revenue Service regulations can also be involved and definitely demand the services of qualified legal counsel. The qualification provisions are presented in Appendix A to this chapter.

To summarize, the savings plan has certain advantages as an employee benefit as well as some disadvantages. The advantages to the company accrue from two aspects of the plans: the ownership of stock by the employee and the accumulation of savings with deferred compensation bonuses. These two aspects are seen to have unique and favorable

effects on employee morale that cannot be obtained from any other benefit program. On the other hand, the exposure of the employee to loss of his savings in a company sponsored investment in company stock is seen as a major disadvantage regardless of the safeguards provided. It appears likely that savings plans will be adopted by increasing numbers of companies, however, for one reason if for no other: they are extremely popular with employees. This is illustrated by the high participation rate of eligible employees. The participation rate and several other relevant characteristics are presented in the following section which examines other studies of employee savings plans.

#### 2.4 Previous Studies of Savings Plans

During the last fifteen years several studies have been made of companies offering savings plans as an employee benefit. The published results of these surveys contain material that is essentially a description of the structure and operations of the plans.

These studies were relevant to this research for several reasons. First of all, from the studies and from correspondence with the personnel responsible for the studies, the names of the companies comprising the population for the empirical research were derived. (The research population is defined in detail in Chapter Four.) Secondly, it was because of certain unique features of the savings

plan that this research into savings plans as a potential source of capital was undertaken. Primarily these features are the investment in the stock of the sponsoring company and the steady flow of funds into the plans which must be periodically invested. Information documented in the past studies such as the percentage of savings plans that allow the funds to be invested in company stock, the employee savings rate allowed, and the company contribution rates required was significant to this research. This research avoided duplicating the areas covered in the past studies, therefore it is especially important to summarize relevant findings of the previous studies.

The savings plan, as defined in this study, came into its present form only after qualifying as deferred compensation for federal tax purposes in 1951. Prior to that date the savings plan was but one of many forms of stock purchase plans offered to employees. The presence of the company contribution in some stock purchase plans was the basic feature that could be said to distinguish the pre-qualified savings plan from other stock purchase plans. Accordingly, all significant research and published studies pertaining to employee savings plans have been accomplished since 1951.

A brief description of each of the studies considered significant will be presented in chronological order by the publication date. The abbreviation given

parenthetically following the formal title of the study will be used in subsequent reference to the study. Following the descriptions, certain findings of these studies will be presented in comparative tables.

#### 2.4.1 Description of Previous Studies

(a) Employee Savings and Investment Plans, 1953, National Industrial Conference Board, Studies in Personnel Policy No. 133 (NICB No. 133-1953).

Since the 1920's the National Industrial Conference Board has published the results of various surveys of companies' practices in stock purchase plans. When a survey of 68 such plans (only 28 active) was published in 1953, the then labeled "savings and investment" plans were excluded.<sup>25</sup> This new type of thrift plan that encouraged employees to save and at the same time retained elements of employee stock ownership, was described in a separate study because of its importance as an apparently new trend. Thus, this report was the first to exclusively cover employee savings plans (which are alternatively entitled thrift plans or savings plans in the report). Although the population of the survey is not revealed in the published report, mention is made of exploring all known sources of information, and that probably there were no more than the

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<sup>25</sup>National Industrial Conference Board, Studies in Personnel Policy, No. 132, Stock Ownership Plans for Workers (New York, 1953).

18 plans reported on that had been adopted. The data for the report were secured from the companies' own published material and through individual contacts with various officials of the companies. The report thoroughly summarizes the mechanics of these 18 plans. In addition to the information from the study presented subsequently in this section in combination with information from other studies, the comments regarding the source of company stock are of interest. This report notes that "the plans provide for purchase of stock either on the open market or through private transactions at not more than market price" (p. 11). Two companies are mentioned by name that allowed the plan to purchase stock directly from the company. However, there is no indication in the report that the savings plan is considered as a source of capital for the company.

(b) Employee Savings Plans in the United States, 1962, National Industrial Conference Board, Studies in Personnel Policy No. 184 (NICB No. 184-1960).

This study of savings plans in effect in 1960 is the most comprehensive and detailed study published to date. The survey encompassed practically all companies on the New York and American Stock Exchanges as well as a sample of 54 large insurance companies and 32 large banks. From this population, 102 companies (one with two plans) were identified as having a qualified employee savings plan and all but 10 of these were listed on the New York Stock Exchange.



No banks or insurance companies were found to have employee savings plans. Most of the data presented in the report was based on the plans of 94 companies, as detailed information was not available on the remaining 8.

The definition of the savings plan in this NICB publication is substantially the same as the definition presented in Chapter One. However, this survey included savings plans that had no provisions for investment in company stock.

The detailed 100 page report on this study makes a careful distinction between three kinds of savings plans: short-term, long-term, and combination plans. The short-term plans (7 in number) are identified as those plans that distribute the funds to the employee during the course of his employment. There is no option to defer receipt until retirement, but all savings and company contributions are automatically distributed at the end of each class year vesting period (most commonly 3 to 5 years). The long-term plans (68) are the true supplemental pension plans with specific provisions designed to discourage the withdrawal of funds by the participants prior to retirement. The combination plans (28) allow the participant the choice of saving under a short-term option whereby he will receive all funds at the end of the class year vesting period or saving under the long-term option whereby all funds will be held until termination of employment.

The choice has to be made at the beginning of the class year in some plans and can be deferred until maturity of the class year in other plans.

This extensive report presents a detailed explanation of all the possible variations to the savings plans and tabulates the number of companies using each, with frequent summaries by type of industry, size of firm, and type of plan (short-term, long-term, and combination). However, there is no information given on the amount of funds returned to the companies by the plans through purchases of newly issued stock. The report does mention that of 65 plans for which information on the source of stock was available, 5 plans had to purchase stock from the company (either newly issued or treasury stock), 8 plans could purchase treasury stock from the company, and in the remaining 36 plans the trustee apparently was not allowed to purchase shares from the company but had to buy stock on the open market (p. 39). Only 4 of this last group definitely stated that purchases of stock could not be made from the company. From this rough tabulation, it would appear that newly issued stock could certainly have been purchased by about one-third of the plans (21 of 65), thus raising new equity capital, and this ratio could have been even higher.

(c) 1963 Study, Savings and Thrift Plans, Profit Savings Plans, and Stock Purchase Plans, 1963, Bankers Trust Company, New York (BTC-1963).

This study made by the Pension Trust Division of Bankers Trust Company was compiled to assist employers in developing new plans. The Bankers Trust administers many employee benefit plans and the survey was used to solicit business. The published report does not disclose how the plans included were selected or the source of the information. The report contains a statistical analysis of the provisions of 103 plans of which 74 are savings plans and 29 are profit sharing plans.

There is no information in the publication on the source of the company stock purchased by the savings plans. However, there are some statistics presented in the report not available in other studies. Based on their experience, the Bankers Trust Company states the profit sharing plans are more costly to the company than the savings plans. From their data they estimate that the average profit sharing plan is designed to cost the employers from 5% to 15% of the compensation of the participating employees, while the average savings plan cost ranges from 1% to 5% of the participants' compensation (p. 7).

The study analyzed the extent employees choose to acquire stock of the sponsoring company when the plan offers other investment options (p. 15). Of 37 plans surveyed, the median percent of participants electing to invest the maximum permitted by the plan in company common

stock was 75%. In the plans (25) where the alternative investment media was limited to a fixed income portfolio, the median percent electing to invest the maximum permissible in common stock was 87% with 11 of the 25 plans above 90%. The indication was that the employees tended to invest the maximum possible in company stock where the option was available. This means that more funds were available for use as a capital source if the company desired to take advantage of this opportunity through the savings plan.

(d) Employee Savings Plan Trends, 1965, article in The Conference Board Record, November 1965, p. 51 (NICB 1965).

This article written by Harland Fox is an effort to up-date the 1960 study (NICB No. 184-1960). The survey, made in January 1965, uncovered 45 new plans adopted since 1960. The article is primarily a comparison of the basic provisions of the savings plans between the 97 plans previously analyzed and the 45 new plans. The findings were that the general outline of the plans was essentially the same in the new plans as in the old.

The population for the survey was the same as the 1960 survey except that all companies on the New York Stock Exchange were included. The previous study had excluded companies in the following non-manufacturing industries: transportation, other than rail and air; contract construction; and service industries. The study found that of the 1,082 United States corporations with securities listed on

this exchange, 130 or 12% had an employee savings plan. The plans were found to be particularly common among listed companies in two industries: petroleum, where 70% (27 of 39) had a plan; and natural gas companies, where 59% (16 of 27) had a plan.

Ninety-four of the companies included in the previous study were asked whether any changes had been made in their plans. The only significant change noted was that 15% of the companies had increased the employee savings rate or the company contribution rate, thereby increasing the cost of the plan.

(e) Employee Stock Purchase Plans, 1966, National Industrial Conference Board, Studies in Personnel Policy No. 206 (NICB No. 206-1966).

This study is an analysis of employee stock purchase plans in operation in the spring of 1966 among companies with securities listed on the New York Stock Exchange as well as large banks and insurance companies. The report covers six different types of stock purchase plans; the employee savings plan is one of these.

This report states that by mid-1966, 149 United States corporations with securities listed on the New York Stock Exchange had a savings plan (an increase of 19 from the previous study one year earlier). However, the study defined stock purchase plans to be only those plans that distributed the company stock to participants while they

were still employees. This requirement eliminated 109 plans that were "long-term" plans designated primarily as supplemental retirement plans or plans that did not allow any employee contributions to be used for the purchase of stock. The remaining forty "short-term" plans plus the plans of two banks and two insurance companies were included in the study.

The following tabulation from the study indicates the prevalence of the various types of stock purchase plans among the listed companies and the median percentage of eligible employees participating in the plans.

<u>Type of Plan</u>	NYSE Companies <u>No.</u>	<u>%</u>	<u>Percent Participating</u>
Monthly Investment Plans (MIP)	72	29	9
Market Purchase Plans	40	15	10
Loan Arrangements	9	4	15
Stock Purchase Option Plans	61	24	30
Company Contribution Plans	29	12	49
Employee Savings Plans	<u>40</u>	<u>16</u>	90
Total	251	100%	

Company contribution plans are similar to savings plans except that they do not utilize a trust, are not qualified, and usually distribute the shares of stock within a year of purchase. If all 149 NYSE listed companies that had savings plans had been included, the savings plans

would have accounted for 41% (149 of 360) of the companies offering stock purchase plans. From this survey it is apparent that when all the savings plans are considered, this type of employee stock ownership plan is the most widely used.

The participation rate reflects the result of bargain purchases of stock on those eligible to join these plans. The Monthly Investment Plan offers no bargain except for having brokerage fees paid by the company. At the other extreme, the savings plans typically match fifty cents for each dollar of employee contribution, which in effect allows the employee to purchase a share of stock for two-thirds of its market price. Company contribution plans typically match twenty or twenty-five cents per employee dollar. The bargain purchases also affect the extent to which participants contribute at the maximum permissible rate, ranging from 5% or less of the participants that contribute at the maximum allowed in MIP plans and market purchase plans to 75% in employee savings plans.

(f) 1967 Study of Employee Savings Plans, Bankers Trust Company, New York (BTC-1967).

This latest report by the Pension Trust Division of Bankers Trust Company is a survey of employee savings plans qualified under Section 401 (a) of the Internal Revenue Code. (See Appendix A for requirements for qualification under this section.) The profit sharing

plans included in the 1963 study (BTC-1963) are not covered in this latest study, indicating the increase in the significance of savings plans. The report omits any reference to the extent of the survey or how it was determined which plans to include, except for the tax qualification. (Note, profit sharing and stock option plans can also qualify under this same section of the code which covers deferred compensation plans.) The report does state that the study is believed to include all the savings plans adopted by large (not defined) corporations in the United States, and also includes the plans of a number of medium-sized and small companies. This publication summarizes the significant provisions of 132 tax qualified savings plans adopted by 128 companies.

One significant feature of the report is a one or two page individual summary of 129 plans with the company identified. The significant provisions summarized on an individual basis include eligibility requirements, employee and company contributions, vesting, voluntary withdrawals, voting, and investment of funds. These data were very useful in defining the population for the empirical survey of the dissertation research by identifying and eliminating those companies whose plans did not include company stock as an investment option and those companies with a plan where the company contribution is based on profit sharing.



Another feature of the report is a comparison of the various characteristics of the plans adopted in the 1963-66 period (42) with the older plans adopted prior to this period (90). The comparison affords a description of the trends that seem to be emerging in the structure of the plans. The trends will be mentioned where appropriate in the following section.

One final publication needs to be mentioned as certain companies in the research population came from this source. This report entitled, Stock Ownership for Employees, published by the New York Stock Exchange in 1961, is primarily a list of companies on the exchange having some type of stock ownership plan. Of the 233 companies identified at that time as having some type of plan leading to employee stock ownership, 114 companies had stock purchase plans, 80 had savings plans, and 39 had profit sharing plans.

This concludes the description of the previous studies concerned with employee savings plans. These studies taken together provide a comprehensive description of the various characteristics of the plans. There is very little information in any of the studies directly identifying the extent the plans are or could be used as capital sources. In the following section a summary of relevant information from these studies is presented in comparative tables.

#### 2.4.2 Relevant Findings of Previous Studies

The information presented in this section relates to the employee savings plan as an equity capital source in one of three areas. The first area is the amount of funds that the plans have available to purchase stock of the company. The amount available depends upon: (a) the participation rate of eligible employees; (b) the employee savings rate; (c) the company contribution rate; and (d) the prevalence of company stock as an investment. The information available from the previous studies on each of these items is presented.

The second area is related to the cost of the plans and therefore, indirectly to the cost of raising capital through the plans. The estimated total cost of the plans has been presented in this chapter in section 2.3.2 (Disadvantages of the Plans as an Employee Benefit). The major element of this cost is the company contribution which is dependent upon the employee savings rate, the company matching rate, and the participation rate. Information on all of these is summarized subsequently. A small element of the cost of savings plans is the administrative costs, largely trustee fees. Almost no information is presented on this in any of the studies. Reducing these costs in some plans are the forfeitures of the company contributions by participants withdrawing prior to the date of vesting.

Information is summarized from the previous studies on the disposition of the forfeitures and the relative size of them.

The final table of data from the past studies is a summary of the voting practices on company stock held by the trustee. The implications on financial planning of who votes the stock are explored in the following chapter.

(a) Participation of eligible employees: The employee responses to the savings plan has been enthusiastic as indicated by the participation rate which was found to be quite high in all of the studies. Table II-1 shows the overall participation rates in five of the studies. The median was slightly higher in the study including only those plans where the employee receives the stock while still an employee (NICB No. 206-1966). The percentage of companies with participation rates greater than 96% appears to be decreasing.

(b) Maximum allowable employee contribution rate: Most savings plans permit the employee to select his savings rate from a permissible range. The allowable rates are usually expressed as a percentage of employee compensation. The selected rate in turn determines the amount the company will contribute, and thus, the total funds available for investment. There is no information in the past studies on the average percent of base compensation saved. However, information is available on the maximum percent of

Table II-1: Employee participation

Percentage of eligible employees participating	NICB No. 133 1953	NICB No. 184 1960	BTC 1963	NICB No. 206 1966	BTC 1967
96-100%	26%	21%	12%	11%	7%
91-95%	13	14	14	39	25
86-90%	13*	19*	25*	7*	12
81-85%	7	18	19	17	20*
76-80%	7	10	14	11	11
71-75%	7	7	6		5
66-70%	7	4	4		5
61-65%	7	2	2	4	2
under 61%	20	5	4	11	13
	—	—	—	—	—
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
Plans for which data available	15	57	49	28	83

\*median

## Source:

See Section 2.4.1 for complete reference to previous studies.

NICB No. 133-1953, p. 10.

NICB No. 184-1960, Table 4, p. 17.

BTC 1963, Table V, p. 5.

NICB No. 206-1966, p. 52.

BTC 1967, Table IV, p. 14.

compensation allowed to be saved that will be matched by company contributions. Table II-2 indicates what percentage of the plans in each study restrict the savings rate from 2% to 10% of compensation.

The median rate is 6% of compensation in all studies except the 1953 study. The companies that allow participants to contribute more than 6% that will be matched with company contributions usually must satisfy the Internal Revenue Service that this does not discriminate in favor of the higher-paid employees. Such discrimination would prevent the plan from qualifying for the deferred compensation tax advantage.

The trend is toward limiting contributions to 6% of compensation. In the last study available, only 12% of the plans adopted in the 1963-66 period permitted employee contributions of over 6%, compared to 31% of the older plans (BTC-1967, p. 16).

It should be noted that there are several variations to limiting employee savings in addition to a maximum percent of compensation. These include variable rates based on length of service, age, and membership time in the plan, as well as dollar limitations. The dollar limitations reduce the permissible contributions of high-paid employees.

(c) Company contribution rate: One of the distinguishing characteristics of a savings plan, as defined in this research, is the method used to determine the company

Table II-2: Maximum employee contribution rate

Percentage of compensation that will be matched by the company	NICB No. 133 1953	NICB No. 184 1960	BTC 1963	NICB 1965	NICB No. 206 1966	BTC 1967
10%	22%	17%	16%	9%	22%	11%
9%		1				
8½%		1			3	(b)
8%		12	16	16	16	12
7½%		4	4			2
6%	11	24 *	25 *	38 *	35 *	34 *
5%	33 *	30	28	25	16	31
4½%				4	5	(c)
4%	17	3	(a)	4	3	7
3%		5	11			2
2½%				2		
2%				2		1
other	17	3				
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
Plans for which data available	18	97	71	45	37	124

(a) less than 5%

(b) 8-8½%

(c) 4-4½%

\* median

## Source:

See Section 2.4.1 for complete reference to previous studies.  
 NICB No. 133-1953, Table 4, p. 8.      NICB 1965, Table 3, p. 54.  
 NICB No. 184-1960, Table 5, p. 19.      NICB No. 206-1966, p. 53.  
 BTC 1963, Table IV, p. 4.      BTC 1967, Table V, p. 18.

contribution. In most plans the company contribution is expressed solely as a percentage of employee contributions. As indicated in Table II-3, the majority of companies match each dollar saved by the participating employees with fifty cents of company money. A less frequent practice is to begin with a base contribution rate and add supplemental contributions based on profits, length of service, or length of participation in the plan.

Although the median matching percentage remains 50%, there appears to be a trend among newer plans to match employee contributions at a rate lower than 50%. Of forty-two plans adopted in the four year period 1963-1966, 33% matched at a rate lower than 50% compared to 26% of ninety plans adopted prior to 1963 (BTC-1967, p. 19). Some of the newer plans do have provisions for supplementing the contributions, as mentioned above. The extent the provisions will affect the matching rate has not been determined nor compared with the older plans.

Based on the data presented in the last three tables, an average savings plan would thus require a company contribution that would amount to 2 and 1/2 percent of the compensation of the eligible employees ( $85\% \times 6\% \times 50\% = 2 \frac{1}{2}\%$ ). The total funds available for investment would be the employee's savings (85% participation times 6% of total compensation, or 5.1% of total compensation) and the company contribution (2 1/2% of compensation for a total of 7.6% of

Table II-3: Company contribution rate

Percentage of employee contributions	NICB #133 <u>1953</u>	NICB #184 <u>1960</u>	BTC <u>1963</u>	NICB <u>1965</u>	NICB #206 <u>1966</u>	BTC <u>1967</u>
over 100%						2%
100%		14%	11%	17%	4%	10
60-75%	8%		1			4
50%	61	63	65	54	70	54
26-49%	8	7	8	15	15	10
25%		14	10	8	11	13
20% or less	15		5	6		5
other	<u>8</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>2</u>
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
Plans for which data available	13	70	74	35	27	132

## Source:

See Section 2.4.1 for complete reference to previous studies.

NICB No. 133-1953, Table 10, p. 9.

NICB No. 184-1960, p. 31.

BTC 1963, Table VIII, p. 8.

NICB 1965, p. 55.

NICB No. 206-1966, p. 52.

BTC 1967.



compensation). However, not all of these funds can be considered as a potential source of capital. Many plans have provisions for investment of the funds in media other than company stock as is indicated in the following summary of past studies.

(d) Investment of contributions: The investment provisions of employee savings plans vary greatly both in number of portfolios that are available and in the degree of choice allowed by the employees. Company stock is the most prevalent investment media for the savings plans funds, as can be observed from Table II-4. Company stock is especially used as the investment for the company's share of contributions to these plans. The company contribution must or can be invested in the company's own stock in eighty to ninety percent of the plans surveyed in all of the studies.

Two of the studies (NICB No. 133-1953 and NICB No. 206-1966) included only those plans that allowed some portion of the funds to be invested in company stock, therefore, the figures for these two studies do not describe the general population of savings plans.

The greater use of company stock as the investment medium for the company contribution than for the employees' savings can be explained in part by the attempt to safeguard the employee's savings by requiring part or all of the funds from this source to be placed in low risk government bonds. A further explanation, presented below, is that where the employee was allowed some choice as to the investment

Table II-4: Investment of contributions

	NICB No. 133 <u>1953</u>	NICB No. 184 <u>1960</u>	ETC <u>1963</u>	NICB <u>1965</u>	NICB No. 206 <u>1966</u>	ETC <u>1967</u>
Investment of Company Contributions						
Company stock only	55%	67%	65%	67%	87%	67%
Company stock and other	4%	22	34	16	13	22
No company stock	<u>0</u> <u>100%</u>	<u>11</u> <u>100%</u>	<u>1</u> <u>100%</u>	<u>17</u> <u>100%</u>	<u>0</u> <u>100%</u>	<u>11</u> <u>100%</u>
Plans for which data available	18	97	74	45	37	132
Investment of Employee Contributions						
Company stock only	28%	15%	14%	20%	24%	14%
Company stock and other	39	60	62	49	38	55
No company stock	<u>33</u> <u>100%</u>	<u>25</u> <u>100%</u>	<u>24</u> <u>100%</u>	<u>31</u> <u>100%</u>	<u>38</u> <u>100%</u>	<u>30</u> <u>100%</u>
Plans for which data available	18	97	74	45	37	132

## Source:

See Section 2.4.1 for complete reference to previous studies.

NICB No. 133-1953, Table 11, p. 10.

NICB No. 184-1960, Table 14, p. 46.

ETC 1963, Table XIII, p. 14.

NICB 1965, p. 56.

NICB No. 206-1966, p. 56.

ETC 1967, Table X, p. 39.

decision, this choice was frequently allowed only for the employees' own savings.

The employee control of investment decisions was analyzed in one study. The tabulation below indicates the number of plans in this study which allowed a participant control over the investment of contributions (NICB No. 184-1960, p. 49).

	<u>Plans</u>
Some employee control	59
Employee controls all contributions	20
Employee controls own savings only	39
Investment predetermined, no employee control	<u>38</u>
Total plans in survey	<u>97</u>

Among the plans that allowed the participant some control over the investment decision, almost two-thirds limit the decision to the employees' own savings. This study further revealed that where a participant could choose between company stock and United States Government securities, the option most preferred (by 80 to 90% of the participants) was the one that would maximize the amount of contributions invested in company stock (NICB No. 184-1960, p. 50).

The trend is toward even greater emphasis on the mandatory investment in company common stock. Of the

newer plans (those adopted 1963-1966), 79% required at least some investment in company stock compared to 62% of the plans adopted prior to 1963 (BTC-1967, p. 38).

The typical plan, as previously described, generating funds to be invested of seven and one-half percent of compensation would require the company's contribution to be invested in company stock. The participant's own savings could be invested in company stock, but could be diverted into other securities at the option of the employee. This completes the summary of information from previous studies that describes the variables that determine the amount of funds available in these plans to purchase company stock.

(e) Forfeitures of company contributions: Due to the vesting requirements of the savings plans and as a result of certain penalties imposed on withdrawals by employed participants, forfeited amounts will accumulate in most plans. The disposition of these forfeitures can affect the amount required to be paid by the company into the plan to fulfill its matching obligation. As indicated by Table II-5, the preponderant practice is to apply the forfeitures to reduce company contributions. Furthermore, the practice of utilizing the forfeitures to reduce company contributions is becoming more prevalent. Of the plans adopted in the 1963-1966 period, 76% of those that had forfeiture provisions applied the forfeitures to reduce

Table II-5: Disposition of forfeitures

	NICB No. 184 1960		BTC 1967	
	Plans	Percent of Total	Plans	Percent of Total
Applied to reduce company contributions	54*	56%	78	60%
Allocated to participants in proportion to current year's contribution			17	13
Allocated to participants in proportion to balance in accounts			25	19
Other methods			2	1
No forfeitures			8	6
Information incomplete	—	—	2	1
Total	<u>97</u>	<u>100%</u>	<u>132</u>	<u>100%</u>

\* No further breakdown in this study reported.

Source:

See Section 2.4.1 for complete reference to previous studies.

NICB No. 184-1960, p. 35.

BTC 1967, Table IX, p. 37.

future company contributions. When compared with only 58% of such plans adopted prior to 1963, the trend toward this practice is indicated.

The treatment of forfeitures as a reduction of the company contribution has two effects on the savings plan as an equity capital source. This practice will reduce the total funds available for investment and more particularly, that portion of the funds most likely to be invested in company stock, the company contributed portion. However, when the costs of the savings plans to the company are considered, utilization of forfeitures to offset company contributions has a favorable effect of lowering the costs.

Frequently in the literature concerning savings plans, including the studies cited in this section, the forfeited funds are estimated to cover the administrative costs of the plan. Only one study (NICB No. 184-1960) asked the companies surveyed to provide estimates of either the forfeitures or the administrative expenses. The results of the replies are presented in Table II-6. The estimates of the forfeitures range from less than 1% to 20% of the company contribution with the median just under 4%. Estimates of administrative expenses range

Table II-6: Size of forfeitures and administrative costs

	<u>Forfeitures as Percentage of Company Contribution</u>		<u>Administrative Costs as Percent of Total Costs</u>	
	<u>Plans</u>	<u>Percent of Total</u>	<u>Plans</u>	<u>Percent of Total</u>
8% and over	6	19%	7	12%
7 - 8	5	16	5	9
6 - 7	1	3	4	7
5 - 6	3	9	9	15
4 - 5	1	3	10 *	17
3 - 4	3 *	9	8	14
2 - 3	1	3	5	9
1 - 2	6	19	4	7
under 1%	6	19	6	10
	—	—	—	—
	<u>32</u>	<u>100%</u>	<u>58</u>	<u>100%</u>

\* median

## Source:

See Section 2.4.1 for complete reference.

NICB No. 184-1960, p. 36.

from less than 1% to 16% of the total cost of the plan with 4.3% the median.<sup>26</sup>

(f) Voting of trustee held company stock: The predominance of the companies own stock as the investment medium of savings plan funds was illustrated in Table II-4. Much of this stock will remain with the trustee until retirement of the participant, in order to capitalize on the tax advantage. Over a period of years it is possible for the savings plan to accumulate significant amounts of company stock and become one of the larger shareholders in the company. Thus, the provisions of the plans for voting the stock held in trust may have important effects on management. Of course once the stock is distributed, the employee automatically gains the right to vote. The possible effects of having employee shareholders are explained in the next chapter.

Table II-7 summarizes the popularity of the various provisions as reported in three past studies. (Note a similar survey of voting provisions contained in the savings plans' descriptions was made as part of the research. The

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<sup>26</sup>Note, a direct comparison is not possible in Table II-6 as the forfeitures are expressed as a percentage of company contributions while the administrative costs are expressed as a percentage of total cost (company contribution plus administrative costs).



Table II-7: Voting of company stock

	Percentage of plans following each practice		
	NICB #133 <u>1953</u>	BTC <u>1963</u>	BTC <u>1967</u>
Employee directs voting of all or substantially all shares	20%	60%	62%
Employee directs voting of all or substantially all vested shares - Trustee votes balance	47	10	15
Trustee directs voting of all shares	33	28	23
Committee directs voting of all shares	-	2	-
	<u>100%</u>	<u>100%</u>	<u>100%</u>
Plans for which data available	15	65	108

## Source:

See Section 2.4.1 for complete reference to previous studies.

NICB No. 133-1953, p. 14.

BTC 1963, Table XV, p. 16.

BTC 1967, Table XI, p. 42.

results of this survey are presented in Chapter Five, section 5.5.2.) Two other studies reported on the voting provisions, but in too limited form to be included in the table. One study (NICB No. 184-1960), found that in forty-six of eighty-two plans (56%), the participant was allowed to vote some or all of the company stock in his account. A later study (NICB No. 206-1966), reported twenty-six of thirty-three plans (79%) allowed the employee to vote the shares purchased with his own savings and could also vote the shares resulting from the company's contribution in sixteen plans. The employee had at least partial proxy control in about three-quarters of the plans covered in Table II-7. The usual procedure was for the employee to receive all the normal proxy material and through a special form he could direct the trustee how to vote eligible shares held for his account. However, the trustee could control a large block of shares if the employee were negligent about his voting instructions. In addition, some plans provided for the trustee to vote all nonvested shares. The trustee could be expected to vote in favor of existing management.

This completes the summary of information reported in previous studies on the employee savings plan that was considered relevant to this research. In summary, the surveys completed prior to this research were largely of a descriptive nature directed toward defining the features offered by the various existing savings plans and tabulating

the predominance of these features. Of interest to this research, investigating the capital generating potential of the plans, are those features that determine the amount of funds ultimately invested in company stock, the treatment of forfeitures, and the provision for voting trustee held stock. The average plan was described by the previous studies as having 85% of the eligible employees participating, allowing up to 6% of their compensation to be withheld as savings, and matched on a 50% basis by company contributions. The company portion of the funds almost always was invested in company stock while the employee portion was more likely to be subject to the option of the employee among various investment media including company stock. The forfeiture of company contributions was found to be relatively insignificant and most often applied to reduce future company contributions. Most of the plans allowed the employee to vote at least a portion of the stock held in trust in his account; however, in many plans the trustee still exercised control over some or all of the stock voted.

## 2.5 Summary

The purpose of summarizing the existing information regarding employee savings plans has been threefold: (1) to provide a historic background for this research; (2) to aid in determining the research population for the empirical

study; and (3) to secure pertinent data for considering the plans as a source of capital to the firm.

Plans enabling employees to acquire stock have had a cyclical history in the United States. The first wave of employee stock ownership plans occurred in the 1920's, but with the depression, these plans fell into disfavor for years. It was not until the decade of the 1950's that economic conditions and other favorable factors promoted renewed interest in reestablishing and improving the plans.

The employee savings plan has emerged as the most popular type of the new stock ownership plans because it offers protection for employees' savings in several ways. The introduction of the company contribution, the elimination of the subscription practice, the limiting of the amount invested, and the provisions of company guarantees against employee loss regardless of the level of the stock market prices are examples of the built-in safety features. Growth of the plans has also been encouraged because of the involvement of companies in collective bargaining and especially because the plans qualify for deferred compensation tax advantages. The expansion of fringe benefits in American business has further promoted the popularity of employee savings plans by aiding employees to accumulate savings to provide for emergencies during active service as well as for supplemental pension benefits after retirement.

As an employee benefit, the savings plan has certain advantages and disadvantages. The ownership of stock by the employee and the accumulation of savings with deferred compensation bonuses have unique and favorable effects on employee morale. A major disadvantage is the employee's risk of loss of savings (regardless of provided safeguards) in a company sponsored investment in company stock; however, the present high participation rate of eligible employees indicates that the plans will continue to be adopted by increasing numbers of companies.

Several studies, primarily outlining the structure and operation of employee savings plans, have been made since 1950. The most comprehensive of these is a survey made in 1962 by the National Industrial Conference Board. As a whole these descriptive studies consider employee savings plans solely as an employee benefit and present little information regarding the plans as having value to the company as an equity capital source. Of indirect bearing to this research, however, these previous studies outline the features that determine the amount of funds ultimately invested in company stock, the treatment of forfeitures, and the provisions for voting trustee held stock. Cumulatively these studies describe the average plan as having an eligible employee participation rate of eighty-five percent with a saving limit of up to six percent of

base compensation and a company contribution rate on a fifty percent matching basis. Most of the company portion of these funds is invested in company stock while the employee portion is subject to option among various investment media including company stock.

## APPENDIX II A

### Internal Revenue Code Provisions

There is little question that the growth of the employee savings plan is due to a large degree to the tax benefits. The purpose of this appendix is to explain these benefits and to present the general requirements a plan must meet to qualify for these benefits. These requirements for qualification have the effect of specifying the structure of the savings plans.

#### Tax Benefits

The primary benefit to the employer is the allowance for contributions under the plan as deductions from gross income (1). To be deductible, the contribution to the employees trust must constitute an ordinary and necessary business expense. This means the contribution, when considered together with all other compensation paid the employee, must not exceed reasonable compensation for services rendered (2). These contributions are deductible in the taxable year when made, provided such year ends within or with a taxable year of trust (3).

The primary benefit to the employee participating in the plan is that he is not taxed on the company contributions to the plan until such time as the accumulated funds or securities purchased with these contributions are distributed to him (4). Upon distribution at the termination of employment, it is possible for the employee to be taxed at capital gains rates rather than ordinary income rates if the entire interest in the trust fund is received in a lump sum within one year of retirement (5).

The tax basis of this distribution is the excess of the cost of the securities over the participant's contributions. The unrealized appreciation (increase in market value) is not taxed at distribution if this distribution occurs at termination of employment, but is taxed when the securities are sold.

Another benefit to the employee is that the income of the trust fund is exempt from taxes. Thus if reinvested, the dividends and interest paid on the securities held in the trust fund escape taxation until distribution (6).

The trust fund must meet certain qualifications and meet certain requisites as to investment instruments; these will be presented subsequently.

There is also a tax benefit to the employee's beneficiaries in case of death. When on the death of a participant in a savings plan and a distribution is made to a designated beneficiary, those shares which are attributable to the company contributions are excluded from the estate of the participant for Federal Estate Tax purposes (7). The beneficiary must be designated in writing and not the participant's estate.

### Qualification Requirements

To be eligible for these tax benefits, the savings plan must achieve and retain the status of a "qualified" plan by fulfilling the relevant provisions of the Internal Revenue Code and Regulations. These rules are numerous, complex, and do not afford the opportunity for a concise summary. The rules presented herein are only the most significant rules.

The primary requirement to become qualified is the establishment of a domestic trust (8). This trust must be set up for the exclusive benefit of the employees or their beneficiaries. The plan must be designed so that it is impossible to divert the trust funds or income thereon for the benefit of anyone other than the employee participants and their beneficiaries (9).

Certain requirements are contained in the statutes concerning the employees the plan must cover in order for the plan to be qualified. Section 401 (a) (3) of the Internal Revenue Code requires that a plan, if it is to qualify, must meet either of the two following coverage requirements.

1. The plan must meet the mathematical test of covering 70% or more of all employees or if 70% of all employees are eligible to participate in the plan, at least 80% of those eligible must elect to participate. In computing this requirement certain categories of employees may be excluded such as seasonal or temporary employees and those who have not been employed for the minimum period required by the plan (10).
2. The plan will benefit the employees in general and will not discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated (11).

For the savings plans, the second of these two requirements is the one under which most plans are qualified. Under this provision, it is possible to qualify a plan designed solely for hourly or salaried employees. In classifying employees to determine eligibility, a plan



without being deemed discriminatory may be limited to employees within a prescribed age group, who have been employed for a stated number of years, or who are in other classifications (12). This concern for discrimination in favor of higher paid employees has resulted in restrictions on the contributions by participants. The contribution requirements must not be so burdensome as to keep out lower paid employees. The general rule is that employee contributions of six percent or less of compensation are not deemed burdensome (13).

In addition to the coverage requirements, there are several other requirements that must be met for a plan to qualify. The more important qualifying requirements are:

1. The plan must be in writing and a copy made available to the employees setting forth all the provisions necessary for qualification (14). This is usually accomplished in the savings plan by a trust agreement and a prospectus describing the plan.
2. All contributions must ultimately be vested to the employees (15). It must be impossible under the provisions of the plan for the employer to divert or recapture his contributions. (Sale of company stock to the plan is not included under this section of the code, but is included under allowable trust investments which is presented later in this appendix.) All funds contributed to the plan must be for the exclusive use of employees or their beneficiaries. Although ultimate vesting to the employees is required, the securities purchased with company funds must not be vested immediately. In order to use a qualified trust fund, it is necessary to require that company-purchased securities cannot be distributed to a participant who is still an employee of the company until the securities have been in the fund at least two years (16).
3. The plan must be permanent to qualify (17). The employer still has the right to amend or terminate the plan at any time; however, it is expected that the plan will be established on a permanent basis.

### Advance Rulings

The employer is not required by the Internal Revenue Code to seek an advance determination that the plan meets the requirements of the Code to be considered "qualified." If no advanced ruling is obtained, the qualified status of the plan will be examined by the Internal Revenue Service

at the time the employer's tax return is audited. If the plan is found not to be qualified at this time, the employer may lose at least one year's deduction. Therefore, most taxpayers take advantage of the advance determination. The Internal Revenue Service will issue advance determination letters, called "approval" letters, as to the qualified status of the plan after receipt of certain information (18).

The information required for obtaining this advance determination letter is basically the same as required in registration of the plan with the SEC. Primarily a complete description of the plan along with copies of the trust agreement and copies of any communication with the employee is required for an appraisal of the compliance with the regulations and rulings determining qualification. Frequently a conference at the local District Director's office is necessary to work out changes to make the plan acceptable. If the local District Director insists on changes the company is unwilling to accept, a procedure is established to appeal to the National Office of the Internal Revenue Service in Washington, D.C.

### Effects of Disqualification

The tax effects of losing the qualified tax status are undesirable, especially in a deferred compensation plan such as the savings plan where the employer's contributions are funded (i.e., irrevocably and permanently set aside so as to be outside the donor's control). The effect, if the employee's rights are not vested (as in a savings plan), is that the employee still incurs no income tax liability until the funds are distributed, but the employer may be forever barred from securing a tax deduction for the contribution (19).

The employer would definitely not receive a deduction at the time of the contribution or when the employee's rights became vested. The law is not clear as to whether the deduction would be allowed when the funds are eventually distributed to the employee or his beneficiaries.

The contribution under a non-exempt plan are deductible when made only if the employee's rights to them are nonforfeitable, that is, not contingent on continuance of employment or other factors (i.e., no period before vesting).

### Trust Investments

The qualified plan must be for the exclusive benefit of the employees or their beneficiaries, as previously noted. This requirement extends to the investment of trust funds as well as other activities of the trust. The specific requirements of the trust investment policy are (20):

1. The cost of the investment must not exceed fair market value at time of purchase.

2. A fair return commensurate with the prevailing rate must be provided.
3. Sufficient liquidity is to be maintained so as to permit distribution in accordance with the plan.
4. The safeguards and diversity that a prudent investor would adhere to are present.

The trust may lose its qualified exempt status if it engages in certain transactions which are prohibited. These prohibited transactions are any transactions in which the trust (21):

1. Lends any part of its income or corpus to the employer without the receipt of adequate security or a reasonable rate of interest;
2. Pays any compensation to the employer in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered;
3. Makes any part of its services available to the employer on a preferential basis;
4. Makes any substantial purchase of securities or any other property from the employer for more than adequate consideration;
5. Sells to the employer any substantial part of its securities or other property for less than adequate consideration;
6. Engages with the employer in any other transaction which results in a substantial diversion of its income.

In view of the requisites of the trust investment policy and the prohibited transactions, the question arises as to whether the stock of the employer can be purchased by the trust without violating these restrictions. If the trust instrument and local law permit investment in the securities of the employer (including stock and bonds), such investments are not deemed inconsistent with the purposes of the trust. The District Director must be notified if trust funds are invested in stock or securities of, or loaned to, the employer, and full disclosure of the reasons for such investment and the conditions under which it is being made (22). Such notification is made as part of the annual information return or an advance determination letter may be requested. The purpose of the notification is to allow the District Director to determine whether the trust serves any other purpose than constituting part of a plan for the exclusive benefit of employees.

The following references use the standard abbreviation found in most tax publications:

IRC - Internal Revenue Code  
 Sec. - Section of law or regulation  
 Regs. Par. - Regulations paragraph  
 Rev. Rul. - Revenue Ruling  
 Rev. Proc. - Revenue Procedure  
 C.B. - Cumulative Bulletin of the Internal Revenue  
 Service

1. Sec. 404, IRC
2. Regs. Par. 1.404 (a)-1(b)
3. Sec. 404 (a)(1), IRC
4. Sec. 402 (a)(1), IRC
5. Sec. 402 (a)(2) and 403 (a)(2), IRC
6. Sec. 501 (a), IRC
7. Sec. 2039 (c), IRC
8. Sec. 401 (a)
9. Sec. 401 (a)(2), IRC
10. Sec. 401 (a)(3)(A), IRC
11. Sec. 401 (a)(4), IRC
12. Sec. 401 (a)(5), IRC
13. Rev. Rul. 61-157, Part 4 (g), 1961-2 C.B. 67
14. Regs. Par. 1.401-1 (a)(2)
15. Sec. 401 (a)(7), IRC
16. Rev. Rul. 54 231, 1954-1 C.B. 150
17. Regs. Par. 1.401-1 (b)(2)
18. Rev. Proc. 67-4 IRC 1967-1
19. Regs. Par. 1.404 (a)-12
20. Commerce Clearing House, 1967 Standard Federal Tax  
Reporter, Paragraph 2605.061
21. Sec. 503 (c), IRC
22. Regs. Par. 1.401-1 (b)(5)(ii)

## APPENDIX II B

### Securities and Exchange Requirements Concerning Employee Savings Plans

Those companies having savings plans to which both the employer and employee contribute and which apply the combined funds to finance newly issued stock are required to file a registration statement with the S.E.C. and to file annual reports on such plans. Those companies required to file such plans are limited to those over which the S.E.C. has jurisdiction and those which meet certain minimum requirements as to the size of the issue (detailed below).

These registrations and annual reports are a matter of public record and can be seen in the public reference room in Washington, D.C. Copies of any specific registration statement can be obtained.

S.E.C. Authority - The Securities and Exchange Commission derives its authority to require registration and periodic reports under the Securities Act of 1933 and The Securities Exchange Act of 1934. The most applicable section is Section 12 of The Securities Exchange Act of 1934. Section 12 (a) makes it unlawful to trade securities on a national exchange unless registered with the S.E.C. Section 12 (b) (1) allows the issuer to file the same registration with both the exchange and the S.E.C. The over-the-counter securities are covered under Section 12 (g) (1) which requires registration by all issuers who are engaged in Interstate Commerce; whose total assets exceed one million dollars and whose equity class securities are held by 500 or more persons. Thus any company whose security is traded on a national exchange or engaged in interstate commerce, subject to the restrictions above, who has an employee savings plan, as described below, must file a registration statement on the plan with the S.E.C.

The issuers of securities registered pursuant to Section 12 are required to file annual reports under Section 13. The form of the annual report and the information required are specified in Section 15 (d).

Requirements for Registration and Reporting of Securities  
Offered to Employees

The basic issue is whether the offering of securities to employees constitutes a 'sale' within the meaning of Section 2 (3) of the Security Act of 1933. The S.E.C. has taken the position that stock purchase plans which contemplate distribution of securities to employees are in themselves securities and must be registered unless exempt. Particularly where the employees have a choice whether to make contributions or not a 'sale' is found within the meaning of Section 2 (3).

The savings plans may be exempt from registering under the following sections of the Security Act of 1933:

- Section 3 (a) (1) - plans continuously in existence since a date prior to July 27, 1933.
- Section 3 (a) (8) - certain types of insured plans.
- Section 3 (a)(11) - plans limited to employees residing in a state in which the issuer is a resident or incorporated and doing business (note, this would apply only if the issuer is also exempt from Section 12 (g) (1) of the 1934 Act described previously).
- Section 3 (b) and Regulation A thereunder - exempts those plans where the maximum employees' contributions do not exceed \$300,000 each year (based on current market price even though the issuer offers securities to its employees at a price below current market price).
- Section 4 (2) - plans offered privately to limited numbers of employees.

The S.E.C. has designated a special form specifically designed for registration under the Securities Act of 1933 of securities to be offered to employees pursuant to certain plans (Form S-8). The instructions of this form state that any issuer required to file reports pursuant to Section 13 or 15 of The Securities Act of 1934 may use this form to register securities offered to its employees pursuant to a stock purchase, savings or similar plan which meets the following conditions:

- (1) Periodic cash payments are made, or periodic payroll deductions are authorized, by participating employees in an amount not to exceed a specified percentage of the employee's compensations or a specified maximum annual amount;

- (2) Contributions are made by the employer in cash, securities of the issuer or other substantial benefits, including the offering of securities at a discount from the market value thereof or the payment of expenses of the plan, in accordance with a specified formula or arrangement;
- (3) Securities purchased with funds of the plan are acquired in amounts which, at the time of the payment of the purchase price, do not exceed the funds deposited or otherwise available for such payment; provided, that such purchases are made periodically, or from time to time upon a reasonably current basis, and at prices not in excess of the current market price at the time of purchase;
- (4) Prior to the time the employee becomes entitled to withdraw all funds or securities allocable to his account, he may withdraw at least that portion of the cash and securities in his account representing his contributions.

This form requires in detail who may participate, contributions, withdrawal, defaults, administration, investment of funds, and certified financial statements. In addition, copies must be included with the registration form of the plan as presently in effect, of the issuer's report to stockholders, and of all written communications intended to be used in connection with the offering.

The SEC has also issued a special accounting release (Accounting Series Release No. 93, July 27, 1962) governing the filing of annual reports pursuant to Section 15 (d) of the Securities and Exchange Act of 1934 relating to employee stock purchases, savings and similar plans. This amendment to Regulation S-X prescribes the form and content of financial statements filed on a new Form 11X. This annual report form requires detail of the plan assets, liabilities, income and changes in plan equity from the beginning to the end of the reporting period.

## CHAPTER THREE

### THEORETICAL MODEL

- 3.1 Introduction
- 3.2 Financial Theory
  - 3.2.1 General
  - 3.2.2 Dividend Variable
  - 3.2.3 External Financing Variable
- 3.3 Characteristics of Employee Savings Plans as an Equity Capital Source
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- 3.4 Possible Influences on the Planning of Financial Managers
  - 3.4.1 Possible Influences on Dividend Policy
    - (a) Return on investment opportunities
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    - (b) Flexibility
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- 3.5 Summary



## CHAPTER THREE

### 3.1 Introduction

The employee savings plan is a potential new source of equity capital for the firm. If the employee savings plan becomes more prevalent as an employee benefit, the availability of the savings plan as an equity source will become more widespread. Certain questions need to be raised when the employee savings plan is considered as an equity source. What effect will the availability of this new equity source have on financial planning? What are the advantages of this capital source? Are there certain disadvantages? How will the dividend policy be affected?

The underlying purpose of this chapter is to investigate these questions. In order to present a systematic analysis, the inquiry is divided into three separate sections. The first is a review of the applicable financial theory and an organization of this theory into a framework from which the impact of any source of capital can be evaluated. This is followed by an examination of the general characteristics of new equity capital and the unique characteristics of new equity capital acquired

through employee savings plans. The last section is an incorporation of these characteristics into the theoretical framework, with detailed explanation of the possible effects.

### 3.2 Financial Theory

#### 3.2.1 General

The term, financial theory, as used herein, refers to the collective body of knowledge useful to managers of individual business enterprises in planning the inflows and outflows of funds. The management of existing assets, frequently included in the area of financial theory and in most elementary finance text books has been excluded from this study as it relates more directly to operational management than to financial planning and is not pertinent to the issue at hand. Financial theory, as has been defined, is involved only when the existing stock of assets is increased or decreased.

Financial theory has not been developed to the point where a complete or a generally accepted theory can be stated. Present financial theory consists of a combination of microeconomics, basic relationships, and general considerations that aid the financial manager as he evaluates alternative flows of funds. In many cases these relationships and considerations are not precisely defined and are often contradictory. The same situation exists to some degree in all theory relating to the business enterprise

where research is complicated by the multiplicity of variables and the intricacy of human behavior.

Financial theory may be divided into three inter-related components: specification of the overall goal of financial management; theory directed toward achieving the goal in those decisions relating to the demand for funds which are concerned with the amount and composition of assets; and theory directed toward achieving the goal in those decisions on the supply of funds which are concerned with the volume and structure of financing.<sup>1</sup> Traditionally, the theory in each of these areas has been presented from a static reference point even while acknowledging the components are interdependent.

The financial theory pertinent to this study relates only to the supply of funds. Therefore, no attempt is made to present a summary of the body of knowledge of financial theory relating to goal determination or planning the outflow of funds. The following analysis is a broad summary of the financial theory that relates to the supply of funds decisions which the firm encounters.

In order to isolate the theory pertinent to this study, the traditional static reference point is taken. Certain variables are taken as given. The estimates and

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<sup>1</sup>These three components are essentially those presented by Ezra Solomon, The Theory of Financial Management (New York, 1963), p. 9.

expectations of variables beyond the firm's control have been accepted as given. These include general economic conditions, industry trends, current and prospective conditions in the capital market, and federal income tax provisions. The estimates of other variables within the firm's control are assumed to have been previously determined and are taken as given for analyzing the financing decisions. These variables include the predicted supply of funds generated from operations, the estimated working capital changes implied from the operating budget resulting in supply of or demand for funds, and the demands for funds as a consequence of the capital budget. The overall goal that has been generally agreed upon in recent literature, and is accepted here, is the maximization of the value of present holders of equity interest as that interest existed at the moment of decision (in this case, the financing decision).<sup>2</sup> Given these variables and guided by this goal, the active decision variables of the financing decision are:<sup>3</sup>

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<sup>2</sup>For a discussion of the goal of financial management see Gordon Donaldson, "Financial Goals: Management vs Stockholders," Harvard Review, XLI, No. 3 (May-June 1963), pp. 116-129.

<sup>3</sup>The two major decision variables are commonly referred to as the financing decision and the dividend decision. For example see James C. Van Horne, Financial Management and Policy (Englewood Cliffs, New Jersey, 1968), Chapter One.

1. The amount of the funds generated internally from operations that should be paid as cash dividends and/or the amount that should be retained.
2. The amount and form of funds to be supplied through external financing.

As mentioned earlier, financial theory has not been developed to the extent where a generally accepted theory can be precisely stated. This is especially true in the evaluation of the sources of supply of funds. Ezra Solomon succinctly states the condition of theory regarding financing decisions as follows: "A unique 'correct' solution for the entire set of financing decisions probably exists but our understanding of the parameters of the very large number of interrelationships involved is still too small to permit the formulation of a truly general solution which has operative meaning."<sup>4</sup> However, the existing body of knowledge in the area of financing decisions does offer significant relationships and factors which can be developed into an overall financing policy for one particular firm.

### 3.2.2 Dividend Variable

There are two major areas of disagreement among financial theorists in attempting to specify optimum firm behavior in the financing decisions. One is the policy

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<sup>4</sup>The Theory of Financial Management, pp. 138-9.

regarding optimum partition of earnings between dividends and retention which is briefly examined in this section. The other is the optimum debt in the capital structure which is presented later in the analysis.

It was not the purpose of this study to contribute to the resolution of the areas of disagreement in financial theory. The purpose of this study was to investigate the possible implications on financial planning of a relatively new source of equity capital regardless of the individual position of the management of a particular firm on the issues of dividend policy or capital structure. Accordingly, this summary of financial theory is an attempt to place existing theory into a framework for the purpose of analysis, without advocating a position on issues of disagreement.

On a strictly theoretical level, the owners should determine the disposition of earnings. The owners made the initial decision to invest their funds in a particular corporation based on an evaluation of earnings potential for the risk involved. The decisions regarding reinvestment of earnings should also be theirs, based on current evaluation of earnings potential and risk, compared to alternative investment opportunities. However, due to the taxation of dividends as ordinary personal income and the reorder costs of investing, the policy concerning distribution of earnings is more efficiently made by management.

From an economic point of view, rational management, acting in the best interests of residual owners, should determine the amount of funds generated by earnings to retain and the residual would be paid out as dividends.<sup>5</sup> The firm would retain and invest the internal funds it generates so long as the expected yields is greater than the existing capitalization rate of earnings for the risk involved. The federal tax provisions on personal income with higher rates on ordinary income (dividends) than on capital gains (retained earnings) strengthens the argument for retaining earnings for internal investment purposes.

Moving from the purely economic point of view into the complex financial environment the financial manager must face, there are new factors to be considered. The collective opinion of investors, as expressed in the value of owners' shares in the security markets, seems to put more value on a stable, liberal dividend payout policy than on a retention policy based on investment opportunities.

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<sup>5</sup>The disagreement over optimum firm policy regarding the retention of earnings comes directly from the controversy over the relative role played by dividends and earnings in determining the value of shares. One school supports the position that dividends are all important. The leading exponent of this view is Myron Gordon as stated in The Investment, Financing, and Valuation of the Corporation (Homewood, Illinois, 1962). The opposite school takes the position that the difference between the two is a mere detail; for example see M. H. Miller and F. Modigliani, "Dividend Policy, Growth, and the Valuation of Shares," Journal of Business, XXXIV (October 1961), pp. 411-33.

The dollar of dividends appears to be valued higher in the market than the dollar of net present worth. Many reasons are advanced for this seemingly irrational behavior, including the informational value of dividends and the desire for a certain return now (even of a lesser amount) rather than an uncertain return in the future. Regardless of the reasons or the rationale, the effect of dividends on the value of the owners' interest must be considered by financial managers. Research indicates that corporate managers do acknowledge this impact of dividends and set a target payout ratio to be gradually adjusted toward as earnings change.<sup>6</sup>

Thus, financial theory supports both determination of earnings to be retained with the residual paid out as dividends and the determination of dividend payout with the residual retained. This quandary must be resolved by the financial manager in light of the demands of the individual firm's situation.

There are several other considerations advanced by financial theory that influence the firm's dividend policy. The stability of earnings must be considered, as a policy of stable dividends for a firm with a cyclical earnings

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<sup>6</sup>John Litner, "Distribution of Incomes of Corporations among Dividends, Retained Earnings, and Taxes," American Economic Review, XLVI (May 1956), pp. 97-103.



record is not only misleading but also difficult to maintain.<sup>7</sup> The previous dividend policy must be considered, as once the dividend rate per share has been established, there is substantial negative market reaction to reducing the dividend.<sup>8</sup> The stage in the life cycle of the firm must be considered.<sup>9</sup> In a new and growing firm, the alternative sources of capital are more likely to be limited and more reliance must be made on internal sources of capital. As the firm matures and becomes better established, the external financing should be easier to obtain and more earnings can be paid-out. Finally, as the firm (and industry) matures, there probably will be fewer investment opportunities of high expected return open to the firm and accordingly, the requirements for funds will be reduced.

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<sup>7</sup>For a discussion of the impact of unstable earnings on dividends see Robert Johnson, Financial Management (Boston, 1964), p. 540.

<sup>8</sup>For an empirical study indicating the emphasis on previous dividend rate see G. C. Thompson and F. J. Walsh, Jr., "Companies Stress Dividend Consistency," Management Record (National Industrial Conference Board, New York), XXV (January 1963), pp. 30-36.

<sup>9</sup>The influence the maturity of the firm has on financing policy is presented in J. F. Weston and E. F. Brigham, Managerial Finance (New York, 1966), p. 407.

Future external equity financing must also be considered.<sup>10</sup> If future sale of stock is contemplated, the financial manager must consider all courses of action, including dividend policy, that will increase the marketability of the stock and also raise the market price per share, thereby reducing the cost of capital.

Finally, the dividend policy will be directly affected by the capital structure policy decided upon. Once the firm is in operation, the primary source of equity capital is usually retained earnings. Therefore, the degree of leverage desired by the company and the volume of funds committed by the firm will affect the dividend policy. These considerations on capital structure are analyzed in the following section.

### 3.2.3 External Financing Variable

The active decision variable of external financing has two dimensions, amount and form, whereas the internal financing variable contains only amount, the form being retained earnings. The basic goal of maximizing the value of existing holders of equity interest, when applied to the external financing variable produces the companion goal of minimizing the combined cost of capital to the firm.

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<sup>10</sup>The argument for considering future equity financing and the theoretical conflict involved is well stated in Stephen Archer and Charles A. D'Ambrosio, Business Finance: Theory and Management (New York, 1966), p. 391.

The concept of an optimum capital structure, i.e. the amount of the firm to be financed by debt and the amount to be financed by equity, is implicit in the goal of minimizing the cost of capital. This concept can be traced directly to the traditional microeconomic analysis where it is assumed the rational firm strives for a least-cost combination of sources of capital.<sup>11</sup> However, while this economic concept of optimum capital structure is undisputed, the pragmatic implication is difficult for two reasons. First of all, there is no general agreement among financial theorists as to the degree of debt in the capital structure that is optimum. Secondly, the risk aversion behavior of management, as well as that of owners, influences the planning for the desired capital structure. It is not the purpose of this study to present the theoretical arguments of whether the use of debt in the capital structure will decrease the cost of capital (or increase the value of the firm).<sup>12</sup> At any rate, there does seem to be general agreement that when the income tax effect is considered, debt capital is less costly than equity capital, up to some point, and that some use of debt in the capital structure will reduce the overall cost of capital. For purposes of

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<sup>11</sup>Archer and D'Ambrosio, p. 248.

<sup>12</sup>For a summary of the different points of view see Solomon, Chapters 8 and 9.

this analysis, it is assumed that managers of an individual firm will decide on an optimum capital structure, probably a range of allowable debt to equity, and will attempt to make the financing decisions compatible with the parameters established by this policy and the other considerations presented below.

In addition to the goal of minimizing the cost of capital, several other considerations enter in the financing decision. In each of these considerations the basic question is whether debt or equity financing should be used and if debt, to what degree. The financial manager must consider future financial decisions and therefore desires flexibility.<sup>13</sup> Each source of capital should be used judiciously so that the firm does not overuse a capital source to the extent further financing from each source is unavailable or only available at exorbitant costs. The financial planning should also include the possibility of future complete or partial withdrawal from past capital obligations, i.e. retirement of certain debt issues or shrinkage of the equity base through purchase and retirement of stock. The financial manager should also seek to avoid or minimize the restrictions imposed by certain debt instruments.

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<sup>13</sup>For example see Willis J. Winn and Arleigh Hess, Jr., "The Value of the Call Privilege," Journal of Finance, XIV (May 1959), pp. 182-95.

Closely related to the flexibility consideration is the consideration of timing.<sup>14</sup> The timing of new capital should be considered from two aspects, the minimizing of the cost of capital and the projected date and period over which the funds will be required. Although the capital markets are taken as given for this analysis, the financial manager should anticipate changes in the capital market and estimate how these changes will affect the particular firm's cost of capital. A temporary deviation from the desired long-run capital structure may be warranted to take advantage of market conditions with adjustment back to the desired structure later.

In addition to timing to minimize the cost of capital, the receipt of the funds should be timed to coincide with the need for the funds. This phase of timing involves not only the desired starting date and total funds required, but also the amount and timing of budgeted expenditures over the entire period of utilization. The considerations of timing the financing to minimize the cost of capital and also to provide the funds as needed may be in conflict and a compromise between these two aspects will be necessary.

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<sup>14</sup>Solomon, p. 150.

The financial manager should also consider the effect of the financing on the control of the business enterprise.<sup>15</sup> Unless raised by a rights issue, new equity financing results in a dilution of control of the existing owners. While the control consideration is not as important in the larger widely-held corporations, it still is a factor that must be considered in some degree by all managers.

The risk involved in utilizing debt financing has been implied in the discourse on selection of an optimum capital structure; however, some comments on explicit risk consideration are in order. The investor in corporate stock incurs two types of risk. The first risk is that the company will fail and the total funds invested will be lost. The probability of this risk occurring in most large corporations is small. The second type of risk is the uncertainty of the return on the funds invested. This risk is present in varying degrees in all investments in corporate stock. The use of debt increases both types of risk.<sup>16</sup> There is the risk that the firm may not be able to meet the

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<sup>15</sup>For a thorough discussion of dilution of control see Pearson Hunt, Financial Analysis in Capital Budgeting (Harvard University, 1964), p. 70.

<sup>16</sup>Johnson, p. 150.

fixed payments over the life of the issue (the interest payments) or may not be able to meet the payment of principle at the maturity of the issue. A default on either could result in bankruptcy of the firm. The fixed nature of the cost of debt increases the second type of risk, variability of return. If earnings fall, the earnings remaining after the fixed debt payments will fall by a greater proportion. Conversely, if earnings are increased, the owners' portion remaining after the fixed debt payments will increase at a faster rate. The financial manager should evaluate the rewards for using debt financing against the risk involved, from the owners' point of interest and the owners' risk preference.

Ideally, the financial manager is making corporate decisions guided by the owners' interest; however, the influence of management's own risk preferences (or aversions) is great in debt financing decisions.<sup>17</sup> In the environment of absentee ownership found in most large corporations, the professional manager will undoubtedly weigh carefully the effect of additional risk on his future. The rewards to the professional manager for the risk undertaken are much smaller than the rewards to the owners. This remains so, in spite of stock options and performance bonuses, so long as the bulk of compensation for the professional manager

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<sup>17</sup>Joel Dean, Capital Budgeting (Columbia University, 1951), p. 54.

is salary. Furthermore, the consequences of an unfavorable outcome are much greater for the manager than the owner. The manager stands to lose his lucrative position and possibly his reputation as a competent manager.

One final consideration in financing decisions is the order cost of the new capital.<sup>18</sup> In most studies concerning the cost of capital, the cost in reference is the continuing cost, i.e. interest on debt financing and dividends or earnings for equity financing. The financial manager must also be concerned with the initial ordering cost of the capital. This ordering cost or flotation cost is the difference between the funds given up by the investor for the security involved and the proceeds to the firm (net of flotation expenses paid directly by the firm). These initial costs are deducted from the proceeds that are compared to the continuing costs to determine the rate of "cost of capital." Many ordering costs are relatively fixed per issue offering, i.e. not variable with the size of the issue, forcing the financial planner to consider only large, discrete flotations. The option of small additions to long-term debt or new equity is normally ruled out as economically not feasible. The fact that retained

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<sup>18</sup>For a summary of the role of order costs see Harold W. Stevenson, Common Stock Financing, Michigan Business Reports, Number 29, University of Michigan (Ann Arbor, 1957).



earnings are available without any order costs makes this source of equity funds much more attractive than new external equity capital.

#### 3.2.4 The Framework

The framework of financial theory concerning the financing decisions of a firm may be summarized by analogy to a linear programming model. Only a descriptive model can be presented due to the inability to quantify the relationships (considerations).

The "pay-off" is the increase in value of the owners' interest. This may be expressed as minimizing the cost of capital. Thus, the "objective function" is to minimize the cost of capital through the active variables of dividend policy and external financing policy.

Each of these active variables is constrained by certain considerations. For the dividend policy variable these considerations are: (a) return on investment opportunities; (b) market interpretation of dividend policy; (c) desired capital structure; (d) stability of earnings; (e) previous dividend policy; (f) life cycle of the firm; and (g) planned future equity financing.

The external policy variable is constrained by the following considerations: (a) desired capital structure; (b) flexibility; (c) timing; (d) control; (e) risk; and (f) order costs.

This descriptive model is utilized in the third section of this chapter to analyze how these considerations in the planning of the financing decisions are affected by the introduction of employee savings plans as an equity capital source.

### 3.3 Characteristics of Employee Savings Plans as an Equity Capital Source

In order to evaluate the impact on financial planning of this relatively new capital source, it is first necessary to specify the characteristics of equity capital from employee savings plans. The characteristics are presented in two phases: (1) the characteristics of all new equity capital that apply to equity capital from employee savings plans, and (2) the characteristics that are unique to equity capital from employee savings plans. The following presentation of equity capital refers to new equity capital, not to retained earnings.

#### 3.3.1 General Characteristics

Equity capital is the most costly, both in initial order cost and continuing cost, of all capital sources. Studies of flotation costs of new debt and equity issues indicate that equity order costs are invariably higher.<sup>19</sup>

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<sup>19</sup>For example, Securities and Exchange Commission, Cost of Flotation of Corporate Securities 1951-55, (Washington, D.C., 1957).

The continuing cost of equity capital is usually measured by the ratio of expected annual earnings to the net proceeds from the new issue. This cost will always be higher than the continuing cost of debt (interest) for a firm operating in the optimum capital structure range. The deductibility of interest from operating income to be taxed, in effect reduces the continuing cost of debt capital by almost one-half. No such tax reduction can be applied to the cost of equity capital.

Equity capital has no maturity, and once introduced into the capital structure is relatively permanent. While situations have existed where firms reduced their equity capital base, in the usual case the new equity issue is frozen into the capital structure, effectively increasing the volume of funds committed to the business enterprise. In other words, the financial manager would rarely depart from the desired long-run capital structure to incur additional equity capital with the idea of replacing it later with debt.

The protection of owners' interest has more connotations for equity financing than for debt financing. The financial manager must consider the possibility of the dilution of the existing owners' interest that new equity shares may have. Four types of dilution must be

considered.<sup>20</sup> (1) Dilution of control (voting power) will occur unless the new equity capital is raised through a rights issue to existing shareholders. (2) Dilution of book or asset value can occur if the price at which the new shares are sold is less than the existing book-value per share. (3) The most important consideration is dilution of earnings and the dilution of growth of earnings. Unless the return to be realized from the funds raised by the new equity issue is at least as great as the ratio of expected annual earnings before the new financing divided by the current market price, there will be a dilution of earnings to the existing owners. Furthermore, the rate of growth on the new earnings must also be at least as great as the projected growth of earnings on existing equity or there will be a dilution of future earnings of existing owners. If either or both the return or rate of growth of that return are less, then dilution of earnings will occur. (4) Finally, the financial manager must consider the possibility of dilution of the market price of equity shares. This will depend on the market evaluation of the possibility of one of the other dilutions occurring as well as the form, size, and announced purpose of the new issue.

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<sup>20</sup>The types of dilution were suggested by Phillip Hubbard in "The Many Aspects of Dilution," Financial Analysts Journal (May-June 1963), pp. 33-40.

These general characteristics of high cost, permanence, and potential dilution have a combined effect of relegating the use of traditional new equity financing to the last source of funds utilized. A firm with an established capital structure (debt-equity ratio) in the optimum range raises funds by steady plowback of earnings, commensurate with the established dividend policy and sequential debt issues to keep within the optimum capital structure range. Should the firm's anticipated rate of return, growth, and need for funds suddenly accelerate and neither the dividend policy nor the capital structure is considered alterable, equity financing will then be justified.

### 3.3.2 Unique Characteristics

To insure complete understanding of how employee savings plans can function as an equity capital source, a brief summary of the mechanics of the plans follows. The participating employee authorizes the firm to withhold a portion of his compensation to be added to his savings account. This withholding is matched on a partial basis by a firm contribution to the employee's account. The funds from the employee's earnings withheld and the firm's contribution are sent to an independent trustee. The plan's trustee purchases stock of the contributing firm periodically for the participating employee's account. The arrangement for the trustee purchase of shares of stock from the

contributing firm falls into three groups, labeled A, B, C, for purposes of discussion. Under all of these arrangements the company furnished stock may be newly-issued or treasury stock.

Plan Type A - The most common arrangement found in plans currently in operation is to allow the trustee to purchase the firm's stock either on the open market or from the company (at existing market prices). The only difference in net price between these two purchases would be the brokerage fees paid to a broker on the open market purchases. In most type A plans, the brokerage fees are added to the market price to determine the number of shares credited to each individual employee's account for the funds invested (in a few plans the company pays the brokerage fees). The trustee would therefore purchase from the company whenever possible to save the brokerage fees. The firm could control the amount of equity financing under this arrangement by indicating to the trustee the number of shares it will make available.

Plan Type B - A less common arrangement found in employee savings plans is for the company contribution to be in shares of stock. The contracted company contribution (a percentage of the employee's savings) determines the company cash equivalent to be transferred to the trustee. The number of shares to be transferred is computed by dividing this cash equivalent by the existing market price.

Under this arrangement, the firm could control the amount of new equity financing by utilizing newly-issued shares when additional equity funds are desired and utilizing treasury shares when no new equity financing is desired. This arrangement is much less flexible than type A plans. The firm is forced to deal in its own stock (to acquire treasury stock) to avoid being locked into a steady increase in the equity base. Under this arrangement, the employee's savings portion of the funds may also be invested in the firm's stock as described under type A plans.

Plan Type C - It is possible to have an employee savings plan arrangement whereby the trustee can purchase the firm's stock only from the company. As explained under type B, the firm can control the amount of new equity capital accumulation through the use of treasury stock. This arrangement is the least flexible and is rarely used.

The option of using treasury stock for purposes of sales of company stock to the plan trustee not only allows the firm to control the amount of inflowing new equity capital under type B and C plans, but also opens up an additional investment opportunity regardless of the type of plan. The firm can trade in its own stock with the knowledge that it can always sell the stock at the most opportune time, free of brokerage charges, to the employee savings plan trustee.

The most striking characteristic of equity financing via employee savings plans is the availability of funds in small, steady, even amounts, in contrast to the discrete large amounts usually acquired in stock issues. In other words, the equity funds could be generated by an accretion process as opposed to the lumpiness normally found in equity financing. This source of equity capital is similar to the bank line-of-credit for short term loans. The firm, in both cases, constantly has the source of funds available and can specify the amount (within the limits of the funds available) and the point in time that the funds are to be utilized.

This source of equity funds has more stability than traditional sources (rights issues or cash issues). Relatively exact amounts of funds available can be predicted for planning purposes. This stability means that there is almost no risk involved as to the amount of funds that will be forthcoming for a given number of shares. In traditional equity financing, whether rights issues or cash issues, there is considerable uncertainty regarding the amount of funds that will ultimately be available to the firm. The firm seeking equity funds cannot normally tolerate this uncertainty in amount of funds available. The equity financing is usually undertaken for a specific purpose, e.g. major expansion of plant facilities, retire debt or preferred stock, and the volume of funds required



is not flexible enough to accommodate the uncertainty of the issue. Therefore, the firm will frequently pay an investment broker to assume this risk, by guaranteeing a certain amount, through the process called underwriting. Thus the stability, provided by employee savings plans as an equity source, could eliminate most of the uncertainty in amount of funds to be available per given number of shares issued, and thereby reduce ordering or flotation costs by eliminating the need for underwriting.

The flotation cost of stock issues through employee savings plans source should be lower than rights stock issues or cash stock issues. The term, flotation cost, as used herein, is defined as the difference between the market price of outstanding shares and the net amount available for use by the corporation. The flotation cost is composed of three elements: underpricing, compensation, and company expenses.<sup>21</sup> Underpricing is the difference between the market price of outstanding shares and the offering price of the new issue. Underpricing is necessary to allow for market fluctuations between the announced offering and the actual sale. The degree of underpricing is greater when the stock is offered to existing shareholders (rights issues, also frequently called privileged

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<sup>21</sup>The description of the elements of flotation cost is a summary of the material presented in Stevenson.

subscription offerings). The uncertainty in the amount of funds that will be raised, mentioned above, is inversely related to the degree of underpricing. The greater the underpricing, the more confident the financial manager can be that the total issue will be sold, and accordingly, the less need for underwriting.

Compensation is that part of the flotation cost received by investment bankers, brokers, or agents for their services in furnishing financial advice, merchandising the securities, and underwriting the issue.

The company expenses element of the flotation costs encompasses all expenses paid directly by the issuing corporation. These expenses, in a rights or cash issue, include lawyers' and accountants' fees, printing and engraving costs, Federal and State fees, and other expenses connected with the preparation and issuance of securities.

Of the three elements of flotation costs, underpricing and compensation are eliminated if the stock is sold to the savings plan trustee. There is no need for underpricing to encourage investors to buy the stock as the savings plan participants are committed to purchases of stock by virtue of being in the plan. The services of an investment banker or broker are not necessary for the same reason--the savings plan provides a captive market. There are, however, "company expenses" connected with issuing stock through an employee savings plan. There are

certain one-time costs in setting up the plan such as legal fees, accounting fees, printing costs, SEC filing fees, and costs in drawing up the trust agreement. The continuing costs paid by the firm for an employee savings plan are the company contribution and the administrative costs usually assumed by the company (additional payroll bookkeeping, trustee fees, and registration fees). All of the company expenses are allowable expense deductions in computing taxable income, if the plan meets the Internal Revenue Code requirements of a "qualified plan." This tax effect reduces the net cost to the company by approximately one-half. Although these expenses are paid by the company, it is questionable to what extent they can be properly identified as flotation costs.

Employee savings plans are established primarily as an incentive benefit for the employees, not as an equity capital source. The literature on employee savings plans rarely mentions the possibility of utilizing the plans as an equity source of capital. Assuming that the establishment of the plans was justified solely on the incentive benefits to be derived, there would be no flotation costs identified with subsequently taking advantage of the plans for issuing stock. An alternative assumption would be that the plans exist primarily because of their incentive value or other benefits and only to a small degree as a potential capital source; indicating a small portion of these expenses

might be considered flotation costs. There is no evidence that an employee savings plan was ever established solely as a vehicle to sell stock.

Another unique characteristic of the employee savings plan which may have influence on financial planning is the introduction of two new types of voting stockholders: the employee and the savings plan trustee. The employee, as a shareholder, may be more knowledgeable about the firm's operation than the general public stockholder. The effect of the employee as a voting stockholder has not been evaluated nor has any study been made to date as to the possible effect on management decisions this employee-owner could have. The shares held by the trustee will be continuously growing due to the requirement that the shares must be left in the trust fund until retirement for the employee to gain full income tax advantages. Since the trust agreement is subject to termination by management, the shares held in trust can be depended upon to be voted as recommended by existing management. This block of trustee voted shares which is indirectly company controlled places management in a favorable position on all issues put to stockholder vote.

A final characteristic of employee savings plans is the tax status of the dividends paid on shares held in trust. Most plans provide that even after complete vesting of the shares purchased with the company contribution, the

employee may leave the shares in the trust until termination of employment (including retirement). Furthermore, most plans are designed so that all dividends are reinvested in additional shares. By leaving the shares in trust until termination of employment, the employee avoids paying ordinary income tax rates on the dividends. The dividends (and the company contribution) are not taxable to a participant when made or credited to his account. Upon termination of employment, the employee is subject to long-term capital gains tax on the excess of the cost of the shares over the employee's own contribution, i.e. reinvested dividends and company contributions. There is no tax on the unrealized appreciation. Thus, for the employee shareholder whose stock is in trust, the tax argument favoring retention of earnings does not apply. This shareholder receives the more favorable capital gains treatment whether earnings are paid out as dividends or retained to increase market value. The only difference is in timing; the dividends become taxable as capital gains upon the trust distributing the stock while the appreciation in market price (caused in part by retained earnings) becomes taxable when the stock is sold.

The savings plan that is not utilized as a capital source also has certain characteristics that need to be recognized by financial managers. The trustee has a constant flow of funds which must be invested in the company's

stock periodically. If the plan is not used as a capital source, these steady purchases on the open market will have the effect of cushioning downswings and adding to upswings in the stock prices. The open market purchases may even account for enough volume to cause the market prices to be higher. Additionally, the effects of having employees and the trust voting stock will exist whether or not the plan is used as an equity source.

In summary, the characteristics of this equity capital source that may have effect on the considerations in the financial planning are the accretion type flow of funds, the stability of this source, the limited flotation costs, the employee and trustee voting, the tax status of dividends, and the market purchases by the trustee. In the following section the possible impact of these characteristics on the theoretical framework of the financing decisions presented in the first section is considered.

### 3.4 Possible Influences on the Planning of Financial Managers

The introduction of employee savings plans as an equity capital source may have certain effects on the financial planning of a firm. In order to systematically appraise the effects, it was first necessary to construct a framework of financial theory concerning the financing decisions of a firm, followed by a detailed presentation of the characteristics of equity capital in general and employee savings

plans in particular. The purpose of this section is to superimpose the characteristics into the theoretical framework to investigate how the financial planning could be affected by the new equity source. This is accomplished by systematically reexamining each consideration constraining the active decision variables in light of the characteristics of employee savings plans.

Prior to reexamining the constraining considerations, the overriding goal of maximizing the value of existing owners' interest must be reappraised. Basically, the introduction of employee savings plans as an equity source should not alter this goal nor the companion goal for financing decisions of minimizing the cost of capital. The establishment of the employee savings plan by management theoretically was in harmony with this goal at the time the decision was made to implement it. Ideally, there was a subjective judgment made at that time that the benefits, e.g. greater production, easier recruitment, and greater retention, exceeded the estimated cost.

There may be some new pressure on management in interpreting the goal of maximizing the value of existing owners' interest when the savings plan is in operation and the employees become owners. Management is always faced with conflicting stockholder interests and this conflict may be increased as more employees become shareholders. The employees as stockholders may have different aims for

their investments. Employees probably are primarily interested in the long-term growth in the value of the shares, as most employees will not realize the increase in value until they retire. On the other hand, a major depreciation in the market value of the shares could cause deep resentment and malevolence among the employees, as happened during the 1930's with the stock purchase plans. Thus, the employee shareholder may prefer a smaller growth rate with less fluctuation than the rest of the owners.

The employee owner is further in the unprecedented position of being at the same time an existing owner and a prospective investor. As an owner, he would prefer the market price of a share to be high, i.e. earnings correctly valued or even over-valued, to lower the cost of capital and prevent dilution of earnings. As a prospective investor, the employee would prefer the market price to be low, i.e. earnings under-valued. It is unlikely that the average employee owner is presently aware of this conflict. However, as the employee ownership increases and the employee becomes a more knowledgeable investor, these additional pressures may affect managers as they interpret the goal of maximizing the value of owners' investment.

#### 3.4.1 Possible Influences on Dividend Policy

The active variable of dividend policy was presented as being constrained by the following considerations: (a) return on investment opportunities; (b) market interpretation



of dividend policy; (c) desired capital structure; (d) stability of earnings; (e) previous dividend policy; (f) life cycle of the firm; and (g) planned future equity financing. These considerations are reexamined in light of employee savings plans as an equity capital source and employees as owners.

(a) Return on investment opportunities: The argument was presented that in planning dividend policy, the financial manager should theoretically utilize retained earnings to accept all investment opportunities earning a rate of return above the cost of capital and the residual would be paid out of dividends. If management is guided by this reasoning, there are several possible new effects on financial planning introduced by utilizing employee savings plans as an equity capital source. The cost of capital could be reduced if any new equity capital was obtained from savings plans due to a lower order cost. A lower cost of capital would imply more investment opportunities could be accepted and thus more earnings would be retained.

The continuing market for treasury shares, through the savings plan, could provide a new investment opportunity to be considered, i.e. trading in the firm's own stock. The additional investment opportunity would also imply that more of the earnings should be retained.

The nature of this equity source may aid the financial manager in compromising the opposing demands on earnings made by the return-on-investment-opportunities consideration and the market-interpretation-of-dividends consideration. The financial manager must compromise between the retention of earnings to take advantage of investment opportunities and the maintenance of a liberal and constant payout of earnings (dividends) to take advantage of the market preference for dividends. With the availability of an equity source that could frequently be utilized economically, and at no order cost, the financial manager may be able to maintain a liberal dividend payout policy based on stockholder preference for dividends and still take advantage of all justified investment opportunities. The earnings released as dividends could be replaced by new equity capital from the savings plan. Note, an increase in the percent of equity in the capital structure is not being suggested. The equity base would remain the same percentage, but would change form. There would be less increase in existing owners' equity, i.e. smaller retained earnings, and an off-setting increase in new owners' equity, i.e. larger capital stock and paid-in capital. The net effect would be similar to a stock split. There would be more shares outstanding for the same equity investment. This procedure would differ from a stock split in that the ownership of the shares in question would change,

i.e. existing non-employee shareholders' portion of ownership would decrease and employee shareholders' proportion would increase.

The effect on existing non-employee owners would be the receipt of a larger share of current earnings (larger cash dividends) in exchange for a smaller share of future earnings. The existing non-employee owner would be compensated for a dilution of future earnings by receipt of a larger current income. The desirability of such an exchange for existing non-employee owners would depend upon whether they prefer current dividends or growth in share value.

(b) Market interpretation of dividend policy: The consideration of the apparent market preference for dividends affects the financial planning of whether to retain or pay-out earnings. The acknowledgment of preference for dividends forces management to attempt to maintain a liberal, constant pay-out of earnings with the residual available for investment opportunities. The presence of employee owners holding their shares in the trust of the savings plan may alter the demand for dividends. The fact that the dividends, when paid to the trust, ultimately receive favorable capital gains treatment, could have the effect of increasing the demand for dividends.

The dividends paid on the stock held in trust are not available for consumption, but are immediately reinvested

in additional shares of stock. Theoretically, it should make no difference to the employee owner whether the value of his investment is increased by a greater appreciation in the market value of existing shares through retention of earnings, or by additional shares of constant market value purchased with dividends. Pragmatically, the employee owner may prefer dividends for two reasons. Being a relatively unknowledgeable investor, the employee owner may be susceptible to the illusion that the greater the number of shares, the greater the value. Secondly, the larger dividends could result in the equity being transferred from non-employee owners to employee owners, as described above.

Conversely, it may be argued that the employee owner would prefer a very low dividend pay-out to keep the market value per share low. This would allow their subsequent contributions to purchase more shares of stock.

(c) Desired capital structure: The evaluation of the impact of employee savings plans on the desired capital structures will be deferred until this consideration is examined in the presentation of the external financing policy variable.

(d) Stability of earnings: There would be no change in the effect of the stability of earnings in determining the dividend policy as a result of the addition of an equity source from employee savings plans.

(e) Previous dividend policy: The previous dividend policy may become more important with the addition of employees as shareholders. Similar to a decrease in the per share price, a decrease in dividend pay-out could create deep resentment among employees. The consequences of a disgruntled employee force are even more serious than unhappy stockholders. It is easier for the stockholder to shift investments than it is for the employee to change jobs.

(f) Life cycle of the firm: The stage in the life cycle of the firm will influence the reliance that must be made upon internally generated funds and the availability of outside sources of funds. The existence of a savings plan for funds in the early growing stages of a firm's life, when the demand for funds is greatest, could be beneficial as an additional source of capital. However, to date most companies have not installed employee savings plans until they were well established.

(g) Planned future equity financing: In planning dividend policy, the future financing requirements must be considered. A liberal dividend policy makes the shares more marketable and to the extent such a policy increases the market price per share, the cost of equity capital is reduced. If the future equity financing is to be satisfied by utilizing employee savings plans, the concern for marketability would be decreased. However, the desire to increase market price to reduce the cost of capital would still be present and

perhaps strengthened if more equity financing is undertaken, through employee savings plans, for reasons presented elsewhere.

To summarize, the introduction of employee savings plans as an equity source could increase the complexity of financial planning for an optimum dividend policy. There is no over-whelming argument that suggests that the dividend pay-out would be increased or reduced as a result of employee owners or the existence of this new capital source. The ultimate effect will depend in part on the weight given to the constraining considerations and in part on the degree management identifies with the employee owners.

#### 3.4.2 Possible Influences on External Financing Policy

The active variable of financing policy was described as constrained by the following considerations:

(a) desired capital structure; (b) flexibility; (c) timing; (d) control; (e) risk; and (f) order costs. These considerations are reexamined in light of employee savings plans as an equity capital source and employees as owners.

(a) Desired capital structure: It is assumed that the management of a firm will decide upon a capital structure deemed optimum for the particular firm in question. This optimum capital structure is visualized as a range of allowable ratios of debt to equity and not an absolute unalterable relationship. The question is whether the availability of this new capital source will alter

management's decision of the optimum range for the capital structure. Recall that the planning of capital structure is guided by the goal of minimizing the cost of capital and influenced by the owners' and managers' aversion to risk. The use of employee savings plans could lower the cost of equity capital. However, the source of equity capital should have no effect on the lowering of overall (average) cost of capital through the use of debt. Granted, the overall cost of capital may be lower if employee savings plans provide the equity capital. However, this lower cost of capital is the result of a different equity source and not a different mix of debt and equity.

The influence of the owners' and the managers' aversion to risk could be modified by the addition of employees among the owners. As contended in the consideration of risk in the financial theory section, the manager will have more aversion to risk than the owner because the rewards for taking the risk are smaller and the consequences of unfavorable results are greater. The employee owner would have the same perspective toward risk as the manager. The major criticism of employee savings plans is the lack of diversification. The employee owner has "all his eggs in one basket" when his risk of unemployment and investment are all tied to one company. Therefore, the addition of employees as owners could affect management's planning of

the optimum capital structure by increasing the aversion to risk, implying less debt in the capital structure.

(b) Flexibility: The firm, in planning its financing decisions, must consider future demands for funds. Flexibility in financial planning refers to ability of a management to adjust the firm's sources of funds upwards or downwards in response to changes in needs for funds and changes in the cost of these funds. The stability of employee savings plans as an equity capital source could increase the flexibility of the firm. With a savings plan in existence, a limited equity source is always available, and available without extensive, time-consuming preparation.

The employee savings plan is an ideal equity source to rebalance the financial structure of the firm that has increased debt beyond the desired level. Firms tend to incur more debt than planned for several reasons. The debt issues are easily accessible, have a variety of maturities, and have a direct cost that is usually below the firm's combined cost of capital. In addition, most of the suppliers of permanent assets offer attractive debt financing to cover the purchase of new assets. The firm may also deliberately incur more debt when the capital market conditions warrant (bond prices high and stock prices low). The constant availability of equity capital through savings plans could allow the financial manager to gradually correct the financial structure toward the



desired level. Furthermore, the accretion type flow of funds from this equity source could be used to replace serial debt issues that mature in installments.

When not used as an equity capital source, the purchases of the company stock must be made on the open market to satisfy the requirements of the savings plan. These purchases could have the effect of stabilizing or possibly increasing the market price of the company's shares. This influence on the market price would mean that the timing of new equity flotation, as described below, would be less crucial and accordingly flexibility increased.

Thus, the existence of an employee savings plan could allow the financial manager greater flexibility in his planning, both in the use of equity and debt capital.

(c) Timing: Greater flexibility allows the financial manager to time his new financing to take advantage of market conditions. The stability of employee savings plans as a source of equity capital could allow more exact timing of equity financing. Equity issues could be sold to the plan's trustee when the market value per share was considered high. However, since this source is limited, only limited advantage could be taken of a good market. On the other hand, if the employee savings plan was used to supply equity capital frequently, the effect would be to smooth out the cyclical supply of capital which could minimize fluctuations in the cost of capital.

The financial manager would also be more free to take advantage of favorable market conditions to float debt issues, even if it meant temporarily holding more debt in the capital structure than desired. As mentioned under flexibility, the existence of a ready equity source is always available to readjust the capital structure.

The timing of new equity capital should also be considered from another aspect. In addition to timing to minimize the cost of capital, the financial manager should attempt to regulate the inflow of funds to coincide with the planned requirements of funds in amount and time. Traditionally, new equity capital has been raised in large, infrequent amounts. One explanation for these large blocks of funds is the fixed nature of some flotation costs associated with an equity issue. Another explanation is that new equity capital is normally associated with major investment projects such as a major expansion of production facilities, development of new product markets or purchase of existing enterprises.

The employee savings plan provides new equity capital with a vastly different timed flow of funds from the traditional sources. The slow accumulation of funds through equity issues to the savings plans could aid management in matching the inflow of funds to the demand for funds.

The question of timing, and perhaps the entire issue of the impact of the savings plan as an equity source,

depends upon whether the funds available are large enough in comparison to the firm's capital requirements. Even if the financial planning is altered to allow for the slow accumulation of new equity capital, the funds from this source may not be large enough to be considered. The amount of funds available for a particular firm is contingent upon the provisions of the plan and the number of employees involved. Whether this amount will be considered important in financial planning depends upon the demand for funds in each individual firm.

The availability of employee savings plans could alter the consideration of timing in financial planning in one of several ways. First of all, the financial manager would have to think of equity capital in terms of a steady flow in addition to infrequent, discrete blocks. The option between rates of inflow increases the possibilities of optimum uses of equity capital. If equity capital has a lower cost-of-capital when acquired through the savings plan as suggested, the firm may find it advantageous to raise funds by debt for large projects normally financed by equity, and replace the debt over time with equity from the savings plans. Finally, the financial manager may seek to match investment projects demanding a steady flow of funds to this source of capital supplying funds in like manner.

(d) Control: The use of employee savings plans as an equity source would result in dilution of control for the existing owners. For this reason, the employee savings plan allowing investment in newly-issued stock would have to be approved by the existing shareholders. This legal requirement may prevent the introduction of this equity source in certain companies.

(e) Risk: The question of the change in financial risk and the aversion to financial risk has previously been examined in the presentation of how employee savings plans would affect the capital structure.

Another aspect of risk, the uncertainty of the volume of funds from a given equity issue, could be greatly decreased. As pointed out in the discourse of the characteristics of this new equity source, there is almost no uncertainty as to the amount of funds forthcoming for a given number of shares issued. This lack of uncertainty could make financial planning easier and the results more predictable.

(f) Order costs: The order or flotation costs are an important consideration in planning new financing because of the indirect effect on the continuing cost of capital. The smaller the ordering costs, the larger the proceeds and consequently, the lower the rate of cost-of-capital. For a firm with an employee savings plan in existence, where the plan is justified for employee incentive reasons,

no ordering costs are incurred in utilizing this plan to acquire equity capital. For a firm where the savings plan is justified as an equity source as well as an employee incentive, some ordering costs are incurred. Even where ordering costs may be deemed to exist in using the savings plan as an equity source, they are probably less than the ordering costs from traditional sources.

The financial manager, guided by the goal of maximizing the value of owners' interests, should consider the employee savings plan, when available, as an equity source for reasons of minimizing the cost of capital, if for no other reason. This influence on financial planning is directly related to the basic goal of financial management and not merely to one of the many secondary considerations.

### 3.5 Summary

In order to evaluate how the access to and the use of this equity source could influence financial planning, a brief summary of theory applicable to the inflow of funds was presented. To provide the basis for a systematic evaluation of the effect of employee savings plans on financial planning, the theory was presented in the form of a descriptive model. The goal, minimizing the cost of capital, was seen as a function of two active decision variables: dividend policy (internal funds) and financing policy (external funds). Each of the decision variables

was envisioned as being constrained by various additional considerations that bear on the overall decision. Each consideration was reexamined in light of the availability of equity capital from savings plans and the consequences of using this source.

This presentation of the possible impact on financial planning due to the introduction of a new equity source was designed to be as complete as possible, with consideration given to every influence regardless of overall importance or likelihood. The raising of new equity capital is an infrequent event in the course of a firm's financial operations. Those firms with the option to take advantage of employee savings plans to raise new equity capital are at present in the minority. Therefore, the various influences analyzed are not common phenomena encountered by every financial manager. However, for purposes of analysis, it is a necessary effort to examine in detail what the effect of employee savings plans for financial planning could be. The suggestion is not that all of the influences will occur when employee savings plans are present, but only that any could occur.

However, several concepts developed in this theoretical analysis are envisioned as being present in existing savings plans and these concepts could influence financial planning. The concepts that can be tested fall into two groups: (1) certain characteristics of the savings

plans as an equity capital source; and (2) certain effects on financial planning. The characteristics that are unique to this equity source need to be fully investigated as they determine the extent this source will be considered when new equity financing is warranted and more important, are the cause of any effects on financial planning. The characteristics postulated in this chapter to have the greatest effect on financial planning are as follows: (a) the accretion type of flow of funds; (b) the stability of this source; (c) the limited flotation costs; (d) the employee and trustee voting; and (e) the market purchases by the trustee. The first phase of the empirical research was designed to investigate and evaluate these factors considered most relevant to any ultimate effect on financial planning. The results of this phase of the research are presented in Chapter Five.

The second phase of the field research was formulated to evaluate the possible implications on financial planning as developed in this chapter. The effects on financial planning that appeared most clearly definable are those described as constraining the external financing variable as follows: (a) flexibility; (b) timing to reduce cost of capital and timing to coincide with the needs for funds; (c) control; (d) risk; and (e) order costs. The results of this phase of the research are presented in Chapter Six.

The following chapter is a presentation of the design for these two phases of the field research and the response rate to the requests for information. This data is presented in a separate chapter to provide greater clarity to the subsequent presentation and evaluation of the results of the field research.



## CHAPTER FOUR

### DESCRIPTION OF PROCEDURES FOLLOWED IN CONDUCTING FIELD RESEARCH

- 4.1 Introduction
- 4.2 Source of the Empirical Research Population
- 4.3 Phase One of the Field Research
- 4.4 Source of Company Stock
- 4.5 Phase Two of the Field Research
  - 4.5.1 Responses to YES/NO Questions in Questionnaire
  - 4.5.2 Letters
- 4.6 Interviews
- 4.7 Summary
- Appendix IV-A Cover Letter, Questionnaire, and Follow-up Letter
- Appendix IV-B Companies Comprising the Research Population

## CHAPTER FOUR

### 4.1 Introduction

This chapter is devoted primarily to the description of the procedures followed in conducting the field research. The first step was to identify the companies in the universe that had an employee savings plan that could be utilized as an equity source, i.e. the companies having savings plans where the company stock was being purchased by the plan's trustee for participant accounts. The procedure followed to identify these companies is described in section 4.2.

The research directed toward identifying and describing the characteristics of the savings plan as an equity capital source consisted of an evaluation of the financial operations of the plan and the financial specifications of the plan. The methods utilized to obtain this information and the responses received are summarized in section 4.3.

From the financial specifications (descriptions) of the plans, the number of companies that could sell newly issued shares of stock was determined. In addition, from responses to the questionnaire, the number of companies that did sell newly issued stock during the study period

was tabulated. Section 4.4 is a report of the number of companies that could use the savings plan as a source of capital and the number that did.

A questionnaire was the primary source of information for the phase of field research designed to evaluate the implications on financial planning. The questionnaire was mailed to the financial officers of the companies identified as sponsoring a savings plan where the trustee purchased stock of the contributing company. The response rate to the questionnaire is presented in section 4.5.

Financial managers involved in the decisions and planning under investigation were interviewed. The scope of the interviews is described in section 4.6.

#### 4.2 Source of the Empirical Research Population

The universe for the empirical research was all companies listed on the New York Stock Exchange for the study period, calendar years 1962 through 1966. From this universe, the identification of the companies offering employee savings plans was accomplished primarily through reference to previous studies in this area. The scope of the previous studies was explained in Chapter Two (section 2.4).

To warrant the use of these secondary sources, a trip was made to the New York office of The National Industrial Conference Board. Mr. Harlan Fox, the author

of several of the Conference Board studies, was contacted and the research methodology used by the Conference Board in their studies was discussed. This discussion revealed that in preparation for the 1960 study, all companies on the New York Stock Exchange except those in non-manufacturing industries (transportation, other than rail and air; contract construction; and service industries) were contacted by mail with a request for a description of their savings plan. The companies that failed to reply were investigated using secondary sources (primarily SEC filings) for the existence of a savings plan. The same procedure was followed for the 1965 Conference Board study covering all companies on the New York Stock Exchange. Mr. Fox subsequently provided a list of companies not identified in the studies published by the Conference Board that had a savings plan (NICB letter 1967 in Table IV-2). The companies on this list were added to the research population.

To further insure that no company on the New York Stock Exchange having a savings plan had been omitted from the research population, the Securities and Exchange Commission's News Digest was reviewed for the study period. This bulletin, published every working day of the year, lists all registration statements filed with the Securities and Exchange Commission and the type of statement filed. As described in Appendix B of Chapter Two, the companies

Table IV-1: Research universe, population, and response by type of business

Type of Business	Universe Companies listed on NYSE	Population Companies included in study	Percent of Universe	Response Financial Information	Percent of Population
Total companies	<u>1, 082</u>	<u>126</u>	<u>12%</u>	<u>88</u>	<u>70%</u>
Manufacturing	<u>725</u>	<u>89</u>	<u>12</u>	<u>61</u>	<u>69</u>
Petroleum	<u>59</u>	<u>25</u>	<u>64</u>	<u>20</u>	<u>80</u>
Other Manufacturing	<u>666</u>	<u>63</u>	<u>9</u>	<u>41</u>	<u>65</u>
Primary metals	<u>55</u>	<u>9</u>	<u>16</u>	<u>6</u>	<u>67</u>
Chemicals	<u>72</u>	<u>13</u>	<u>18</u>	<u>8</u>	<u>61</u>
Stone, clay, glass	<u>39</u>	<u>6</u>	<u>2</u>	<u>4</u>	<u>67</u>
Transportation equipment	<u>83</u>	<u>10</u>	<u>12</u>	<u>5</u>	<u>50</u>
Food	<u>69</u>	<u>5</u>	<u>7</u>	<u>5</u>	<u>100</u>
Textile & apparel	<u>40</u>	<u>2</u>	<u>1</u>	<u>1</u>	<u>50</u>
Machinery (except electrical)	<u>92</u>	<u>5</u>	<u>1</u>	<u>5</u>	<u>100</u>
Paper	<u>28</u>	<u>2</u>	<u>2</u>	<u>1</u>	<u>50</u>
Electrical machinery	<u>64</u>	<u>4</u>	<u>6</u>	<u>3</u>	<u>75</u>
Fabricated metals	<u>46</u>	<u>3</u>	<u>7</u>	<u>2</u>	<u>67</u>
All other	<u>98</u>	<u>4</u>	<u>4</u>	<u>1</u>	<u>25</u>
Public Utilities	<u>114</u>	<u>24</u>	<u>21</u>	<u>19</u>	<u>79</u>
Natural gas companies & systems	<u>27</u>	<u>9</u>	<u>33</u>	<u>6</u>	<u>67</u>
Gas & electric utilities	<u>87</u>	<u>15</u>	<u>17</u>	<u>13</u>	<u>87</u>
Mining	<u>15</u>	<u>4</u>	<u>27</u>	<u>1</u>	<u>25</u>
Finance	<u>42</u>	<u>3</u>	<u>7</u>	<u>3</u>	<u>100</u>
Services	<u>18</u>	<u>1</u>	<u>5</u>	<u>0</u>	<u>0</u>
Transportation & Communications	<u>80</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>100</u>
Trade	<u>88</u>	<u>4</u>	<u>5</u>	<u>2</u>	<u>50</u>

## Source:

Universe: Fox, Harland, "Employee Savings Plan Trends," The Conference Board Record, Nov. 1965, p. 51.

Population and response: compiled by author

Table IV-2: Source of research population

<u>Source</u>	<u>Companies identified</u>	<u>Reason eliminated</u>						<u>Total eliminated</u>	<u>Added to research population</u>
		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>		
NICB 1960 study	83	10	5	5	4	1		23	58
NICB 1965 study	35		8	1	3			12	23
NYSE 1961 study	79	8		3	1		61	73	6
NICB letter 1967	67	1	12		15		9	37	30
BTC 1967 study	125		11	9	6		93	119	6
SEC News Digest	3								<u>3</u>
Research Population									<u><u>126</u></u>

## Reason eliminated:

1. Company no longer in existence.
2. No investment in company stock.
3. Profit sharing determines company contribution.
4. Company not on New York Stock Exchange for full study period.
5. Savings plan not tax qualified.
6. Company already in study from previous source.

## Source:

See detailed description of previous studies in Chapter Two, 2.4.1.  
 NICB 1960 study, p. 36.  
 NICB 1965 study, p. 60.  
 NYSE 1961 study, p. 11.  
 NICB letter 1967, letter to author from Mr. Harland Fox, The National Industrial Conference Board, March 14, 1967.  
 BTC 1967 study, p. 44.  
 SEC News Digest, various, July 1959 through March 1967.

offering savings plans where a portion of the funds are invested in the sponsoring company's stock are required to file a registration statement with the Securities and Exchange Commission. These News Digests were examined for the years 1962 through April 1967 and three additional companies were identified as having a savings plan (SEC News Digest in Table IV-2).

For the study period (1962-66), 126 companies with securities listed on the New York Stock Exchange had an employee savings plan (12% of all listed companies). As Table IV-1 indicates, these plans are particularly common among listed companies in two industries--petroleum (64% have a plan) and natural gas companies (33%). In manufacturing they are fairly common among chemical companies (13%) and four of the fifteen mining companies listed (27%) had plans.

It should be recognized also that the plans are more common among larger companies. For example, all but four of the (24) oil companies with sales of \$100 million or more have a plan compared with only 33% (5) of the (15) listed companies with sales under \$100 million. Similarly, 24% of the manufacturers with sales of \$500 million or more have a plan compared with 9% of the companies with sales of \$100-499 million and 4% of the listed manufacturers with sales under \$100 million. Finally, 40% (12) of the (30) utilities with operating revenue of \$200 million or more

have a plan compared with 24% (6) of the (25) companies with operating revenue of \$100-199 million and 12% (6) of the (52) listed companies with revenue under \$100 million.

Due to the scope of this research, not all companies having a savings plan were eligible for this research and certain companies were eliminated. Table IV-2 contains information on the source of identification of the companies in the universe having a savings plan and the reasons for eliminating some companies. The 126 companies comprising the research population are listed in Appendix B to this chapter. The transmittal letter and questionnaire presented in Appendix A to this chapter were mailed to the financial vice-president or treasurer of each of the companies.

#### 4.3 Phase One of the Field Research

The information for the analysis of the characteristics of the savings plan as an equity capital source was obtained from the financial reports on the operations of the savings plan and the provisions for management of the plans contained in the formal description of the plans. The financial officers of the 126 companies with savings plans were requested to: (a) complete the questionnaire; (b) return a copy of the savings plan description as distributed to eligible employees; and (c) return financial statements on the plan for the years 1962 through 1966. Preliminary analysis of the financial statements on the



savings plan revealed that the statements usually omitted the source of the company stock purchased by the plan's trustee, i.e. whether the stock was purchased from the company or in the open market. It was necessary, therefore, to obtain this information on the source of the stock directly from the companies involved. The financial officers were requested in the first question of the questionnaire to list in a table the annual amount and source of company stock purchased by the plan trustee. The response rate to these requests is summarized in Table IV-3. Fifty companies provided all the information requested. Another thirty-four companies provided a portion of the information requested. Including the companies that declined participation, a total of seventy-six percent of the research population responded to the request for information.

For seventeen of the companies that did not respond with the complete information requested, the financial statements and descriptions were obtained from the Securities and Exchange Commission filings. These data from the SEC records were used to supplement the mail responses to provide the analysis of the financial information presented in Chapter Five.

Table IV-3: Replies to mail requests

<u>Type of reply</u>	<u>Replies</u>		<u>Supple- mented by SEC data</u>	<u>Financial Analysis</u>	<u>Question- naire Analysis</u>
	<u>Number</u>	<u>Percent of Total</u>			
Reply complete	50	40%		50	50
Questionnaire and description (no financial statements)	13	10		13	13
Description and financial statements (no questionnaire)	8	6		8	
Description only	13	10	6	6	
Letter, will not participate	12	10	2	2	
No reply	<u>30</u>	<u>24</u>	<u>9</u>	<u>9</u>	—
Totals	<u>126</u>	<u>100%</u>	<u>17</u>	<u>88</u>	<u>63</u>

Source:

Developed by author

#### 4.4 Source of Company Stock

Since the purpose of this research was to investigate the implications that the savings plan as an equity capital source had on financial planning, the number of companies that could use the savings plan as an equity capital source was of prime interest. The source of stock of the sponsoring company utilized as an investment for savings plans is summarized in Table IV-4. The formal description of the savings plan in thirty-five plans specified that the company could sell newly issued stock to the trustee of the savings plan or make the company contribution in newly issued stock. One company's plan description specified that only treasury stock could be purchased by the plan trustee; however, during the study period, newly issued stock was sold by the company to the savings plan. Accordingly, this company was included in the count of those plans that could acquire newly issued stock. Of the thirty-six plans that could purchase newly issued stock, six plans could purchase stock only from the company, i.e. no open market purchases were permitted. These plans could regulate the amount of capital raised from the savings plan by the use of treasury stock. The remaining thirty plans were designed so that purchases of company stock could be made either through the open market or from the company, if the company made available such stock. Thirteen

Table IV-4: Source of company stock used in savings plans

	<u>Number</u>	<u>Percent of Total</u>
Plans that could use newly issued stock	36	41%
Plans that could not use newly issued stock but could use treasury stock	12	14
Plans that could not use newly issued stock or treasury stock (open mar- ket purchases only)	<u>40</u>	<u>45</u>
Total	<u>88</u>	<u>100%</u>
Plans that did use newly issued stock during the study period	13	

## Source:

Compiled from plan descriptions, SEC registrations, and replies to questionnaires.

of these thirty-six companies (36%) sold newly issued stock to the savings plan during the study period.

Twelve additional companies could sell their stock to the savings plan providing only reacquired previously outstanding stock (treasury stock) was utilized. The thirty-six companies that could sell newly issued stock could also sell treasury stock to the savings plan. The sale of treasury stock could be considered a secondary equity capital source or utilized as an investment opportunity.

Forty-four of the forty-eight plans that allowed the trustee to purchase either newly issued or treasury stock from the company specified in the plan description the precise method for establishing the value of the company stock. This procedure was necessary to insure the participants in the savings plan that the shares purchased from the company were priced no higher than similar shares on the open market. Twenty of the plans based the value of stock purchased from the company on the closing price on the New York Stock Exchange or the mean of the high and low price on the day purchased. Eight plans specified the closing price on the day preceeding the purchase. One plan required the company to quarterly set the price it would offer stock for the coming three months. The remaining plans (fifteen) provided that the stock value should be based on exchange prices of the preceeding month or shorter period.

Of the forty plans identified in Table IV-4 that could not use newly issued or treasury stock, only five explicitly prohibited purchases of stock from the sponsoring company. The description of the remaining thirty-five plans usually specified that stock was to be purchased on the open market or from private sources at a price not to exceed the current market value.

#### 4.5 Phase Two of the Field Research

The first phase of the field research was an objective analysis of the savings plan. In contrast, the second phase of the field research was formulated to gather and analyze the subjective opinions of the financial officers having the opportunity to utilize the savings plan as an equity capital source. This phase of the research was designed to determine the implications on financial planning as observed by the financial officers involved in the planning.

The primary source of information for the evaluation of the effects of the savings plan on financial planning was a questionnaire mailed to the financial officers of the 126 companies in the research population. A copy of the questionnaire is included in Appendix A to this chapter. As indicated in Table IV-3, sixty-three completed questionnaires were received for a response rate of 50%.

#### 4.5.1 Responses to YES/NO Questions in the Questionnaire

The directions and questions in the questionnaire were designed to elicit maximum relevant information without time consuming study on the part of the respondent. The responses to the questionnaire, combined with information obtained from letters from financial officers and information obtained through interviews, will be presented in Chapter Six. However, the responses will be presented as they bear on the postulated effects on financial planning developed in Chapter Three rather than being presented by the order of the questions in the questionnaire. Accordingly, there will not be a presentation of the total responses to the questions that provided for a YES or NO answer in Chapter Six.

The responses to the questions requesting an answer of YES or NO are summarized in Table IV-5 to provide the reader with a complete tabulation of the total replies to these questions. The comments and analysis of the responses will be presented in Chapter Six where reference will be made to specific questions and replies as they apply to the effects on financial planning.

#### 4.5.2 Letters

Eight financial officers who did not complete the questionnaire replied with letters answering some of the questions posed and offering additional comments on the savings plan as an equity capital source. The material

Table IV-5: Tabulation of responses to YES/NO questions asked on the questionnaire

<u>Question</u>	<u>YES</u>	<u>NO</u>	<u>No Answer</u>	<u>Total</u>
3. Has your company ever allowed the trustee of the savings plan to purchase newly issued stock directly from the company or made the company contribution in newly issued stock instead of cash?	15	48		63
3A-1. Does your company's savings plan allow the company the option to sell newly issued stock to the trustee?	13	32	3	48
3A-2. If your company were to raise capital by selling unissued stock, would you consider the savings plan as a possible source of funds?	3	41	4	48
3B-4. Are the funds to be generated by the sale of stock to the trustee included in the capital budgeting and planning of the company?	7	3	5	15
IF YES, does this source of funds require any special considerations in the planning?	2	2	3	7
4. In your opinion, are there advantages to the company in using the savings plan as a source of equity capital (i.e. sell to the plan newly issued stock)?	13	34	16	63
5. In your opinion, are there disadvantages to the company in using the savings plan as a source of equity capital (i.e. sell to the plan newly issued stock)?	33	15	15	63



Table IV-5: Tabulation of responses to YES/NO questions asked on the questionnaire

<u>Question</u>	<u>YES</u>	<u>NO</u>	<u>No Answer</u>	<u>Total</u>
6. Do you feel the employee savings plan has any positive effect on employee relations?	52	3	8	63
6b. Has your company specifically measured the impact of the savings plan on any area of employee relations (for example, turnover rate)?	3	52	8	63
				156

Source:

Replies to questionnaire.

from the letters will be used where appropriate to supplement the replies to the questionnaire. Whenever referred to, the material from the letters will be identified as such to prevent confusion with the replies to the questionnaire.

#### 4.6 Interviews

The financial officers of five companies of the 126 identified as having a savings plan were interviewed to gain additional insight into the effect of such plans on financial planning. Two of the five companies were known to have provided newly issued shares to the savings plan and had thereby raised millions of dollars of new equity capital over the life of their savings plans (in excess of ten years in both cases). The other three companies where interviews were conducted had plans where all purchases of company stock by the savings plan had been on the open market.

All questions contained in the questionnaire were asked in the interviews and these five companies are included in the sixty-three reported to have completed the questionnaire in Table IV-3. In addition, numerous related areas were explored based on the individual provisions of the plans involved and the individual capital requirements of the company. The information obtained from the discussions will be presented in Chapter Six and where not in

direct response to a question also on the questionnaire will be identified as obtained through interviews.

#### 4.7 Summary

The universe for this research was all companies listed on the New York Stock Exchange continuously from 1962 through 1966. From this universe, 126 companies were found to have had an employee savings plan where the stock of the sponsoring company was utilized as an investment. The information gathered on the companies and their plans came from three sources: (1) the financial statements covering the operations of the savings plans and the descriptions of the plans; (2) a questionnaire mailed to the financial officers; and (3) interviews with the financial officers.

The information obtained from the first source was collected primarily to identify and evaluate the unique characteristics of the savings plan as an equity source that could have an impact on the financial planning of the firm. The financial statements of the operations of the savings plans and the descriptions of the plans were obtained for 88 of the 126 companies. The results of the analysis of this information is presented in the following chapter.

The information obtained from the last two sources was collected to test whether the implications on financial

planning that were postulated in Chapter Three existed and if there were any other effects on financial planning due to the availability of this source. Sixty-three questionnaires were returned of the 126 mailed. In addition, letters from eight financial officers not completing the questionnaire contained relevant comments regarding the savings plan as an equity capital source. Interviews were conducted with the financial officers of five companies to further explore the relationship of the savings plan to financial operations of the firm. The results of the second phase of the research investigating effects on financial planning are summarized in Chapter Six.

The analysis of the information obtained and the implications and conclusions derived, which are reported in the following two chapters, only apply to the companies for which the information was available and only for the time period studied. As in any research not covering one hundred percent of the population, the results can not, applied to all units in the population with certainty.

## APPENDIX IV-A

MICHIGAN STATE UNIVERSITY EAST LANSING • MICHIGAN 48823

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GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

DEPARTMENT OF ACCOUNTING & FINANCIAL ADMINISTRATION • EPPLEY CENTER

I am currently doing research in the area of accounting and finance for a doctoral dissertation. Specifically, this research involves an investigation of the employee savings plan as an equity capital source. Enclosed is a brief description of the proposed research.

Your company has been identified as having an employee savings plan, and to complete my research I need your assistance. Certain information required for this study can only be obtained from the financial officers and the financial records of the companies having savings plans. Would it be possible for you to supply me with a copy of your savings plan description as distributed to eligible employees and the financial statements on the plan for the years 1962 through 1966? In addition, your assistance in answering the enclosed brief questionnaire would be greatly appreciated.

All information supplied will be held strictly confidential and no individual company will be identified in the dissertation.

Comments and questions concerning the project are certainly welcome. The study should be completed during the early fall of 1967. At that time, a summary of the findings will be mailed to all participating companies.

Thank you for your cooperation and assistance.

Very truly yours,

Frederick G. Davis  
Doctoral Candidate

Myles S. Delano, Ph.D.  
Dissertation Director

## Company Questionnaire

1. Please list in the following table the annual amount and source of company stock purchased by the plan trustee, and the annual trustee fees. (Unless indicated otherwise, figures are assumed to be calendar year totals.)

	1962	1963	1964	1965	1966
Total stock purchased from all sources:					
Number of shares:					
Total cost	\$	\$	\$	\$	\$
Treasury stock purchased from the company:					
Number of shares					
Total cost	\$	\$	\$	\$	\$
Newly-issued stock purchased from the company					
Number of shares					
Total cost	\$	\$	\$	\$	\$
Trustee fees, total	\$	\$	\$	\$	\$

2. Occasionally financial officers prepare estimates of the costs of raising capital by issuing new stock. If you have considered these flotation costs for your particular company during the study period (1962-1966), please give your estimate below, if not, continue on to question 3.

Average flotation costs, expressed as a percent of net proceeds available to the company from:

Rights issues \_\_\_\_\_ % of net proceeds

Cash issues \_\_\_\_\_ % of net proceeds

3. Has your company ever allowed the trustee of the savings plan to purchase newly issued stock directly from the company or made the company contribution in newly issued stock instead of cash?

\_\_\_\_\_ Yes. PLEASE ANSWER THE QUESTIONS IN SECTION 3B, PAGE 3.

\_\_\_\_\_ No. PLEASE ANSWER THE QUESTIONS IN SECTION 3A, PAGE 2.

## Company Questionnaire

4. In your opinion, are there advantages to the company in using the savings plan as a source of equity capital (i.e. sell to the plan newly issued stock)?  
\_\_\_\_\_Yes \_\_\_\_\_No

IF YES, what do you consider the primary advantage?

5. In your opinion, are there disadvantages to the company in using the savings plan as a source of equity capital (i.e. sell to the plan newly issued stock)?  
\_\_\_\_\_Yes \_\_\_\_\_No

IF YES, what do you consider the primary disadvantage?

6. Do you feel the employee savings plan has any positive effect on employee relations? \_\_\_\_\_Yes \_\_\_\_\_No

a. What areas of employee relations do you feel are directly affected?

- b. Has your company specifically measured the impact of the savings plan on any area of employee relations (for example, turnover rate)?  
\_\_\_\_\_Yes \_\_\_\_\_No

IF YES, please describe the procedure and the results.

NOTE: Please include a copy of your savings plan description and the financial statements on the plan for the years 1962 through 1966 (or for that part of the period the plan was in effect).

Additional comments on the savings plan, particularly as a source of capital would be appreciated. Use the reverse side of this page for such comments and feel free to add additional pages.

## Company Questionnaire

## Section 3A

- A-1. Does your company's savings plan allow the company the option to sell newly issued stock to the trustee?

\_\_\_\_\_ Yes, please explain below why this option has not been exercised.

\_\_\_\_\_ No, please explain why below.

- A-2 If your company were to raise capital by selling unissued stock, would you consider the savings plan as a possible source of funds? \_\_\_\_\_ Yes  
\_\_\_\_\_ No.

Please discuss your company's policy on the use of the savings plan as an equity capital source.



## Company Questionnaire

## Section 3B

B-1. Please explain how your company decides the number of shares to be offered to the trustees of the savings plan (or to make the company contribution in shares of stock where this option exists).

B-2. When shares of company stock are made available for purchase by the trustee of the savings plan, how does the company decide whether the stock sold should be newly issued or treasury stock?

B-3. When shares of stock are sold by the company to the savings plan trustee, what percent of the selling price is applied against the costs of maintaining the employee savings plan?

\_\_\_\_\_ None

\_\_\_\_\_ % of selling price credited against expenses of maintaining the employee savings plan.

B-4. Are the funds to be generated by the sale of stock to the trustee included in the capital budgeting and planning of the company?

\_\_\_\_\_ Yes          \_\_\_\_\_ No

IF YES, does this source of funds require any special considerations in the planning?          \_\_\_\_\_ Yes          \_\_\_\_\_ No

IF YES, briefly describe these considerations.

**Employee Savings Plans  
As An Internal Equity Capital Source**

**Definition of terms used in the questionnaire**

**Savings plan** - as used in this study, a savings plan includes the following basic elements:

- 1) Voluntary employee savings, within a specified range, are made through payroll deductions.
- 2) Company contributions are primarily a function of the level employee savings.
- 3) The combined funds are put into a "qualified" employee trust for deferred distribution (qualified under Section 401 (a) of the Internal Revenue Code of 1954).
- 4) Company stock and government securities are the predominant form of investment.

**Company stock** - the common stock of the corporation making contributions to the trustee of the savings plan.

**Treasury stock** - company stock, as defined above, which has been issued and reacquired by the issuing corporation; it has not been cancelled and it legally is available for reissuance.

**Newly issued stock** - company stock, as defined above, which is being issued for the first time.

**Trustee** - the bank designated in the trust agreement to receive, hold, invest, and account for the funds of the savings plan.

**Trustee fees** - compensation paid by the company to the trustee for the services rendered in connection with the savings plan.

**Flotation costs** - the difference or spread between the market price per share before the new issue and the net proceeds per share. Flotation costs include underpricing, fees deducted by the underwriter, and expenses of the issue paid by the company.

**Rights issues** - sales of newly issued stock to existing shareholders through subscription rights or warrants.

**Cash issues** - sales of newly issued stock on the open market to other than existing shareholders.

**Employee Savings Plans  
As An Internal Equity Capital Source**

**Research Proposal**

**Purpose** - The primary purpose of this study is to examine the implications of contributions to employee savings plans as a potential source of capital. Specifically, this study will consider the company and employee contributions to employee savings plans where such contributions are deposited with a trustee, who in turn purchases stock of the company in question. This study will involve a theoretical exploration of the advantages of employee savings plans as a means of raising equity capital, as well as investigating the resulting problems. On an empirical level, this study will detail the current magnitude of funds being invested in company stock through employee savings plans, measure the costs of these plans, and investigate how these plans affect financial planning.

**Importance** - There is a growing interest in plans which enable the employee to obtain ownership in his company. It has been estimated that 50% of the companies on the New York Stock Exchange now have some form of employee stock purchase plan. The employee savings plan is becoming the most widespread type of employee stock purchase plan because of certain income tax advantages. These savings plans were originally established solely to benefit the employees and not as vehicles to raise capital for the company. Under most plans, the stock is purchased on the open market and not from the company. For these companies, the employee savings plan, although not presently utilized or even considered as a capital source, represents a readily available potential source of capital. In a few companies, these plans have provided substantial amounts of new equity capital.

Recently, several studies have been made of these plans, i.e. by the National Industrial Conference Board, the Bankers Trust Company, and the Labor Department. To date, these studies have been definitive in nature, covering only the mechanics of the plans. No aggregate information concerning the amount of funds being invested in company stock is recorded in these studies. Research is needed to reveal the scope of employee savings plans as a capital source, both actual and potential. This study is designed to determine whether or not the funds currently being invested in company stock by the trustee of the employee savings plan are significant in terms of the firm's capital needs.

**Methodology** - The first phase of the research has been to gather available data on the savings plans from public sources. For many plans, the registration statements filed with the Securities and Exchange Commission have been examined.

The second phase of the research will be to gather certain information directly from eligible companies from their plan descriptions and financial statements, supplemented by a questionnaire. The enclosed questionnaire is designed to disclose the amount and source of the company stock purchased by the plan trustee, the data necessary for evaluation as an equity source, and how this source of capital is involved in the financial planning of the firm.

The information obtained from the SEC records and the companies will be combined and analyzed to determine the following:

1. The importance of savings plans as an actual and potential source of capital.
2. The efficiency of this equity capital source based on flotation costs.
3. The factors considered by financial managers in evaluating savings plans.
4. The advantages and disadvantages of this equity source.

August 7, 1967

Dear Sir:

On July 8, 1967, I wrote you asking if you would participate in a doctoral dissertation study in the area of utilizing employee savings plans as a source of capital. Since I have not heard from you, I presume that you would like further information concerning the study before deciding to participate.

The purpose of the study is to measure the significance of the funds from these plans as a potential equity capital source. The funds being invested in company stock (regardless whether this stock is presently purchased from the open market or the company) will be compared to the traditional sources of funds utilized by the company involved. Equally important purposes are to determine the percent of trading in the stock being accomplished by the trustee and the percent of shares outstanding subject to vote by the trustee. In addition, the advantages and disadvantages of this source of capital are being analyzed.

I think you will agree that these are important areas for research as your savings plan may some day be considered as a source of capital, if it is not now being used as such. The availability of a definitive study such as this would certainly aid in any consideration by your financial executives of utilizing this source of capital.

To date, out of a population of 130 companies, information has been obtained on the savings plans of 74 companies. Some of these companies have successfully used the savings plan as a source of capital.

In no way will the name of a participating company be associated with the information on its savings plan or the conclusions presented in the study.

If you would like to participate in a study of this nature, would it be possible for you to supply me with a description of your plan, financial statements of the plan for the years 1962 through 1965, and the completed questionnaire mailed to you July 8th? If the questionnaire has been destroyed, your comments on the advantages and disadvantages of the plan as a source of capital would be of value to me.

Please let me know if you wish to participate in this study or if you have any questions concerning the methodology to be employed.

Irrespective of your decision, thank you for the attention which you have given my request.

Very truly yours,

Frederick G. Davis

## APPENDIX IV-B

### Companies Comprising the Research Population

Acme Markets, Inc.  
Aluminum Company of America  
Allegheny Ludlum Steel Corp.  
Amerada Petroleum Corp.  
American Gas Co.  
Armco Steel Corp.  
Ashland Oil & Refining Co.  
Atlantic Richfield Co.  
Atlas Chemical Industries, Inc.  
Babcock & Wilcox  
Beckman Instruments, Inc.  
Campbell Soup Co.  
Carolina Power & Light Co.  
Caterpillar Tractor Co.  
Central and South West Corp.  
Central Illinois Light Co.  
Certain-Teed Products Corp.  
Chrysler Corp.  
Cities Service Co.  
Coca-Cola Co.  
Colgate-Palmolive Co.  
Columbia Gas Systems, Inc.  
Commercial Solvents Corp.  
Consolidated Natural Gas Co.  
Continental Oil Co.  
Conwood Corp.  
Corn Products Co.  
Crescent Corp.  
Crown Zellerbach Corp.  
Crucible Steel Co. of America  
Douglas Aircraft Co.  
Duke Power Co.  
El Paso Natural Gas Co.  
Eversharp, Inc.  
FMC Corp.  
Federal-Mogul Corp.  
Fluor Corp.  
Ford Motor Co.  
Freeport Sulphur Co.  
General American Transportation Co.

General Dynamics Corp.  
General Electric Co.  
General Motors Corp.  
General Public Utilities Corp.  
General Refractories Co.  
Gerber Products Co.  
Gillette Co.  
The Great Atlantic & Pacific Tea Co.  
Grumman Aircraft Engineering Corp.  
Gulf Oil Corp.  
Gulf States Utilities Co.  
Harbison-Walker Refractories Co.  
Hercules, Inc.  
Hoffman Electronics Corp.  
Indianapolis Power & Light Co.  
Interlake Steel Corp.  
International Harvester Corp.  
Jones & Laughlin Steel Corp.  
Kerr-McGee Corp.  
Lehigh Portland Cement Co.  
Lone Star Gas Co.  
Manhattan Shirt Co.  
Marathon Oil Co.  
Maremont Corp.  
McKesson & Robbins, Inc.  
Merck & Co.  
Midwest Oil Corp.  
Mobil Oil Corp.  
Montgomery Ward & Co.  
Mountain Fuel Supply Co.  
NVF Co.  
National Biscuit Co.  
National Steel Corp.  
Niagara Mohawk Power Corp.  
Northern Natural Gas Co.  
Northrop Corp.  
Oklahoma Natural Gas Co.  
Olin Mathieson Chemical Corp.  
Owens-Corning Fiberglass Corp.  
Pacific Gas & Electric Co.  
Pacific Lighting Corp.  
Panhandle Eastern Pipe Line Co.  
Peabody Coal Co.  
Pennsylvania Railroad Co.  
Chas. Pfizer & Co.  
Phillips Petroleum Co.  
Pittsburgh Plate Glass Co.  
Pittston Co.  
Quaker State Oil Refining Corp.  
Rohm & Haas Co.  
Rohr Corp.

San Diego Gas & Electric Co.  
Scott Paper Co.  
Seeburg Corp.  
Shell Oil Co.  
Sinclair Oil Corp.  
Skelly Oil Co.  
South Carolina Electric & Gas Co.  
Southern California Edison Co.  
Southern Natural Gas Co.  
Standard Oil Co. (Indiana)  
Standard Oil Co. (N. J.)  
Sun Oil Co.  
Sunray DX Oil Co.  
Swift & Co.  
Tenneco Co.  
Texaco, Inc.  
Texas Eastern Transmission Corp.  
Texas Gas Transmission Corp.  
Textron, Inc.  
Tidewater Oil Co.  
Timken Roller Bearing Co.  
Transamerica Corp.  
Transwestern Pipeline Co.  
Trans World Airlines, Inc.  
Union Carbide Corp.  
United Engineering & Foundry Co.  
United Gas Corp.  
United States Steel Corp.  
United States Tobacco Co.  
Universal American Corp.  
Universal Leaf Tobacco Co.  
Vanadium Corp. of America  
Virginia Electric & Power Co.  
Vulcan Materials Co.  
Wheeling Steel Corp.

## CHAPTER FIVE

### PHASE ONE OF THE EMPIRICAL RESEARCH

#### 5.1 Introduction

#### 5.2 Analysis of Flow of Funds

##### 5.2.1 Procedure Followed

##### 5.2.2 Results of Comparison of Funds Available to Capital Sources Used

##### 5.2.3 Results of Comparison of Funds Available to Actual New Capital Raised

##### 5.2.4 Subgroup Patterns

(a) Age of the plan

(b) Type of industry

#### 5.3 Analysis of Stability

##### 5.3.1 Procedures Followed

##### 5.3.2 Results of Analysis of Stability of Funds

##### 5.3.3 Results of Analysis of Available Funds Actually Invested in Company Stock

#### 5.4 Analysis of Flotation Costs

#### 5.5 Analysis of Trustee Voting Power

##### 5.5.1 Procedures Followed

##### 5.5.2 Results of Analysis of Voting Provisions

##### 5.5.3 Results of Analysis of Trustee Voting Power



5.6 Analysis of Trustee Trading in the Open Market

5.6.1 Procedures Followed

5.6.2 SEC Interest in Savings Plan Market Purchases

5.6.3 Results of Analysis of Annual Trading Volume

5.7 Summary

Appendix V-A Schedule of Total Sources, Equity Sources,  
and Available Equity Funds from Savings Plans  
1962-1966.

## CHAPTER FIVE

### 5.1 Introduction

The primary objective of this research was to investigate the effects on financial planning as a result of the existence of a potential source of equity capital through the sale of newly issued stock to the trustee of the company sponsored employee savings plan. The unique features of a new capital source determine the direction and degree the financial planning will be altered as the new source is evaluated in the environment of the interaction of company goals, existing financial structure, predicted demand for funds, and available sources of funds. The unique features of the employee savings plan as an equity capital source were labeled characteristics and developed on a theoretical basis in Chapter Three. From the abstract analysis in that chapter, five characteristics were identified that were considered unique to the savings plan and also likely to affect financial planning. These five characteristics that became the subject of the first phase of the empirical research were: (1) the type and magnitude of the flow of funds; (2) the stability of this source; (3) the limited flotation cost; (4) the introduction

of new types of voting shareholders; and (5) the open market purchases of company stock.

This chapter consists of a report of the results of efforts to field test the existence of these characteristics and to more completely describe them. Due to the crucial issue of whether the magnitude of the available funds from this source was sufficient to warrant consideration in financial planning, the largest portion of the empirical research to analyze the characteristics was devoted to accumulation and evaluation of historic information on the amount of funds available. The results of this research on the magnitude of available funds are summarized in section 5.2. The stability of the available funds was analyzed by reference to the growth rate of available funds during the years studied. Section 5.3 is a presentation of the method utilized to compute the growth rates, the size of the rates and explanation of the causes in the growth of available funds. The results of previous studies on flotation costs of new corporate equity issues and the results of an analysis of the implied flotation costs of new equity issues through savings plans are summarized in section 5.4. The development of a new class of voting shareholders was investigated by analyzing the provisions for voting the company stock held in trust for the savings plan and tabulating the percent of outstanding stock held by these plans. The outcome of this investigation is reported in

section 5.5. The final characteristic, the open market purchases of company stock, was evaluated in light of recent Securities and Exchange Commission action against companies trading in their own stock through company regulated employee benefit plans. A resume of the SEC action and the results of a tabulation of the percent of total open market purchases of the company stock made to fulfill the requirements of the savings plans comprise section 5.6.

In each of these sections, the reasoning behind the analysis made and the procedures followed will precede the results of the tests.

## 5.2 Analysis of Flow of Funds

Numerous theoretical advantages of the savings plan as a source of equity capital were developed in Chapter Three. The advantages are meaningless, however, if the funds available from this source are insufficient to warrant consideration in financial planning. The purpose of this section is to present the results of efforts to measure the magnitude of the funds available from this source and compare this amount to the company's capital requirements.

The term, "available funds," is defined as the amount of cash invested by the independent trustee of the employee savings plan in the common stock of the company sponsoring the plan during the study period (calendar years 1962 through 1966). This amount was considered available

to the corporations concerned for new equity financing regardless of whether this stock was actually purchased by the trustee from the company or purchased on the open market. The question investigated was whether the amount of funds available through the savings plan was sufficient to be considered by financial management if new equity financing was deemed appropriate.

#### 5.2.1 Procedures Followed

The problem in designing this portion of the research was to devise a method to evaluate the amount of funds available. The mere accumulation of the annual amount invested in company stock by the trustee of the savings plan was relatively simple and is presented in Appendix V-A (column C). However, these figures, while indicating millions of dollars were available, are rather meaningless by themselves. Three approaches were taken to evaluate these available funds in terms of the need for funds.

The first approach was to compare the funds available during the study period to the sources of capital actually utilized during the study period. For each of the eighty-eight companies for which the total savings plan funds invested in company stock could be determined, the sources of capital actually utilized were accumulated. This information was obtained from the annual reports of these companies, supplemented by Moody's and Standard &

Poor's published summaries of corporate records. Table V-1 is an example of the information collected and various computations made (some of which are described and analyzed in subsequent sections of this chapter). A worksheet similar to the example was prepared for each of the eighty-eight companies.

The funds invested in company common stock by the savings plan (available funds) were compared to the total capital utilized during the study period (total of 1. through 4. in Table V-1) and compared to the equity capital utilized during this period (total of 2. plus 4. in Table V-1). The comparison of available funds to total sources used indicates the portion of actual funds utilized during the period that could have come from the savings plan if newly issued stock had been sold to the plan. The reliance upon funds supplied by equity sources, retained earnings, and new common stock issues varies in each corporation; therefore, a second comparison was made to determine the portion of equity funds utilized during the period that could have been acquired through the savings plan. These comparisons were expressed as percents in order to derive a common measure regardless of the size of the corporation and the number of years for which information was available. The totals of all the sources utilized, the equity sources utilized, the amount available from the savings plan, and

Table V-1: Example of financial information gathered and computations made (dollars in millions)

	Total 5 Years	1962	1963	1964	1965	1966
Sources of funds used:						
1. Depreciation	\$150.8	\$24.9	\$27.3	\$30.8	\$32.4	\$35.4
2. Retained earnings	48.8	8.9	9.1	9.5	10.6	10.7
3. New long-term debt	120.0	--	30.0	--	40.0	50.0
4. New equity capital	52.1	--	--	52.1	--	--
Total all sources	<u>\$371.7</u>	<u>\$33.8</u>	<u>\$66.4</u>	<u>\$92.4</u>	<u>\$83.0</u>	<u>\$96.1</u>
Total equity sources	<u>\$100.9</u>	<u>\$ 8.9</u>	<u>\$ 9.1</u>	<u>\$61.6</u>	<u>\$10.6</u>	<u>\$10.7</u>
Funds of savings plan available for investment in company stock:						
Employee savings	\$ 4.03	\$ 0.66	\$ 0.71	\$ 0.77	\$ 0.90	\$ 0.99
Employer contributions	2.04	0.35	0.36	0.38	0.45	0.50
Reinvested dividends	1.65	0.23	0.29	0.33	0.39	0.41
Total available funds	<u>\$ 7.72</u>	<u>\$ 1.24</u>	<u>\$ 1.36</u>	<u>\$ 1.48</u>	<u>\$ 1.74</u>	<u>\$ 1.90</u>
Funds of savings plan actually invested in company stock						
	<u>\$ 7.55</u>	<u>\$ 1.14</u>	<u>\$ 1.33</u>	<u>\$ 1.46</u>	<u>\$ 1.62</u>	<u>\$ 2.00</u>

Table V-1 Continued:

Funds available from savings plan as percent of total sources used	$7.72/371.7 = 2.08\%$
Funds available from savings plan as percent of equity sources used	$7.72/100.9 = 7.65\%$
Funds actually invested in company stock as percent of available from savings plans	$7.55/7.72 = 97.8\%$



the percentages for each company are listed in Appendix A of this chapter. The companies are not identified due to the confidential nature of the information.

The second approach undertaken to evaluate the magnitude of the available funds was to derive a standard to give the percentages computed in the first phase more meaning. Knowledge of what percent of the funds actually utilized that could have come from sale of stock to the savings plan does not by itself give any indication of whether the available funds were large enough to be considered. The size of the amount of available funds necessary to receive consideration depends upon the views of the financial management of each individual firm. However, the portion of corporate capital that was raised through new issues for all corporations was used as a standard that was applied to corporations in this study to provide an indication of when the available funds become large enough to be considered in financial planning.

The aggregate totals of sources of funds of non-farm, non-financial, corporate business are presented in Table V-2. New equity capital provided by the sale of stock accounted for 2.8% of the total sources of funds utilized by corporate business in the twelve years, 1955-1966. This percentage is utilized as a standard to evaluate the magnitude of new equity capital available from savings plans.

Table V-2: Source of capital; non-farm, non-financial corporate U.S. businesses 1955-1966

<u>Type</u>	<u>Source</u>	<u>Billions of dollars</u>	<u>Percent</u>
1	Capital consumption allowances (depreciation)	\$315.1	50.4%
2	Undistributed profits	169.2	27.0
3	Bonds	57.5	9.2
	Mortgages	21.5	3.4
	Bank loans	36.4	5.8
	Other loans	8.5	1.4
4	Stocks	<u>17.5</u>	<u>2.8</u>
	Total sources	<u>\$625.7</u>	<u>100.0%</u>
Equity sources:			
2	Undistributed profits	\$169.2	90.6%
4	Stocks (external)	<u>17.5</u>	<u>9.4</u>
	Total equity sources	<u>\$186.7</u>	<u>100.0%</u>

Source:

Table B-69 Sources and uses of funds, non-farm, non-financial corporate business 1955-1966, Economic Report of the President Transmitted to Congress January 1967.

Equity capital is raised by a corporate business from two sources: (a) internal to the corporation through earnings not distributed as dividends (undistributed profits) and (b) external to the corporation through new stock issues. For all corporations the external sources provided 9.4% of the total equity capital. This percentage is utilized as a second standard to evaluate the magnitude of new equity capital available from savings plans.

The third approach undertaken to evaluate the available funds in terms of the need for funds was to investigate the amount raised by the corporations through new equity issues using the normal channels; subscription rights to existing stockholders, and new issues sold through the open market. Because only seven of the eighty-eight companies raised new equity capital during the study period (1962-1966), the information on new equity issues was collected for the last eleven years (1956-1966). The amount of funds available from the savings plans of these companies for the last year of the study period was compared to the amount raised by the new equity issue. This information provided an indication of the amount of funds that could be expected to be raised by an equity issue and how long it would take to raise a like amount from the available funds of the savings plan.

### 5.2.2 Results of Comparison of Funds Available to Capital Sources Used

The details of the comparison of the funds available from savings to the total capital actually utilized for each of the eighty-eight companies are presented in Appendix A to this chapter. Table V-3 summarizes this comparison by grouping the companies according to the percent the funds available were of total capital used. The funds available from the company's savings plan, expressed as a percent of the total capital utilized by the company, ranged from less than 1% to 19.8%. The funds available percentage was above the aggregate standard of 2.8% established in the previous section in forty-six companies (52%). The median percent was 3.3%.

The amount of dollars invested in company stock by the trustees of the savings plans ranged from almost 500 million dollars to less than one million dollars for those plans for which information was available for the full five years. Each of twenty-nine of the eighty-eight companies could have raised over ten million dollars from the savings plan during this five year period (1962-1966).

The funds available from the savings plans were also compared to the equity capital actually utilized during the study period for each company. A summary of this comparison is presented in Table V-4. The savings plan's funds as a percent of actual equity funds used ranged from

Table V-3: Summary of funds available from savings plans compared to  
total capital sources utilized 1962-1966

<u>Percent Funds Available of Total Capital Used</u>	<u>Savings Plan Funds Invested in Company Stock</u>	
	<u>Number</u>	<u>Percent of Total</u>
Less than 1%	4	5%
1% thru 1.9%	19	21
2.0% thru 2.8%	19	22
Standard 2.8% from Table V-2		
2.9% thru 3.9%	12*	13
4.0% thru 4.9%	4	5
5.0% thru 5.9%	12	13
6.0% thru 6.9%	6	7
7.0% thru 7.9%	4	5
Greater than 8.0%	<u>8</u>	<u>9</u>
Total	<u>88</u>	<u>100%</u>

\* median

Source:

See Appendix V-A.

Table V-4: Summary of funds available from savings plans compared to equity capital utilized 1962-1966

<u>Percent Funds Available of Equity Capital Used</u>	<u>Savings Plan Funds Invested in Common Stock</u>	
	<u>Number</u>	<u>Percent of Total</u>
Less than 4.0%	10	12%
4.0% thru 6.9%	11	13
7.0% thru 9.4%	10	12
Standard 9.4% from Table V-2		
9.5% thru 13.9%	18*	20
14.0% thru 16.9%	13	15
17.0% thru 19.9%	5	6
20.0% thru 24.9%	8	9
25.0% thru 29.9%	6	7
Greater than 30.0%	<u>5</u>	<u>6</u>
Total	<u>86</u>	<u>100%</u>
Companies with losses during study period	2	

\* median

Source:  
See Appendix V-A

less than 1% to 52.8%. The median for the eighty-six companies was 11.6%. (Two companies had substantial losses during the study period making any comparison of available funds from savings plans to retained earnings plus new equity capital meaningless.) Fifty-five companies (63%) had a higher percentage than the standard of 9.4% established by the aggregate data.

These two comparisons indicate that the funds available from the savings plans in over one-half of the companies were a larger percentage of total capital sources and of the equity capital sources than the twelve year average percentages of new external equity capital for all U.S. corporations. This is at least an indication that these funds available from the savings plan were of enough magnitude to enter the financial planning of many of the companies studied.

There were thirteen of the eighty-eight companies that did use the savings plan as an equity source as reported in Chapter Four. When these thirteen companies were considered separately, the median percent of available funds to total capital sources was 2.4% (compared to a median of 3.3% for all eighty-eight companies). The median for the second comparison of available funds to equity capital sources was only 5.4%, considerably below the median of 11.6% for all companies studied. The small amount of funds available compared to other capital sources

did not deter these thirteen corporations from utilizing the savings plan as a capital source. This is a further indication that the amounts available from the savings plans were sufficient enough in many companies to warrant consideration in financial planning.

These thirteen companies raised a combined total of 148.8 million dollars of new equity capital through the sale of newly issued stock to their savings plans during the study period. The maximum raised by any one company in this manner was 49.1 million dollars. Five of the thirteen companies utilized all the available funds from the savings plans by providing newly issued stock for the total savings plans' demand for company stock during the five years studied. The other eight companies made available newly issued stock for only part of their plan's investment in company stock; the source of the remainder was treasury stock purchased from the company or purchases by the trustee on the open market. These eight companies thereby regulated the new equity capital raised from the savings plans by making available newly issued stock only when new equity funds were desired.

Obtaining funds through a new equity capital issue is usually a rare event in the financial affairs of a firm. The following analysis indicates how infrequently new equity issues were floated by the corporations studied, as well as



the size of the funds available from the savings plans compared to the amount raised through normal equity financing.

5.2.3 Results of Comparison of Funds Available to Actual New Capital Raised

One additional comparison was made to evaluate the amount of funds available from the savings plans. The analysis involved a comparison of the amount available from the savings plan in one year to the amount actually raised in the last issue of new stock through traditional channels. The amount the companies raised in their last equity issue was assumed to be the amount that would normally be raised at one time through new equity financing.

While making the examination of annual reports and corporate records to acquire the information for the tests described in the previous section, a record was compiled of new equity issues through normal channels, i.e. subscription rights to existing stockholders and new equity issues sold through the open market. During the study period only seven of the eighty-eight companies studied (8%) raised new equity capital through normal channels. For these eighty-eight companies, more used the savings plan to raise new equity capital (thirteen or 15%) than used the normal channels.

Considering the last eleven years (1956 through 1966), twenty-six or 30% of the companies raised new equity

capital through rights or cash offers. (Note, three companies had more than one new equity issue during this period, however only the amount of the most recent issue was used for this test.) The amount of funds available from the savings plans of these companies (used to purchase company stock) for the last year of the study period was compared to the net proceeds of the most recent new equity issue for these twenty-six companies. A summary of the results of this comparison is presented in Table V-5. For these twenty-six companies, the funds available from the savings plan in one year, as a percent of the net proceeds from actual new equity issues, ranged from 1.3% to 29.7% with the median 8.3%. In other words, for over half of these companies, it would take over twelve years to raise equivalent funds through the sale of stock to the savings plans as was actually acquired through the last new stock issue.

The results of this comparison indicate that due to the small amount of funds available in any one period, taking advantage of the savings plan as an equity capital source is not likely to replace the traditional new equity sources of rights and cash issues. It is conceivable that some firms, through careful long range planning, could raise the total new equity required through sales of newly issued stock to their savings plan. However, this source appears more suitable for rebalancing the capital structure

Table V-5: Funds of savings plans invested in company stock in 1966  
as percent of net proceeds of last common stock issue sold  
1956-1966

<u>Percent</u>	<u>Companies</u>
less than 3.0%	2
3.0% thru 5.9%	6
6.0% thru 8.9%	7*
9.0% thru 11.9%	5
12.0% thru 14.9%	3
greater than 15.0%	<u>3</u>
	<u>26</u>

\* median

Source:

Proceeds of last common stock issue- Standard and Poor's Corporate  
Records.

Funds from savings plans invested in company stock in 1966- replies  
to questionnaires.

or to compliment the new stock issues through normal sources. Seven of the twenty-six companies did use the savings plan in conjunction with the normal sources to raise new equity capital. Three companies that raised new equity capital through rights or cash issues during the study period also raised equity capital through sale of newly issued stock to their savings plan. Two companies that had raised new equity capital through normal channels prior to the study period sold newly issued stock to their savings plan during the study period. In addition, two companies sold the unsubscribed balance of a rights issue offered to existing shareholders to their savings plan during the study period.

This use of the savings plan in conjunction with traditional equity capital sources could affect financial planning for new equity planning in several ways. The funds from the savings plan could be used where small amounts are required, reserving the traditional sources for those situations where large amounts of funds are needed in a short period of time. When a new rights or cash issue is made, the savings plan could be used as a back-up to provide any required funds not raised through the major issue or to pick up the unsubscribed portion of a rights issue. The availability of the savings plan could thus reduce the uncertainty of the amount of funds

that could be acquired through the new issue, which could reduce the underwriting costs and also reduce the extent of underpricing necessary in a rights issue.

#### 5.2.4 Subgroup Patterns

The results of the analysis of the magnitude of the funds available from the savings plans invested in company stock were separated into subgroups to determine if discernible differences existed. No relationship was found between the size of the company determined by sales and the size of available funds, nor was any relationship found between the number of employees and the size of these funds. However, the separation by age of the plan and type of industry did produce meaningful patterns which are described in this section.

(a) Age of the Plan: The results of the first approach to analyze the magnitude of funds separated by the age of the plan are presented in Tables V-6 and V-7. There were four of the eighty-eight plans for which the effective starting date of the plan was not available. In the newer plans (those in existence less than five years), the funds available from the savings plans were less significant than the funds of those plans in existence longer. Compared to total capital used, only nine of twenty-four newer plans (37%) had funds in excess of the aggregate standard of 2.8%. However, 60% (21 of 35) of the plans in existence

Table V-6: Funds available from savings plans compared to total capital utilized by age of plan 1962-1966.

<u>Percent Funds Available of Total Capital Used</u>	<u>Companies by Age of Savings Plan</u>			<u>Total</u>
	<u>Less than 5 years</u>	<u>5 to 9 years</u>	<u>Greater than 10 years</u>	
Less than 1%	2		1	3 <sup>#</sup>
1.0% thru 1.9%	7	5	6	18 <sup>#</sup>
2.0% thru 2.8%	6*	9	4	19
2.9% thru 3.9%	4	5*	2*	11 <sup>#</sup>
4.0% thru 4.9%	2		1	3 <sup>#</sup>
5.0% thru 5.9%	3	4	5	12
6.0% thru 6.9%		4	2	6
7.0% thru 7.9%		2	2	4
Greater than 8.0%	—	6	1	7 <sup>#</sup>
Total	<u>24</u>	<u>35</u>	<u>24</u>	<u>83<sup>#</sup></u>
* Median	2.4%	3.5%	3.3%	
Range	0.5% to 5.8%	1.3% to 19.8%	0.7% to 10.2%	

<sup>#</sup> Different total from Table V-3, age unknown for five plans.

Source:

See Appendix V-A.

Age of plan from plan descriptions.

Table V-7: Funds available from savings plans compared to equity capital utilized by age of plan 1962-1966.

<u>Percent Funds Available of Equity Capital Used</u>	<u>Companies by Age of Savings Plan</u>			<u>Total</u>
	<u>Less than 5 years</u>	<u>5 to 9 years</u>	<u>Greater than 10 years</u>	
Less than 4.0%	3	1	5	9 <sup>#</sup>
4.0% thru 6.9%	7	1	2	10 <sup>#</sup>
7.0% thru 9.4%	2*	6	2	10
9.4% thru 13.9%	7	9	2	18
14.0% thru 16.9%	1	8*	3*	12 <sup>#</sup>
17.0% thru 19.9%		1	4	5
20.0% thru 24.9%	1	5	1	7 <sup>#</sup>
25.0% thru 29.9%	1	2	3	6
Greater than 30.0%	<u>1</u>	<u>2</u>	<u>2</u>	<u>5</u>
Total	<u>23</u>	<u>35</u>	<u>24</u>	<u>82<sup>#</sup></u>
* Median	8.2%	14.1%	14.1%	
Range	0.8% to 41.6%	3.4% to 52.8%	2.0% to 38.9%	

<sup>#</sup> Different total from Table V-4, age unknown for four plans.

Source:

See Appendix V-A.

Age of plan from plan descriptions.

five to nine years and 54% (13 of 24) of the plans in existence over ten years had funds that were above this same standard.

Those plans in existence for a shorter time than the study period are included in the research population. For these plans, the funds available from the savings plan were compared to total capital used and equity capital used only for the period the plan was in effect. For example, if the plan became effective on June 30, 1964, the funds invested in company stock from that date through December 31, 1966 were compared to actual capital used by the sponsoring company for the two and one-half years ending December 31, 1966.

When the funds available from savings plans were compared to the equity capital used (Table V-7), only eleven of twenty-three newer plans (46%) generated funds which were above the aggregate standard of 9.4%. For the plans in existence from five to nine years, the funds of 77% (27 of 35) were above this standard and for those in existence over ten years, 63% (15 of 24) were above 9.4% of the equity capital. The percent of companies above the standard was smaller for companies in existence over ten years than for those in existence five to nine years due to the large number of oil companies (eleven) in the group in existence over ten years. As explained subsequently, many plans of



these oil companies had provisions which limited the amount of funds available.

The funds of the newer plans were smaller primarily due to the limited amount of dividends that were received on the stock held in trust. The longer the plan was in existence, the greater the number of shares held in trust and accordingly, the greater the amount of dividends reinvested in company stock. A test was made of the growth rate of reinvested dividends and the results are presented in section 5.3.2 of this chapter.

Many of the newer savings plans did allow, within the provisions of the plan, for the company to sell newly issued stock to the trustee. Ten of the twenty-four plans in existence less than five years (42%) contained such provisions compared with twenty-three of the fifty-nine plans in existence longer than five years (39%).

(b) Type of industry: The industry code was obtained for each company in the research population from Dun and Bradstreet's 1967 Million Dollar Directory. These industry codes are the Standard Industry Classification codes prepared by the Technical Committee on such codes of the Office of Statistical Standards of the Bureau of the Budget, Executive Office of the President. Two industries were prevalent enough in those companies that replied to warrant computing separate summaries of the tests of magnitude of available funds. One industry was the utility

industry which includes all companies whose industry code begins with the digits 49. This code encompasses electric companies, gas companies, and natural gas transmission and distribution companies. The second industry was the petroleum industry which includes those companies coded 1311, crude petroleum and natural gas production, and coded 2911, petroleum refining.

There were twenty-eight utility companies in the research population of which financial information for twenty-three (82%) was obtained through response to the mail request for information or SEC records. This was a much better coverage of the population than for all companies for which financial information was available for 88 of 126 (70%). The results of the two analyses of magnitude of available funds are presented in Tables V-8 and V-9 for this industry. These tables should be compared to Tables V-3 and V-4 which present the results for all companies. The median for the utility companies in the first comparison (Table V-8) was below the standard established from aggregate sources of funds (2.8%). It was also below the median of 3.3% for all companies in this comparison. The lower average was due to the more extensive use of debt capital by the utility companies than was found in non-regulated companies. The funds available from the savings plans were above the standard in only eight utility

Table V-8: Funds available from savings plans compared to total capital utilized by type of company 1962-1966

<u>Percent Funds Available of Total Capital Used</u>	<u>Utilities</u>	<u>Petroleum</u>
Less than 1%	1	1
1.0% thru 1.9%	7	6
2.0% thru 2.8%	7*	4*
2.9% thru 3.9%	6	3
4.0% thru 4.9%	2	
5.0% thru 5.9%		4
Greater than 6.0%	—	<u>2</u>
Total	<u>23</u>	<u>20</u>
* Median	2.7%	2.6%
Range	0.3% to 4.4%	0.7% to 12.7%

Source:

See Appendix V-A.

Industry per Dun and Bradstreet's 1967 Million Dollar Directory.

Table V-9: Funds available from savings plans compared to equity capital utilized by type of company

<u>Percent Funds Available of Equity Capital Used</u>	<u>Utilities</u>	<u>Petroleum</u>
Less than 4.0%	1	5
4.0% thru 6.9%	2	2
7.0% thru 9.4%	4	2
9.5% thru 13.9%	5*	5*
14.0% thru 16.9%	6	1
17.0% thru 19.9%		2
20.0% thru 24.9%	3	2
Greater than 25.0%	<u>2</u>	<u>1</u>
Total	<u>23</u>	<u>20</u>
* Median	13.7%	11.0%
Range	1.7% to 38.9%	2.0% to 25.1%

Source:

See Appendix V-A.

Industry per Dun and Bradstreet's 1967 Million Dollar Directory.

companies (35%) compared to 52% above the standard for all companies.

However, when the second comparison to funds from retained earnings and new equity issues was considered, more utility companies had funds available from savings plans that were above the standard (Table V-9). Sixteen companies (70%) had funds available from the savings plan which were above the aggregate standard of 9.4% compared to 62% above the standard for all industries. The results of this second comparison are especially important because the utilities industry raises capital through new equity issues much more frequently than non-regulated industry. Of the twenty-six companies that did float new equity issues in the past ten years (Table V-5), sixteen or 62% were utilities. The utilities accounted for only 26% of the total companies for which financial information was available (twenty-three of eighty-eight). For the utility company that raises new equity capital every few years, the savings plan could be an important source of equity capital that should be taken into consideration.

It is also interesting to note that one utility company had sold convertible debentures to its savings plans and two utility companies had sold preferred stock to their savings plans. For these companies the savings plan had been a source of capital beyond the equity capital considered in this research.

The results of the two comparisons in the petroleum industry are also presented in Tables V-8 and V-9. There were twenty-five petroleum companies in the research population (four also classified as utilities and included in the utilities) of which financial information was available for twenty. By the first comparison, nine of the companies had funds above the 2.8% standard and the median was below the standard. By the second comparison, eleven had funds above 9.4%. In both cases the percent of companies having funds above the aggregate standards was less than the percent for all companies for which financial information was available. There are several possible explanations for the smaller percentages of funds available from savings plans in the petroleum industry. The number of employees compared to the capital invested in this industry was smaller than in the manufacturing industry, thus there were relatively fewer participants in the plans. The savings plans of several petroleum companies (eight) allowed the participants to order the trustee to sell their company stock at any time and shift the funds to other investments or hold the funds in cash for subsequent investment. The trustee usually accomplished these sales through purchases within the plan reducing the funds available for purchase of company stock. The funds available from these plans were taken net of such interfund transactions in preparing the tests. One petroleum company's savings plan specified

that all withdrawals should be in cash which the trustee obtained through interfund sales, again reducing the funds available for purchase of company stock.

For the petroleum companies, the available funds from savings plans were smaller relative to capital requirements than the funds of the plans of manufacturing or utility companies, and thus, would have less effect on financial planning.

### 5.3 Analysis of Stability

The second unique characteristic of the savings plan as a source of new equity capital and one likely to affect financial planning is stability. By stability is meant the continuous existence of the availability of funds in amounts that are relatively the same in each period and subject to reasonably accurate predictions. As pointed out in Appendix II-A, the employee savings plan must be established on a permanent basis to qualify under the Internal Revenue Code for certain income tax benefits. The employer still has the right to terminate or amend the plan; however, the plan must be maintained on a continuous basis while in operation. This IRC restriction has the effect of forcing the employer to retain his savings plan basically on the same terms once the plan has been adopted.

### 5.3.1 Procedures Followed

The funds for equity financing via employee savings plans were characterized in Chapter Three as being available in small, steady, even amounts. The steady, even flow of funds was tested by comparing the plan funds invested in company stock in one year with the funds invested in the previous year. This comparison was expressed as an average annual growth percentage rate (the difference between the two years divided by the amount invested in the earlier year). A similar average annual growth rate was computed for the dividends reinvested in company stock. Information necessary to complete these annual growth rates was available for forty-eight companies.

The amount of funds actually invested in company stock by the savings plan trustee was less than the total of the participants' savings, company contributions, and dividends for various reasons explained subsequently. An analysis was made comparing the amount of funds actually invested in company stock to the amount of funds the trustee could have invested in company stock. This comparison was expressed as a percentage and was computed for each of the thirty-nine companies for which the information was available.

### 5.3.2 Results of Analysis of Stability of Funds

The growth rates of total invested funds were computed only for those companies for which information was



available for four years. The first year of the plan's operation was excluded in counting these four years, as the growth rate between the first and second year of operation would be expected to be large and not representative of the normal fund growth. The growth rates for the invested funds of each company, summarized in Table V-10, are arithmetic averages for which the growth rate of reinvested dividends was also available to allow comparison.

The funds available from the savings plans in most companies grew at a small but steady rate. The funds of only two plans declined during the study period. The majority (79%) of the plans had a growth rate of over 5% per year. The results of this analysis indicate that for the majority of the plans tested, the funds that could be used for equity capital are available in amounts that vary little from one year to the next and the small variance is almost always an increase in funds available. The financial manager considering the use of these funds as equity capital should compute the growth rate of the funds of his company's plan to accurately forecast the amount of funds available.

The primary reason for the growth of invested funds in a mature savings plan is the compounding effect of dividends paid on the stock held in trust. Much of the stock purchased under the savings plan will be left in trust until termination of the participant's employment to gain the most favorable income tax treatment. All of the

Table V-10: Average growth rate funds invested in company stock  
and dividends reinvested in company stock 1962-1966

Average Annual Percent Growth Rate	Funds		Dividends	
	Number	Percent of Total	Number	Percent of Total
negative growth	2	4%		
0.0% to 4.9%	8	17	1	2%
5.0% to 9.9%	16*	33	6	13
10.0% to 14.9%	10	21	6	13
15.0% to 19.9%	8	17	3	6
20.0% to 24.9%	2	4	5	10
25.0% to 29.9%	1	2	7*	15
30.0% to 34.9%			4	8
35.0% to 39.9%			4	8
40.0% to 44.9%	1	2	5	10
45.0% to 49.9%			1	2
greater than 50.0%	—	—	6	13
Total	<u>48</u>	<u>100%</u>	<u>48</u>	<u>100%</u>

\* median

Source:

Compiled from replies to questionnaires.

savings plans, except one, specified that the dividends received on stock held in trust were to be reinvested in company stock (the one exception directed dividends to be distributed when received).

The average annual growth rate of the reinvested dividends is presented in Table V-10. The procedure for computing the average annual growth rate of reinvested dividends was the same as followed for total funds invested. The annual growth rate of reinvested dividends averaged over 20% for thirty-two of the forty-eight companies (66%).

A direct comparison of the growth rates of total funds invested and dividends reinvested is not valid. The growth rate of the reinvested dividends reflects changes in the company dividend payout. The growth rate of total funds invested included changes due to groups of employees added to those able to participate, changes in the savings rate of participants, and in a few plans, changes in the company contribution rate. Even acknowledging these effects on the growth rates, it appears that the growth rate of the dividends far exceeded the growth rate of total invested funds.

The magnitude of these reinvested dividends is illustrated by the portion of total funds invested in company stock. The reinvested dividends as a percent of total plan funds invested in company stock for the last year for which information was available is summarized in

Table V-11. The dividends accounted for over 10% of the funds invested in company stock in almost 70% of the plans. In five plans the reinvested dividends were greater than the company contribution to the savings plan. In estimating the funds available as equity capital, the number of shares held in trust and the projected dividend rate must be taken into consideration.

5.3.3 Results of Analysis of Available Funds Actually Invested in Company Stock

The trustee does not immediately invest all of the funds coming into the trust fund in company stock, even though these funds are designated for that purpose. The trustee must keep certain cash reserves available for withdrawing participants. In addition, funds are allowed to accumulate so round lot purchases of stock can be made to reduce broker's fees. Also, most plans empower the trustee to delay investing to the extent such action is deemed to be in the best interests of the participants concerned. For these reasons, the amount of funds invested in company stock is less than the total amount contributed by the participants and the sponsoring company.

An analysis was made of the amount of funds available that was actually invested in company stock by the savings plans during the study period. The results of the analysis are tabulated in Table V-12. For the thirty-nine companies for which both the contributions and dividends

Table V-11: Dividends reinvested in company stock as percent of total funds invested in company stock 1962-1966

	<u>Number</u>	<u>Percent of Total</u>
Less than 6%	5	7%
6.0% to 7.9%	8	11
8.0% to 9.9%	9	12.5
10.0% to 11.9%	9	12.5
12.0% to 13.9%	6*	8
14.0% to 15.9%	6	8
16.0% to 17.9%	7	10
18.0% to 19.9%	4	6
20.0% to 21.9%	4	6
22.0% to 23.9%	3	4
24.0% to 25.9%	3	4
26.0% to 27.9%	2	3
28.0% to 29.9%	3	4
30.0% to 31.9%	<u>3</u>	<u>4</u>
Total	<u>72</u>	<u>100%</u>

\* median

Source:

Compiled from replies to questionnaires.

Table V-12: Percent of available funds actually invested in company stock 1962-1966

	<u>Number</u>	<u>Percent of Total</u>
99.0% to 100%	7	18%
93.0% to 98.9%	6	15
97.0% to 97.9%	6	15
96.0% to 96.9%	5*	13
95.0% to 95.9%	3	8
90.0% to 94.9%	2	5
85.0% to 89.9%	3	8
80.0% to 84.9%	5	13
70.0% to 79.9%	<u>2#</u>	<u>5</u>
Total	<u>39</u>	<u>100%</u>

\* median

# both companies allow participants to direct contributions to be held in cash until participant deems timing best to buy company stock.

Source:

Compiled from replies to questionnaires.

designated to be invested in company stock and the amount actually invested in company stock were available, the majority (69%) invested over 95% of the available funds. The financial manager considering the company's savings plan as an equity capital source should keep account of the percent invested by the trustee in order to accurately predict the amount of funds available.

#### 5.4 Analysis of Flotation Costs

The third unique feature likely to affect financial planning of the employee savings plan as an equity capital source is the opportunity for the company to sell common stock with little or no initial cost. This initial cost, called flotation cost, was defined in Chapter Three as the difference between the market price of the outstanding shares and the net amount available for use by the corporation per share of new stock sold. The question arises as to the magnitude of this cost savings by using the savings plan to raise new equity capital instead of the traditional sources of rights issues to existing stockholders and cash issues to the general public. Unfortunately, few comprehensive studies of the cost of flotation of common stock issues have been made. Only two were found by this researcher, excerpts of which are presented in this section.

As part of a doctoral dissertation, Harold W. Stevenson made a study of flotation costs of common stock

offerings in 1955.<sup>1</sup> The results of his research are presented in Table V-13. The costs were presented as a percent of the proceeds available for company use, e.g. after all costs had been deducted from the funds given up by the investors. The underpricing costs were determined by comparing the market price of the stock two days before announcement of the subscription issue to the subscription price. The underwriting costs were much smaller for privileged subscriptions (referred to as rights issues throughout this dissertation) than for public issues. The greater the underpricing, the less risk involved for the underwriter and accordingly, the lower his fees. Additionally, the selling job required in rights issues is reduced by the underpricing and direct contact with a favorable market of existing shareholders knowledgeable about the company.

The work required by the company is much more extensive in a rights issue than in a public issue. Accordingly, the expenses are much higher for the rights issue. The most revealing results of Dr. Stevenson's research were the high costs of underpricing in rights issues. Of the fifteen industrial companies for which he able to compute the underpricing costs, Stevenson found

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<sup>1</sup>"Common Stock Financing," Michigan Business Reports, Number 29, University of Michigan (Ann Arbor, 1957).



Table V-13: Relationship of cost of flotation to gross proceeds  
Registered common stock offerings in 1955

	Size of Issue (\$ millions)				
	<u>Under 1.0</u>	<u>1.0-4.9</u>	<u>5.0-9.9</u>	<u>10.0-19.9</u>	<u>20.0 and over</u>
Rights Offerings:					
Public Utilities:					
Compensation		2.71%	1.58%	1.64%	1.07%
Expenses		1.52	1.32	0.86	0.77
Total Costs		<u>4.23%</u>	<u>2.90%</u>	<u>2.50%</u>	<u>1.84%</u>
Manufacturing:					
Compensation	5.44%	4.53%	2.33%	2.24%	1.28%
Expenses	2.74	1.68	0.81	0.72	0.38
Total Costs	<u>8.17%</u>	<u>6.21%</u>	<u>3.14%</u>	<u>2.96%</u>	<u>1.65%</u>
Public Offerings:					
Public Utilities:					
Compensation	5.80%	4.89%	4.11%	2.09%	2.68%
Expenses	2.73	0.98	0.65	0.31	0.30
Total Costs	<u>8.52%</u>	<u>5.87%</u>	<u>4.76%</u>	<u>2.40%</u>	<u>2.98%</u>
Manufacturing:					
Compensation	11.71%	8.34%	6.41%	3.99%	-
Expenses	3.16	1.57	0.74	0.54	-
Total Costs	<u>14.87%</u>	<u>9.90%</u>	<u>7.14%</u>	<u>4.53%</u>	

Based on : Rights offerings; utilities 26 companies, manufacturing 17 companies  
Public offerings; utilities 13 companies, manufacturing 43 companies

Source: Cost of Flotation of Corporate Securities 1951-1955, Securities and  
Exchange Commission, Washington, D.C., 1957, page 61, Table 19.

the average underpricing in 1955 to be 18.1% of the net proceeds. The underpricing averaged 9.4% for forty-eight utility companies issuing common stock through rights issues for the same period. The potential savings by using the savings plan instead of a rights would be substantial.

The Securities and Exchange Commission prepared an extensive study of the cost of flotation of corporate securities for the period 1951-1955.<sup>2</sup> This study covered all registered securities: common stock; preferred stock; and bonds, notes, and debentures. The flotation costs were summarized by type of industry, size of issues, and type of expense for the three types of securities and by public and rights offerings. Table V-13 is one of the summaries presented in this SEC study. This summary is a comparison of flotation costs in rights offerings and public offerings by the size of the issue. The costs were expressed as a percent of gross proceeds, the amount given up by the investor (contrasted with the costs expressed as a percent of net proceeds by Stevenson in Table V-11) and do not include underpricing costs in the rights offerings.

The costs of flotation decline directly as the size of the issue increases. This is due to the many fixed costs, i.e. legal fees, accounting fees, printing costs, and

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<sup>2</sup>Securities and Exchange Commission, Cost of Flotation of Corporate Securities 1951-1955 (Washington, D.C., 1957).

Federal and State fees. This relationship of cost to size of issue accounts, in part, for new equity capital to be raised in infrequent, large amounts, as explained in Chapter Three (section 3.4.2). The impact of the savings plan as an equity capital source would be much greater when smaller amounts of funds are needed. There are greater potential costs savings, as well as the fact that the funds available from the savings plan are limited.

The financial officers of the companies in the research population were asked to provide estimates of average flotation costs (see question 2 of the questionnaire, Appendix IV-A). Only four responded to this question, so no conclusions can be drawn. Several financial officers commented that the flotation costs could not be estimated as they vary with the size of the issue and the risk and services assumed by the underwriter.

The financial officers of the companies that had sold newly issued stock to the savings plan were asked what percent of the selling price is applied against the costs of maintaining the plan (question B-3). If the company attributed flotation costs to the stock sold to the savings plan, then part of the proceeds from such sales should be credited against the costs of maintaining the plan. Eleven replies were received to this question; ten checked that none of the selling price is so applied. One response stated that 100% of the selling price is credited against

the expenses. A review of the annual report of this company indicated that none of the proceeds were so applied; the respondent apparently misunderstood the wording of the question. (This respondent also listed as the primary advantage of using the savings plan as a source of equity capital, ". . . practically costless flotation.")

The costs of flotation are a significant factor to be considered in the raising of new equity capital through issuing new common stock, as indicated by the information summarized in this section. A limited reply suggests that when the new equity capital is raised through the employee savings plan, there are no flotation costs involved.

#### 5.5 Analysis of Trustee Voting Power

The use of company stock as an investment medium for employee savings plans was postulated in Chapter Three as exerting influences on financial planning beyond the effects attributed to the consideration of the plans as a source of equity capital. These secondary influences on financial planning were envisioned as the result of two characteristics that exist in all savings plans regardless of whether or not the plans are considered as capital sources. One such characteristic is the development of two new classes of voting shareholders. The procedures followed to investigate this characteristic and the results

are presented in this section. The following section is a report of the analysis of the second characteristic, the trustee purchases of company stock on the open market.

The possible impact of the employees and the trustee as voting stockholders was presented in Chapter Three. It was suggested at that point that the employees, and especially the trustee of the plan, probably could be depended upon to vote as recommended by management. The voting practices of employees and the trustee were beyond the scope of this research, however, the degree of control of voting shares in the hands of these two was considered as applicable to the area being studied. Preliminary investigation revealed that the number of shares of stock held by employees and the increase as a result of the existence of a savings plan could not be obtained from existing corporate records. Not one of the companies contacted in the pilot study could identify which of their shareholders were employees from their stockholder records. However, the voting provisions for the stock held in trust and the percent of outstanding stock under trustee control were collected.

#### 5.5.1 Procedures Followed

For the savings plan to qualify for the favorable income tax provisions, an independent trust must be formed to receive and administer the savings of participants and the contributions from the company. The obligations and

powers of the trustee are formalized in a trust agreement between the corporation and the bank acting as the trustee. The entire agreement or applicable portions were included in the descriptions of the savings plans obtained from the companies. From these descriptions, the voting provisions for the stock held in trust were obtained for seventy-seven plans.

For those plans (sixty-five) which had voting practices that allowed the trustee to vote all or some of the company stock held in trust, the percent of outstanding stock held in trust was computed. The number of shares held in trust was obtained from the latest savings plan statement of assets. This number was compared to the total number of shares outstanding at the nearest year end per the annual report of the company.

#### 5.5.2 Results of Analysis of Voting Provisions

The types of voting provisions for the company stock held in the trust of employee savings plans and the number of plans following each type are listed in Table V-14. The predominate practice (53% of the total) was to permit the employee to instruct the trustee how to vote all shares credited to his account regardless of whether the shares were purchased with the employees' savings or the company contribution (Type A). Those shares for which the employee issued no instructions could be voted by the trustee at the trustee's discretion. A similar summary of

Table V-14: Voting practices of company stock held by trustees of employee savings plans

<u>Type of Voting Provision</u>	<u>Plans</u>	<u>Percent of Total</u>
A Employee may instruct trustee how to vote all shares in his account, trustee votes uninstructed shares.	41	53%
B Employee may instruct trustee how to vote shares purchased with his savings and vested company contributed shares, trustee votes uninstructed shares.	10	13
C Same as A, except uninstructed shares not voted.	1	1
D Same as A, except trustee must vote uninstructed shares in accordance with management's recommendations.	5	7
E Same as B, except uninstructed shares not voted.	4	5
F Same as B, except non-vested shares not voted.	1	1
G Trustee votes all shares held in trust.	12	16
H Trustee or management committee votes all shares held in trust.	2	3
I Shares held in trust not voted.	<u>1</u>	<u>1</u>
Total plans for which information available	<u>77</u>	<u>100%</u>
Voting provisions not known	<u>11</u>	
Companies for which financial available	<u>88</u>	
Plans which trustee has voting power (A, B, G, and H)	<u>65</u>	

Source:

Descriptions of savings plans.

voting practices is presented in the survey of previous studies in Chapter Two (section 2.4.2, Table II-7). In that survey of three studies, the plans having provisions similar to Type A constituted 20%, 60%, and 62% of the total plans.

The voting practice allowing management to direct the voting of those shares held in trust (Types D and H) seems to involve a conflict of interest. The management in these plans has a block of stock which it could control in all proxy battles which would not be in the best interests of the public shareholders. This practice would be similar to allowing management to vote treasury stock.

One large plan stipulated that none of the stock held in trust for the savings plan could be voted. The financial officers of the company sponsoring this plan were among those interviewed. However, they did not know the reason for the inclusion of this provision when the plan was adopted, unless it was to make the plan more acceptable to the stockholders.

In sixty-five of the seventy-seven plans (84%), the trustee was given the power to vote all or part of the shares of company stock held in trust. In most of these plans (fifty-one), the number of shares subject to trustee vote depended upon the number of employees who did not bother to return proxy voting instructions. Although not subject to exact determination, the trustee of these plans



did exercise some voting power. The maximum number of shares subject to trustee control in these sixty-five plans was all of the shares held in trust.

#### 5.5.3 Results of Analysis of Trustee Voting Power

The percent of outstanding stock held in trust was computed for those plans having voting practices which allowed the trustee to vote some or all of the company stock held in trust. The results of this comparison are summarized in Table V-15. For most of the companies, the shares of common stock held in trust for the savings plans did not constitute a major portion of the outstanding shares. However, the longer the plans are in effect, the higher the percent of shares that could be held in trust due to the income tax advantages to the employee of leaving the stock in trust until termination of employment. For many widely held companies, the number of shares necessary to establish control is only a small percent of the total outstanding shares. The shares held by the savings plans could reach a controlling percentage for some companies in the near future.

#### 5.6 Analysis of Trustee Trading in the Open Market

The company stock for most savings plans did not come from the company's unissued stock or from company held treasury stock, but was purchased in the open market by the plan's trustee. Only thirteen of eighty-eight plans

Table V-15: Percent of outstanding common stock held in trust for employee savings plans 1966

	<u>Plans</u>
Less than 1.0%	18
1.0% thru 1.9%	16
2.0% thru 2.9%	13*
3.0% thru 3.9%	4
4.0% thru 4.9%	3
5.0% thru 5.9%	5
6.0% thru 6.9%	2
7.0% thru 7.9%	2
Unknown	<u>2</u>
Total	<u>65</u>
* median	2.7%
range	0.1% to 7.6%

Source:

Outstanding common stock- Standard and Poor's Corporate Records.  
Shares held by trustee- 1966 annual reports of employee savings plans.

purchased newly issued stock from the company during the study period and these thirteen did not acquire all of their stock from the company. The steady purchases of the company's common shares in the open market by the plan trustee or purchases by the company supplying treasury shares to these plans is bound to have an effect on the market for these shares. During an interview, the treasurer of one company expressed the belief that the purchases of his company's savings plan kept their stock one-quarter to one-half a point higher than would have resulted without the plan.

#### 5.6.1 Procedures Followed

The magnitude of purchases by the trustee of the savings plan necessary to affect the market price of a company's stock depends upon the individual company and the market conditions. However, when the volume of trustee trading reaches certain levels, the Securities and Exchange Commission may suspect attempts to manipulate the stock price. SEC action recently revealed interest in such stock purchases by two companies and therefore, the first step in analyzing the effect of open market purchases was to review these SEC actions. These two cases were investigated and the reasons for SEC concern, the restrictions applied, and the implications for the managements of companies sponsoring savings plans are explained in the next section.

In order to appraise the degree of open market trading accomplished by the trustees of the savings plans, the number of shares purchased by the trustee from sources other than the company were compared to the total purchases of the company's stock on the New York Stock Exchange for the last two years of the study period (1965 and 1966). The financial officers were asked to supply the total number of shares of company common stock purchased by the savings plan and the number of shares supplied by the company for each year of the study period (Question 1 of the Questionnaire, Appendix IV-A). From this information, the number of shares of company stock purchased by the trustee from sources other than the company was determined for fifty-one companies for the calendar years 1965 and 1966.

The annual trading volume of the company's stock on the New York Stock Exchange was obtained for the years 1965 and 1966.<sup>3</sup> The number of shares purchased by the plan trustee for each company for each year was divided by the total traded on the exchange to determine the percent of exchange volume accomplished by the trustee. Any analysis of the resulting percentages must be qualified by

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<sup>3</sup>The New York Times National Economic Review, January 9, 1967, and January 17, 1966.

the acknowledgment that the New York Stock Exchange does not constitute the total market for many of the companies' shares which are listed on other exchanges.

#### 5.6.2 SEC Interest in Savings Plan Market Purchases

In an interview with a treasurer of a company with a savings plan, it was disclosed that the legal counsel of this company was reexamining the practices of their plan's purchases of company stock in light of SEC action involving Georgia-Pacific Corporation and Genesco, Inc. Subsequent research revealed that these companies had been making purchases of their own stock for reissue in conjunction with employee benefit plans (a savings plan in the case of Georgia Pacific). Both companies were alleged to have used these purchases of their own stock to manipulate the market price to a favorable level in conjunction with stock exchanges for acquisitions.

Genesco had two employee stock purchase plans and a retirement trust for which the company bought its own shares on the market. In a prospectus dated May 10, 1966, it was disclosed: (a) that during four separate months between January 1, 1961 and October 29, 1965, the purchases of Genesco common under the employee benefit plans accounted for 75% or more of the volume traded on the New York Stock Exchange, 50% or more during nineteen months, and 25% or more during forty-three months of the indicated forty-eight month period; (b) that the company exchanged over one million

shares of its common stock for stock assets of other companies during this period; and (c) that the transactions involved may have resulted in violations of Section 10b of the 1934 Act and Rules 10b-5 and 6 promulgated thereunder.<sup>4</sup> The final result was the agreement by Genesco to the imposition of restrictions on the purchase of their shares as a condition to the public offering of common stock.

In Georgia-Pacific the allegations were based on purchases of common stock for the employee savings plan which were supposed to have inflated the price of Georgia-Pacific common stock, and thereby reduced the cost of its acquisition of several companies through exchange of stock. On one occasion eleven separate orders were placed in one day for Georgia-Pacific stock by the company sponsored employee trust fund. On three days the employee trust fund accounted for 25%, 50%, and 80% of the shares traded after 3:15 p.m.<sup>5</sup> The consent judgment granted in a Federal court enjoined Georgia-Pacific from purchasing any Georgia-Pacific security during a distribution, except as the SEC may subsequently permit and establish limitations as to

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<sup>4</sup>Genesco, Inc., SEC Prospectus for 64,812 shares of Common Stock (\$1 Par Value), dated May 10, 1966.

<sup>5</sup>"SEC Attacks Georgia-Pacific Buying of Stock," Wall Street Journal, April 28, 1966, p. 32.

purchases of their own stock on the New York Stock Exchange. The court action did not compel restitution to shareholders or upset the acquisitions.

The allowable purchases as decreed in Georgia-Pacific and as determined for Genesco are summarized below:

	<u>Volume Traded on</u> <u>N.Y. Exchange</u>	
	<u>Daily</u>	<u>Weekly</u>
Georgia-Pacific	15%	10%
Georgia-Pacific Trust	10%	10%
Genesco	20%	15%

In computing the percentages of volume that may be purchased by Georgia-Pacific, the purchases of its trust must be considered as if they had been made by the company itself.

In an article concerning the Georgia-Pacific case, the SEC was reported to be considering the following rule change to prevent fraud in stock purchase plans:<sup>6</sup>

- (1) Placing of a specific limit on the percentage of trading volume in a company's stock that could be accounted for in a specific period by purchases of company-related funds.
- (2) Require that in making such purchases, company stock purchase plans must follow the market price instead of leading it.
- (3) Require public disclosure by officials of a stock purchase plan whenever company shares are acquired.

However, in response to correspondence from this researcher, Special Counsel of the Securities and Exchange Commission

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<sup>6</sup>"SEC May Alter Rules to Prevent Cases of Alleged 'Fraud' in Stock Purchase Plans," The Wall Street Journal, April 29, 1966, p. 6.

stated the above rule changes had not been adopted nor formally proposed at this time (September 1967).

The question is what effect these SEC actions have on purchases of company stock by the trustees of employee savings plans. In a 1964 "no action" letter, the Commission stated that where purchases are made by an independent trustee who has full discretion as to time and price, the staff will not recommend any action to the Commission solely by reason of such purchases.<sup>7</sup> It behooves those companies having savings plans to allow the plan trustee complete independence in making such purchases of company stock on the open market.

#### 5.6.3 Results of Analysis of Annual Trading Volume

The percent of annual trading volume of the company's stock on the New York Stock Exchange accounted for by purchases of the savings plan trustee was computed for the last two years. Table V-16 is a summary of these computations for those companies for which the information was available. For most companies, the plan's purchases of company stock on the open market constituted less than 10% of the annual NYSE trading volume. For those few companies where these purchases amounted to 10% or more

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<sup>7</sup>As cited in Richard L. Baker, "Purchases by a Corporation of Its Own Shares," The Business Lawyer, XXII, No. 2 (January 1967), p. 447.



Table V-16: Percent of the annual trading volume on the New York Stock Exchange purchased by the savings plan trustee 1965, 1966

<u>Percent</u>	<u>Companies 1966</u>	<u>Companies 1965</u>
Less than 1%	4	3
1.0% thru 1.9%	5	6
2.0% thru 2.9%	7	10
3.0% thru 3.9%	7	7*
4.0% thru 4.9%	6*	5
5.0% thru 5.9%	2	
6.0% thru 6.9%	6	6
7.0% thru 7.9%	4	2
8.0% thru 8.9%	2	4
9.0% thru 9.9%	1	1
10.0% thru 14.9%	2	2
15.0% thru 19.9%	2	3
greater than 20.0%	<u>3</u>	<u>2</u>
Total	<u>51</u>	<u>51</u>
* median	4.6%	3.9%
range	0.5% to 39.0%	0.5% to 52.3%

Source:

Annual trading volume on the New York Stock Exchange-"Economic Review," The New York Times (Jan. 9, 1967 and Jan. 17, 1966). Purchases on open market by savings plans' trustees- replies to questionnaires.

of the annual trading, the market price could definitely be affected and the SEC may take an interest in such purchases.

The ultimate effect on the market price depends on the timing of such purchases as the marginal effect of this additional demand for stock will depend upon conditions existing in the market at that moment. The percent of trading volume accomplished on individual days could have been much higher than the annual averages and the market price in such cases affected accordingly.

## 5.7 Summary

The existence of an employee savings plan, investing in the common stock of the sponsoring corporation, introduces a new variable to be considered in the complex environment in which financial planning takes place. Any effects on financial planning due to the presence of a savings plan are the results of certain attributes unique to these plans. Therefore, the first phase of the field research was designed to investigate these attributes, or characteristics, and thereby provide a foundation for subsequent evaluation of the effects on financial planning. This chapter has been a report of the analyses conducted on five characteristics considered to be the most likely causes of any changes in financial planning.

The first characteristic investigated was the flow of funds from the savings plans into investments in the common stock of the sponsoring company that could be utilized when the firm seeks new external equity capital. The primary question investigated was whether the amount available was large enough to warrant consideration as a source of equity capital. Unfortunately, due to the individual policies and demands of each company, the results of the research do not allow an unqualified answer to this question applicable to all companies having savings plans. However, the results of the comparisons conducted do imply that the funds were of enough magnitude to have been considered in many companies.

Two analyses were made comparing the funds available from the savings plan annually to the sources of capital actually utilized by the companies concerned. In both comparisons for the study period, over 50% of the companies had a source of new equity capital available through their plans that was a greater percentage of the amount of capital actually used than the eleven year average percent of capital raised from sales of new stock to capital raised for all U.S. corporations. Those companies that did utilize the savings plan as an equity source had an average percentage of amount available from the savings plans to the amount of capital used lower than the average of same percentage for all companies studied.

The implication drawn was that while new equity capital supplies only a small portion of the total capital requirements of corporate business, the funds available from the savings plans were large enough to have been considered as a source of these new equity funds in most of the companies studied. The fact that the companies that did utilize this source of equity funds did not have disproportionate amounts available compared to their capital requirements enforces the implication that the amounts available were worthy of consideration.

A comparison was made comparing the amount available from the savings plan in one year to the amount raised on the last new equity issue through normal channels. The results of this comparison added weight to the implication that the magnitude of the funds available was sizeable enough to have warranted consideration in financial planning. The funds available from the plans in one year were found to average 8.3% of the amount raised by twenty-six companies in their last new equity issues through rights issues to existing shareholders or cash issues to the general public. This percentage seems small until it is viewed in the perspective of the infrequency of new equity issues. It was necessary to go back twelve years to uncover the figures for companies and then only twenty-six of the eighty-eight companies had floated new equity issues during that time. This comparison also revealed that in a

few companies the savings plan had been used in conjunction with the traditional sources to raise new equity capital.

The second characteristic of the presence of a savings plan considered likely to cause some changes in financial planning was the stability of the funds available as a source of capital. The plans are permanent in nature and the funds are available in continuous, predictable amounts. The stability of these funds was analyzed by computing the annual rate of change in the amount of funds available. The average annual rate of change in funds available was found to be a small increase in the majority of the plans with the average between 5-10% growth per year. This growth was attributed primarily to the compounding effect of reinvested dividends which averaged a growth rate of over 20% per year. The results of this analysis indicate that the amount of funds available on an annual basis were fairly even in amount. Further, the analysis indicates that the funds available from the savings plans are subject to reasonably accurate prediction if all factors are taken into consideration in making projections. Two factors that must be considered in making estimates of the amount of funds available are the growth rate of reinvested dividends and the percentage of funds under trustee control that can be expected to be invested in company stock.

The savings plan established and maintained as a supplemental wage benefit can provide new equity capital

virtually free of flotation cost. This attribute was investigated to determine the amount of cost saving and whether the firms that used the plans as a source of equity did account for the funds as free of flotation. The results of previous studies indicated that the flotation costs of raising equity capital through traditional sources varied with the type of company, the size of the issue and whether the issue was sold through subscriptions to existing shareholders or to the general public. The flotation costs were found to range from 4% to 21% of the net proceeds. The highest flotation costs were associated with small subscription issues offered by manufacturing companies. The lowest flotation costs were found in large public issues offered by utility companies. The size of the flotation cost that may be eliminated (or conversely the increase in funds raised for a given number of shares) by taking advantage of the savings plan instead of using the traditional sources of equity capital will therefore depend upon the circumstances of the particular company and the options being considered.

The accounting treatment of the funds actually raised through the sale of newly issued stock to the savings plan was investigated to determine if any portion of amount received was considered a cost of flotation and accordingly credited against the costs of maintaining the savings plan. The investigation was limited to the thirteen companies

that had used the savings plan as a source of equity capital during the study period. Eleven of thirteen responded to the request for information on this issue. This limited analysis established that all eleven companies had considered the funds raised through the savings plan as free of flotation costs. The results of the investigation into flotation costs imply that these costs can consume a sizeable portion of the gross proceeds of an equity issue and they may be eliminated through sale of newly issued stock to the savings plan.

The contributions to the savings plan and the dividends on stock held by the plans are administered through an independent trust to comply with the Internal Revenue Code requirements. The plan's undistributed investment in common stock of the company sponsoring the plan is held by the trustee. The result of these administrative arrangements is that the trustee of a savings plan has a block of stock which may be voted at his discretion. The development of this new type of voting shareholder was considered a characteristic of the savings plan that could affect financial planning and which existed whether the savings plan was considered as a source of equity capital. The trustee voting power was investigated by first tabulating the practices for voting the stock held in trust and the number of companies following each practice, followed by an analysis of the percent of outstanding stock held in trust.

The provisions for voting the stock held in the savings plan trust were quite varied. However, the majority of the plans allowed the employees to instruct the trustee how to vote all or part of the shares held in trust with the trustee having the power to vote uninstructed shares. Through this type of arrangement to vote uninstructed shares or the power to vote all shares, the trustee had voting power over part or all of the shares held in trust in sixty five of the seventy-seven companies for which information could be obtained (84%). The stock held in trust as a percent of outstanding voting shares ranged from less than 1% to 7.6% with the median of 2.7%. The results of the analysis indicate that for the time covered (1966), the trustee voting power was limited and therefore unlikely to have had much implication for financial managers. However, due to certain income tax requirements, the amount of stock held in trust will continue to grow and the voting power of the trustee may become important in the future, especially in widely held corporations.

The final characteristic considered unique to savings plans that may affect financial managers in their planning is the open market purchases of company stock to satisfy the requirements of the plans if such stock is not provided from newly issued stock. The money coming into the plans weekly must be directed into company stock which requires constant purchases of shares of company stock.



Daily purchases on the major stock exchanges are made in behalf of many of the larger savings plans. This trading in the open market was investigated by reviewing the interest of the Securities and Exchange Commission in this area and compiling a comparison of the volume of trustees' purchases on the open market to the volume of trading on the New York Stock Exchange.

The results of SEC action to limit the purchases of the firm's stock for company sponsored plans for the Georgia-Pacific Corporation and Genesco Inc. signify that the SEC is reviewing such purchases. Further, the restrictions imposed on these two companies suggest that 10% to 15% of the trading volume is the maximum that the SEC considers appropriate by company sponsored stock plans to prevent manipulation of the market price. This interest by the SEC implies that the trustee be allowed to make purchases of company stock completely independent of management and to limit such purchases so they do not lead the market.

The degree of open market trading accomplished by the trustees of the savings plans was evaluated by comparing the annual number of shares of company stock purchased by the trustee from sources other than the company to the number of shares traded on the New York Stock Exchange for the last two years of the study period (1965-1966). The percent of annual NYSE trading volume accomplished by the

plans' trustees averaged 4.6% in 1966 and 3.9% in 1965. However, in both years the purchases of seven plans (of fifty-one) accounted for over 10% of the annual trading volume. The actual effect on the market price depended upon the timing of these savings plan purchases, the impact of the resulting marginal increase in demand for shares, and the general market conditions existing. Of course, the purchases on individual days could have accounted for a much larger percentage of the trading volume. The implications of this comparison are that the constant purchases of the company stock for the savings plan may be large enough in some companies to affect the market price, especially when such purchases are maintained throughout the short run price swings of the stock. Further, this comparison indicates that the percentage of trading in the company stock accomplished by the savings plan trustee has reached such proportions in a few plans that the danger of SEC investigation exists.

Appendix V-A Schedule of total sources, equity sources, and available equity  
funds from savings plans 1962-1966  
(dollars in millions)

	A	B	C	D	E	
Companies by size of percent in column D	Years Data Available	Total Sources	Equity Sources	Available From Savings Plan	Percent Column C of Column A	Percent Column C of Column B
1	5	\$1539.8	\$ 578.0	\$305.3	19.8 %	52.8 %
2	3	2.1	loss	0.3	16.1	N.C.
3	4	14.0	7.4	1.8	12.7	24.1
4	4	61.5	35.0	7.1	11.5	20.2
5	2	91.2	43.6	9.8	10.8	22.6
6	5	144.3	64.2	15.1	10.5	23.5
7	5	331.5	124.7	33.8	10.2	27.1
8	4½	71.2	22.0	6.1	8.4	27.2
9	5	11.9	2.1	0.9	7.7	44.5
10	5	149.6	92.3	11.4	7.6	12.3
11	4	1553.3	319.3	115.2	7.4	36.0
12	5	881.1	290.1	61.2	7.1	21.8
13	5	136.6	61.7	9.4	6.9	15.3
14	5	114.1	40.5	7.8	6.9	19.4
15	5	51.6	33.3	3.3	6.4	9.9
16	5	4315.7	1734.8	268.1	6.2	15.5
17	5	83.0	37.2	5.1	6.1	13.6
18	5	26.9	18.4	1.6	6.0	8.7
19	2½	201.4	100.6	11.6	5.3	11.5
20	5	8752.7	2685.3	498.8	5.7	18.6
21	4	444.0	169.1	62.8	5.7	14.1
22	5	1323.1	288.0	62.5	5.5	25.1
23	5	605.6	353.3	62.8	5.4	9.2
24	5	2101.1	1009.2	113.7	5.4	11.3
25	5	5228.5	1855.4	401.3	5.4	15.2
26	5	1959.6	546.9	104.2	5.3	19.0
27	5	272.6	85.0	14.6	5.3	16.9
28	1	4.9	1.9	.3	5.2	13.3
29	5	299.9	95.9	15.7	5.2	16.2
30	1½	121.9	56.9	6.2	5.1	11.0
31	4	587.2	171.0	30.0	5.1	17.6
32	3	424.1	127.2	20.7	4.7	15.6
33	5	370.4	78.0	14.5	4.4	21.1
34	5	435.4	48.0	16.9	4.3	38.9
35	1 11/12	336.7	123.6	13.6	4.0	10.9

		A	B	C	D	E
Companies by size of percent in Column D	Years Data Available	Total Sources	Equity Sources	Available From Savings Plan	Percent Column C of Column A	Percent Column C of Column B
36	2½	\$ 171.1	\$ 31.2	\$ 6.7	3.9%	20.8%
37	5	78.8	19.3	3.0	3.3	15.4
38	3	209.1	loss	7.9	3.3	N.C.
39	5	181.2	39.2	6.8	3.3	17.3
40	5	2055.0	587.1	74.5	3.6	12.6
41	3	87.8	46.7	3.0	3.5	6.5
42	5	1218.8	288.1	43.9	3.5	14.8
43	4½	2.4	0.8	0.1	3.4	10.6
44	3½	2154.9	1117.6	72.0	3.3	6.4
45	4	92.1	19.1	3.1	3.3	16.1
46	5	133.5	30.8	4.4	3.2	14.3
47	2	169.6	59.5	5.0	2.9	8.2
48	5	92.7	18.1	2.6	2.8	14.4
49	5	279.2	70.2	7.4	2.7	10.6
50	1½	30.3	5.1	0.8	2.6	11.7
51	5	943.2	224.3	24.7	2.6	11.0
52	4	157.9	86.4	4.0	2.5	4.6
53	4	28.4	9.3	0.7	2.5	7.8
54	4	767.5	165.8	19.2	2.5	11.6
55	3	140.8	13.6	3.4	2.4	25.3
56	3 2/3	57.6	3.3	1.4	2.4	41.6
57	3	64.9	14.2	1.6	2.4	10.9
58	5	164.5	51.1	3.8	2.3	7.5
59	5	241.9	40.3	5.8	2.3	13.7
60	5	255.1	loss	5.9	2.3	N.C.
61	5	176.9	50.5	4.6	2.2	7.6
62	3	181.0	52.0	4.0	2.2	7.7
63	2	33.4	14.4	0.8	2.2	5.8
64	2 7/12	195.5	68.4	4.3	2.2	6.1
65	5	374.2	53.4	7.7	2.0	14.1
66	5	841.8	434.4	21.9	1.8	3.5
67	5	681.2	46.9	12.6	1.8	26.7
68	3	235.8	94.5	4.5	1.8	4.5
69	5	412.6	62.6	7.5	1.7	10.3
70	1½	112.9	61.2	2.0	1.7	2.5

		A	B	C	D	E
Companies by size of percent in Column D	Years Data Available	Total Sources	Equity Sources	Available From Savings Plan	Percent Column C of Column A	Percent Column C of Column B
71	1½	\$ 250.5	\$ 39.5	\$ 1.3	1.7%	10.8%
72	1	49.4	21.6	7.7	1.6	3.6
73	5	1395.0	422.7	22.2	1.6	5.2
74	4 5/12	127.0	22.6	2.2	1.5	9.2
75	3	59.9	21.0	1.1	1.5	4.3
76	3	371.8	27.0	5.7	1.5	21.0
77	3	28.9	4.9	0.4	1.5	8.9
78	3	651.0	141.4	9.3	1.4	6.5
79	3	211.1	84.4	2.9	1.3	3.4
80	2 5/12	367.0	109.4	4.9	1.3	4.5
81	5	288.4	113.1	3.5	1.2	3.1
82	3½	347.4	54.9	4.1	1.2	7.3
83	5	75.0	30.2	0.8	1.1	2.3
84	5	665.5	177.6	7.6	1.1	4.3
85	5	631.5	240.0	4.7	0.7	2.0
86	3	112.7	75.4	0.7	0.5	0.9
87	1	63.4	37.4	0.3	0.5	0.8
88	1 5/12	15.2	4.9	0.1	0.3	1.2

N.C. = not computed, loss during the study period

Sources: Columns A and B - Annual reports of companies involved,  
supplemented by Standard and Poor's Corporate Records.

Column C - Replies to questionnaire, supplemented by  
registration statements filed with The Securities and  
Exchange Commission.

## CHAPTER SIX

### PHASE TWO OF THE EMPIRICAL RESEARCH

#### 6.1 Introduction

#### 6.2 Flexibility

##### 6.2.1 Interviews

##### 6.2.2 Questionnaire Responses and Letters

#### 6.3 Timing

##### 6.3.1 Timing to Reduce the Cost of Capital

###### (a) Interviews

###### (b) Questionnaire Responses and Letters

##### 6.3.2 Timing to Match Supply with Demand

###### (a) Interviews

###### (b) Questionnaire Responses and Letters

#### 6.4 Control

#### 6.5 Risk

##### 6.5.1 Risk of Adverse Employee Reaction

###### (a) Interviews

###### (b) Questionnaires and Letters

##### 6.5.2 Risk of Adverse Government Action

#### 6.6 Order Costs

##### 6.6.1 Interviews

##### 6.6.2 Questionnaires and Letters

#### 6.7 Other Findings

6.7.1 Policy in Those Companies that Did Use the  
Savings Plans as a Capital Source

6.7.2 Areas of Employee Relations Affected

6.8 Summary

## CHAPTER SIX

The first phase of the empirical research, described in the previous chapter, was conducted to evaluate and define those characteristics considered to be unique to the employee savings plan. The second phase of the empirical research, described in this chapter, was designed to investigate how the financial planning within a firm was affected by the existence of a savings plan. As outlined in Chapter Four, this investigation of firms sponsoring a savings plan was conducted by mail questionnaire and interview.

### 6.1 Introduction

An investigation of the effects a change in environment has on human behavior is difficult to design, conduct, and evaluate. The ideal research situation would be to observe the human behavior, in this case, financial decision making, before the existence of the new variable and after the introduction of the variable, noting any changes in behavior. The opportunity for such a direct observation was not available in this research.

Another approach in evaluating changes in human behavior would be to examine the results of certain



behavior after the introduction of a new variable. This type of evaluation was utilized in this research by determining the number of companies that did use the savings plan as a source of new equity capital and the amount of new equity capital that was obtained. This information indicated that financial management behavior was altered in these companies as a new capital source was actually utilized which involved new considerations and new responses. However, the disclosure that this new source of equity capital was employed by certain companies did not reveal specifically how the existence of this new variable in the financial environment affected financial planning.

The approach utilized to direct the inquiry into specific effects on financial planning was to gather the opinions of those involved in making the financial decisions which could be affected by the new variable. This investigation was accomplished by first postulating certain effects on the behavior and secondly, by posing indirect questions designed to reveal whether or not these postulated effects existed. The first step, identification of those phases of financial planning that were expected to be affected by the existence of a savings plan, has been described in Chapter Three. The literature on financial management was consulted and synthesized into a model of the elements that were considered most relevant to

management decisions involving the inflow of funds. All possible influences on these elements due to the introduction of a new variable (i.e. the employee savings plan) were examined. From the analytical process specific elements of financial planning were identified as most likely to be influenced by the existence of a savings plan in the firm. For example, the desire to obtain capital as efficiently as possible by reducing order costs was identified as an element considered in planning inflows of capital. The existence of a savings plan, with a potential for supplying new equity capital at no order cost, was predicted to influence this consideration.

The second step, posing indirect questions to the persons whose behavior was in question, was accomplished by a mail questionnaire to the financial officers of firms sponsoring an employee savings plan and personal interviews with a number of these officers. The questionnaire was carefully designed and tested to gather the desired information with a minimum influence on the responses. Accordingly, within the restraint of brevity to gain maximum response, the financial officers were requested to respond to broad questions regarding the employee savings plan and not to specific questions about financial planning. For example, the questionnaire did not mention that funds could be obtained through the savings plan at a reduced order cost or ask if this was considered.

Instead, respondents were requested to disclose their method of accounting for funds from this source and were asked the primary advantage of this capital source. If the lower order cost had been considered, it should have been revealed by these indirect questions.

This chapter is organized around those elements of financial planning identified in Chapter Three as being most likely to be influenced by the existence of a savings plan. The first section (6.2) is a report of the evidence bearing on the concept that the financial manager would have more flexibility in the use of all capital sources when a savings plan was one of these sources. The extent the timing of funds flow was influenced as indicated by the research is presented in section 6.3. The concern for diminishing the control of existing owners was identified as being present in all equity financing. The effect on control of considering the savings plan as a source of equity capital as mentioned in the responses is examined in section 6.4. The changes in risk, as revealed by the financial officers in those companies with a savings plan are summarized in section 6.5. Section 6.6 is devoted to the consideration of order costs and how the financial managers evaluated the savings plan in this consideration. Finally, the information gathered that did not apply to the postulated effects on financial planning is presented in section 6.7.

## 6.2 Flexibility

As defined in Chapter Three, flexibility in financial planning refers to the ability of a management to expand or contract the firm's sources of funds in response to changes in needs for funds and changes in the cost of these funds. The existence of an employee savings plan was postulated as increasing the financial flexibility of a firm by providing an ever-present source of predictable funds without extensive, time-consuming preparation.

### 6.2.1 Interviews

In one company (referred to as Company "A" throughout this chapter), a written analysis of the savings plan as an equity capital source was prepared periodically by the treasurer's staff for consideration by the executive finance committee and the board of directors. Portions of one such analysis were obtained during an interview. This report contained the most complete company analysis of the effect of the existence of an employee savings plan on financial planning, most of which applies to the consideration of flexibility.

The analysis began with a summary of the total amount invested by the savings plan in company stock to the date of the report and an estimate of the funds that would be invested in company stock over the next ten years. The report continued by listing the advantages of selling newly issued shares to meet the savings plan's

requirements. This analysis by Company "A" is presented below in its entirety to allow the reader to grasp the continuity of the reasoning presented even though some comments apply to subsequent sections. The advantages that were listed are as follows:

1. It represents a convenient way of tapping a steady and substantial source of investment funds. If this opportunity is not utilized, it is lost as shares must be acquired by the savings plan daily.
2. It is an economical way of raising equity capital as no distribution costs are involved.
3. Full market value of shares is realized, as contrasted to public offerings where a concession must be made from market price.
4. Daily sales result in true dollar averaging, without the risk of a poorly timed public offering.
5. It allows equity capital to grow gradually without any sudden impact on per share earnings or dividend requirements.
6. It broadens rather than contracts the outstanding shares available to the general public.
7. Instead of the cost of the savings plan resulting in a depletion of cash resources, the sale of shares for both the Corporation and employee contributions results in enhancement of available cash.
8. The increase of equity capital will provide funds to help guarantee ability to meet fixed debt maturities or sinking fund requirements.
9. A steady uninterrupted source of equity capital together with additional earnings on such capital generally fits the requirements of steady growth and may obviate a major financing operation.

The report followed this list of advantages with the following considerations which would favor allowing the savings plan to purchase company stock on the open market rather than from the company.

10. If the Corporation does not foresee any possible need for additional outside capital.
11. If the capital structure of the Corporation is such that any additional outside capital should be in the form of debt rather than equity financing.

At the time this report was prepared, the company's stock was selling on the market at a price below the price of prior years. Accordingly, the report listed considerations to be taken into account in selling shares to the savings plan at the then current deflated price of the stock. Factors against the selling of shares when the company's stock has fallen below a certain minimum price level that were presented in the report are as follows:

12. It may seem to be poor business to sell shares at historically low prices if the price is expected to improve shortly.
13. It might be better to forego the funds than to sell at the relatively low price.
14. When the share price is very low, the dilution of shares is greater.

Factors that were presented suggesting that a low market price should not prevent sale of shares are as follows:

15. Discontinuance of shares when the share price drops below any arbitrary minimum figure would mean loss of the opportunity to add to the equity investment.

16. The advantages of daily price averaging are lost, in favor of an attempt to predict the trend of the market.
17. True dollar averaging of price is fully defensible and there is no basis for selecting any arbitrary figure below which it would be unwise to sell shares.
18. The alternative to steady and gradual increase in total equity investment may be a single financing operation, where it becomes necessary to act on the best possible guess as to market trends. This is a risky approach at best.
19. If the period of low price proves to be brief, nothing significant will have been gained by discontinuing sale of shares. If the price remains at low levels for a lengthy period, or even goes lower, the benefit of continuous addition to the equity investment still justifies continuation of sale of shares. In fact, the ultimate average price may still be higher than that obtained for a single issue, timed according to needs and the best possible judgment as to market trends.

This report concluded the analysis of the use of the savings plan as an equity source with the following:

Dealing specifically with \_\_\_\_\_ Corporation, the following appears clear:

- a. \_\_\_\_\_ will require substantial capital over the years.
- b. Present debt ratios make added equity capital desirable.
- c. Retained earnings may not suffice to meet requirements for growth and debt retirement.
- d. The current market price of \_\_\_\_\_ shares is low in relationship to ultimate potential.

Relating these specifics to the foregoing general discussion, the weight falls heavily in favor of continuing to sell shares to the savings plan.

The benefits of continuing the flow of equity funds uninterrupted are such that sales should be continued regardless of market price.

This report has been quoted extensively to illustrate that for a corporation requiring equity capital and willing to plan the financial growth of the company to accommodate the gradual flow of funds, the savings plan does provide a source of funds with certain advantages. Several of the comments from this report reflect that the use of the savings plan as a source of capital does provide greater flexibility.

Certain of the advantages (1, 4, 5, 9) and factors in favor of continuing sales in spite of a low market price (16, 17, 19) deal specifically with the convenience of obtaining funds at a rate that eliminates much of the concern with price fluctuations that is usually present in contemplations of a new stock offering. The management of this company was especially impressed with the opportunity to take advantage of continuous sales of new stock to the savings plan. These frequent new stock sales provided capital under the concept of dollar averaging in contrast to a single financing operation where the uncertainty of the market price would have been greatly magnified.

This steady flow of equity capital can increase the flexibility of the use of other sources of funds. The continuous flow of funds from the savings plan can be utilized to replace debt; especially debt requiring periodic retirement as suggested by number 8 above.



Another indication of the increase in flexibility provided by the existence of a savings plan was the sale of treasury stock to these plans. On the question of the use of treasury stock, the financial officers interviewed were unanimous in their policy. Treasury shares were usually acquired for a specific purpose, such as for use in acquisitions. Occasionally the management would acquire its own shares when, in its opinion, the company's stock was considerably underpriced on the market. However, all of the financial officers interviewed were against engaging in transactions in treasury stock in an attempt to trade on short term price swings. The savings plan provided a convenient vehicle for selling treasury stock that had been acquired for some purpose which did not materialize or when the stock was undervalued.

One company had sold treasury stock to its plan at one time, but newly issued stock had been sold for the four years preceeding the interview. When questioned on this policy, the financial officers replied that the treasury stock had been acquired many years ago and not used for the original purpose. This treasury stock was liquidated before any newly issued stock was sold to the savings plan. In this instance, for this company, the sale of treasury stock could be considered as raising new equity capital.

In another company, the provisions of the savings plan specified that the trustee could purchase company stock only from the company and this company had been selling treasury shares to its plan for several years. The financial officers stated during an interview that company stock was purchased almost daily to provide stock for the savings plan and other employee incentive programs. These gentlemen went on to suggest that should their company require new external equity capital, it would be relatively simple to sell newly issued stock to the savings plan. The administrative procedures established for the sale of treasury stock could be readily adapted and the amount and timing of the funds could be predicted with considerable accuracy based on past experience with treasury stock.

#### 6.2.2 Questionnaire Responses and Letters

The responses to the questionnaires indicated that during the period studied most of the financial managers did not seriously consider the savings plan as a source of equity capital. The possibility of increasing the flexibility of the use of all sources was never mentioned. In response to the question of whether the company had ever allowed the trustee to purchase newly issued stock directly from the company (question 3), forty-eight of sixty-three replied in the negative. Thirty-two of the forty-eight signified that the provisions

of their plan did not even grant the company the option to sell newly issued stock to the trustee (question 3A-1). Furthermore, only three of the forty-eight checked "yes" in answer to whether they would consider the savings plan as a possible source of funds if their company were to raise capital by selling unissued stock (question 3A-2).

Thus, only eighteen of the sixty-three managers that responded (29%) had utilized the savings plan as an equity capital source in the past or would consider doing so in the future. (Fifteen indicated on question 3 that they had sold newly issued stock to the savings plan in the past and three indicated they would consider this source in the future on question 3A-2.) The primary reasons for this unexpected lack of consideration of the savings plan as an equity capital source appear to have been the timing of the available funds and the fear of inducing unfavorable governmental action. These concerns are presented in detail in subsequent sections of this chapter.

### 6.3 Timing

The consideration of timing new financing was described in Chapter Three as having two aspects. The first timing consideration concerns the attempt to minimize the cost of funds by planning new financing to take advantage of market conditions. The savings plan was

envisioned as aiding in this aspect of timing by: (a) providing a ready market when the stock market conditions were favorable; (b) providing a continuous market, which if utilized, would smooth out market price fluctuations; and (c) permitting debt issues to be sold when their market was favorable and readjusting the capital structure through stock sales to the savings plan.

The second timing consideration concerns the attempt by financial managers to regulate the inflow of funds to coincide in amount and time with the projected requirements for funds. The existence of a savings plan was postulated as requiring an alteration to the generally accepted belief that new equity capital was economically available only in large, infrequent amounts. The slow, steady accumulation of funds through new equity issues to the savings plan was seen as increasing the potential uses of new equity capital by providing a source to match with investment projects demanding a steady flow of funds over an extended time period.

#### 6.3.1 Timing to Reduce the Cost of Capital

(a) Interviews: The written analysis of the use of the savings plan as an equity capital source prepared by the financial management of Company "A" contained several considerations applicable to timing equity financing to reduce the cost of capital. This company was particularly concerned with the continued sale of newly issued stock to

its plan when the market was depressed. However, the management concluded that the continued use of this equity capital source through all stock price fluctuations was preferable to a single, large public offering which would involve more exposure to the uncertainties of the market.

In interviews with companies that had not sold newly issued stock to the trustee of the savings plan, the financial officers were asked why this source had not been utilized. The reply in all three cases was that for the period the plans had been in operation the companies had not considered issuing new stock to raise capital. These gentlemen stated that sufficient funds were available through retained earnings and debt issues. In one of these companies, a treasurer remarked that his company had not raised cash through new equity capital in the past ten years, however new shares had been issued in conjunction with acquisitions.

(b) Questionnaire Responses and Letters: The responses to why the savings plan did not allow the company the option to sell newly issued stock to the trustee (question 3A-1) concurred with the replies received during interviews; the companies did not require additional external equity financing. Fifteen of the twenty-five responses that offered explanations on this question stated simply that no provision was made for such sales at the time the plan had been established as the company was not in need

of additional new equity financing and the need had not arisen since. The answers to the question of whether the plan does allow the sale of newly issued stock to the trustee indicated that in many companies the question of using the plan as a source of capital had not arisen. Lack of need of equity capital and the provisions of the savings plan were the predominate reasons given for not selling newly issued stock to the plan's trustee.

The companies that had sold newly issued stock to the trustee of the savings plan did not mention this aspect of timing nor was timing to take advantage of market conditions listed as an advantage of the savings plan as a source of capital (question 4). However, three respondents stated the savings plan had been allowed to purchase the unsubscribed shares in a stock offering to existing shareholders. The use of the savings plan as a reserve source in offerings to existing shareholders allowed the subscription price to be set higher than would have been necessary to insure that the issue was fully subscribed. The higher subscription price increased the funds available from the new issues and reduced some concern for the exact timing of the issues.

#### 6.3.2 Timing to Match Supply With Demand

(a) Interviews: In the interview with Company "A," the financial officers were asked whether the flow of funds from the savings plan was objectionable, i.e. the small

amounts available continuously. Their reply was that this slow accumulation was an advantage because internal growth has to be gradual. The management of this company stated they had learned from past experience that when equity capital was raised through public or subscribed issues, the money could not be put to use all at once, thereby reducing total profitability until capital improvements were completed and in operation.

In another company, in answer to the question of whether the savings plan as a source of funds requires any special consideration in financial planning, the financial officers stated that available funds were more difficult to estimate than would be supposed. The estimate of available funds had to take into consideration the employees' contribution rate and the dividend income. In addition, the price of the company's shares had to be predicted to provide an estimate of the number of shares required.

The question of the timing of the flow of funds was also discussed in interviews with financial managers of companies that had not sold newly issued shares to the trustees of their savings plans. Their concerns were identical to the concerns expressed in the mail questionnaire, which are described in the following section.

(b) Questionnaire Responses and Letters: The general opinion of the financial officers responding to the

questionnaire on the concern for the timing of funds to meet demand may be summarized as viewing the funds from the plan as too limited at any one time to be adequate. This opinion was expressed in answer to why the managers would not consider the plan as a source of funds if the company were to raise capital by selling unissued stock in the future (question 3A-2). The predominate reason mentioned for not considering the plan as a possible source of capital was the small amount of funds available in relation to the total requirements of the company. Sixteen replies (of twenty-seven listing remarks to this question) raised this issue of insignificant funds with such comments as: ". . . could not rely on a source so small for our capital," ". . . would spread over a period of years whereas requirements are immediate," ". . . small amount would necessitate that capital be provided by other means in addition," and ". . . it would be undesirable to raise equity capital on a continuing basis."<sup>1</sup>

Similar opinions were expressed in response to the question of whether there were disadvantages to the company in using the savings plan as a source of capital and if so what was considered the primary disadvantage

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<sup>1</sup>Neither the personnel making comments quoted in this chapter nor the companies involved can be identified due to the assurance in the cover letter that all responses and information provided would be kept confidential.



(question 5). There were forty-eight responses to the question; thirty-three checked "yes," there were disadvantages, and fifteen indicated that in their opinion there were no disadvantages to the company in using the savings plan as a source of equity capital. Of the thirty-three respondents providing what they considered to be the primary disadvantage, ten mentioned the small amount of funds available at any one time. Several of the replies compared the funds available from their plans over a short period of time to the annual capital requirements. The following is typical of the comments on the flow of funds available from the savings plan: ". . . If capital funds are needed, usually the amount is large and the need is immediate. Not enough money can be realized from the plan on a monthly basis." It is interesting to note that only one of the companies that had sold newly issued common stock to its savings plan considered the timing of available funds the primary disadvantage and this reply was qualified as follows: ". . . It is possible that when using the Savings Plan as a source of equity capital, the Company may not be able to raise the necessary capital as quickly as required. However, through careful planning this disadvantage could be overcome."

In contrast, only one respondent of the thirteen that considered there were advantages to the company in using the savings plan as a source of equity capital

(question 4) mentioned the timing of funds. This financial officer indicated the primary advantage was that ". . . the savings plan provides a continuous and rather predictable source of equity capital."

These opinions seem to be in direct contrast to the statistics developed in the previous chapter which indicated that for approximately one-half of the plans the funds available from the savings plan were a greater percentage of the demand for funds than national averages of funds historically provided by new equity capital. The explanation of this apparent contradiction may be found in the historic use of new equity capital. The offering of a new equity issue is normally an infrequent event in the life of a company and only considered when adequate equity funds are not provided by retained earnings. Further, when such an offering is made the amount to be raised is normally substantial to reduce the order costs and preclude further new equity issues for several years.

From the responses to the questionnaire, it is apparent that in many companies the financial managers still considered equity financing in terms of a large amount raised at one time. The small amounts available from the savings plan at any one time excluded the plan from this type of consideration as an equity capital source. Only if the financial managers were to expand

their equity financing planning to include small amounts over a long period of time, as has been done in a few companies, would the savings plan become a possible source of new equity capital for all companies sponsoring these plans. Perhaps the major contribution of this research will be to expose the financial managers of companies with savings plans to the possibilities of its use as an equity capital source when properly planned for.

#### 6.4 Control

The use of the employee savings plan as an equity source would result in dilution of control for existing owners and therefore, would require additional considerations in the financial planning. The question of the dilution of control was not a major concern of those financial managers interviewed, but did appear on the responses to the questionnaire.

Three negative replies to the question of whether the company's plan allowed the option to sell newly issued stock to the trustee (question 3A-1) stated that to sell newly issued stock to the savings plan would conflict with the pre-emptive rights of existing stockholders. Another reply to this question specifically listed dilution of control as the reason their plan did not allow sales of newly issued stock to the trustee.

In response to whether the plan would be considered if the company were to raise capital by selling unissued stock (question 3A-2), the necessity to protect existing shareholders was mentioned. Two of the five that said they would consider the savings plan as a future source stated that the plan would be used only if new shares were being sold to all shareholders. One other affirmative reply to this question was qualified by the provisions that such sales be legal in every respect and that shareholder approval be obtained. Likewise, two of the companies that reported they had sold newly issued shares revealed in response to question 3B-1 that newly issued shares had been sold to the savings plan only when a common stock rights issue was offered to all common stockholders.

The effect on the company's stockholders was listed as the primary disadvantage of turning to the savings plan as a source of equity capital by five of the thirty-three respondents to question four. Three financial managers stated the use of this source would be undesirable for shareholder relations because of potential dilution. One respondent replied that newly issued stock should not be sold to the savings plan because ". . . a public company should be interested in widespread ownership of its equity capital." Another considered such sales objectionable as they would place employee

stockholders in a class apart from all other stockholders and inequities to either party could result.

The voting provisions of the stock held in trust under the savings plans and the percent of outstanding shares subject to trustee voting have been presented in Chapter Five (section 5.5). The investigation of trustee voting power disclosed that in 84% of the plans, the trustee was given the power to vote all or part of the shares held in trust. However, at the time of the research the shares of common stock held in trust did not constitute a major portion of the outstanding shares (the median was only 2.7% of outstanding).

In contrast to this concern for existing shareholders, one financial officer was of the opinion that the primary advantage of sale of stock to the plan was that such sales ". . . concentrate ownership in a stable and sophisticated holding not subject to market influences." However, the consensus of opinion was that the use of the employee savings plan as an equity capital source would result in dilution of control for existing owners. Because of this concern and the legal requirement existing in many companies to obtain shareholder approval of sales of newly issued stock to any party other than existing shareholders, many companies avoided use of this source of capital.

## 6.5 Risk

In the analytical process of identifying the changes in financial planning that might occur due to the introduction of the savings plan described in Chapter Three, the impact on various phases of risk was examined. At the time that investigation was made, prior to the empirical research, the risk was postulated as being affected in two ways. The first effect that was considered was that the employee-stockholder would have more aversion to risk than the nonemployee shareholders and this might affect management's consideration of risk. No such effect on risk was detected in the interviews conducted or in the responses to the questionnaire.

The second effect on risk that was postulated was that the uncertainty of the volume of funds from a given equity issue could be greatly decreased. The stability and predictability of the funds available from the savings plan were envisioned as providing a source where there would be almost no uncertainty as to the amount of funds forthcoming for a given number of shares. The only evidence of awareness that the use of the savings plan could reduce the uncertainty of the amount of funds forthcoming was in the favorable comments on the flow of funds which have already been presented.

The empirical research did reveal, however, that sales of newly issued stock to the savings plan introduces

two kinds of risk that had not been fully anticipated. The new risks were the potential unfavorable employee reaction and the risk of unfavorable government action.

#### 6.5.1 Risk of Adverse Employee Reaction

The sale of newly issued shares to the trustee of the savings plan involves the company even more in the value of the participants' holdings and exposes the company to criticism should the market price of the shares decrease. The description of those plans that allowed the trustee to purchase stock from the company usually prescribed a precise method for establishing the value of the stock. The methods were summarized in Chapter Four (section 4.4). The provisions were an attempt to dispell any indication that the company was taking advantage of the participants by stipulating the shares purchased from the company were to be based on existing market prices. However, in spite of such protections incorporated into the plans, many financial managers expressed the opinion that the company could create ill will among the employees by directly providing the stock purchased with the employee savings.

(a) Interviews: One question asked in the interviews but not on the questionnaire was, "What are the effects, if any, of having employees as stockholders?" None of the persons interviewed felt the dividend policy had been affected. Two treasurers, however, mentioned the greater

concern over price decreases of the company stock in the market. One of these treasurers said that even though the employee was, in effect, paying only two-thirds of the market price (the company contribution rate was 50%), when the stock price fell below the purchase price, some factory workers felt they were losing money and the company was to blame. It is interesting to note that in the 1966 annual report of two savings plans where the company stock had dropped considerably in price during the year, the market value of the stock in trust was compared to the amount of only the employees' contributions and not to the total cost of the shares as had been the practice in past years. This was an obvious attempt to prevent employee unrest during depressed market conditions.

(b) Questionnaires and Letters: Six of those respondents that checked "no" to the question of whether they would consider the savings plan as a possible capital source if the company were to raise capital by selling unissued stock (question 3A-2) expressed opinions on this risk of unfavorable employee reaction. These financial officers were concerned that the employees would suspect the price was "not fair" or that accumulations by the trustee would violate the "concept of dollar averaging understood by the employees to be the policy of the plans."



Of the thirty-three respondents providing what they considered to be the primary disadvantage to the company in using the savings plan as a source of equity capital, eleven mentioned the possible unfavorable impact on employee relations. This was expressed in a variety of phrases such as: ". . . conflicts with the sole purpose to provide employee benefits," ". . . criticism by employees that the price is not fair," and ". . . might raise suspicions of unions that the plan is for the benefit of the company."

In a letter from a company manager of the employee benefits department (who did not complete the questionnaire) this concern for avoiding any action that would impair the favorable effect on employee relations was expressed as follows:

Our savings plan does have a positive effect on employee relations, partially because the announcement of current unit values quarterly offers an opportunity to communicate this employee benefit more frequently than others. The employee's personal investment naturally makes him more curious with respect to the plan's operation and indirectly creates greater interest in management's goals.

Partially because of the employee interest stimulated, we have avoided utilizing any of our employee benefit programs as a source of capital. With the majority of an employee's future financial considerations already dependent on his employer, it tends to stimulate additional security if insurance, pensions and investments are derived from and/or are dependent on an outside (third party) factor.

This concern for avoiding any action which would impair the positive effect of the plans on employee relations

may have prevented many financial managers from considering the use of these plans as a source of capital. However, this additional risk did not prevent thirteen of the companies from making sales of newly issued stock to their plans during the study period.

#### 6.5.2 Risk of Adverse Government Action

In response to why the company's savings plan did not allow the company the option to sell newly issued stock to the trustee (question 3A-1), the governmental requirements were listed in four questionnaires returned. The following is typical of these four replies: ". . . The decision to incorporate into the plan the provision that \_\_\_\_\_ Company stock may not be purchased from the company was based on a conservative and realistic approach to observing: (1) Internal Revenue Code restrictions on purchase of employee stock by a Trust; and (2) Securities and Exchange Commission regulations."

The problems of meeting the requirements of federal and state securities acts and maintaining a qualified trust under the Internal Revenue Code were considered to be primary disadvantages by four persons completing the questionnaire. In one reply this problem was expressed as follows: ". . . Strict adherence to the law produces no advantages in an employer-trust transaction that cannot be realized in dealings with third-party market purchases. Further, the employer may, by using

the savings plan as a source of equity capital, place in jeopardy a qualified plan and an exempt trust with their inherent tax savings and other advantages."

The fear of SEC and IRS regulations was cited in several letters and in two of the interviews with officers of companies that had not sold newly issued stock to their savings plan. In two letters and one interview the belief was expressed that such sales were not legal. As pointed out in this dissertation (Appendices A and B of Chapter Two and section 5.6 of Chapter Five), such sales are legal; however, certain precautions must be taken to insure against the appearance of stock manipulation and extra administrative procedures must be followed.

## 6.6 Order Costs

The order or flotation costs are an important consideration in planning new financing because of the direct effect on the continuing cost of capital. The smaller the ordering costs, the larger the proceeds and consequently, the lower the rate of the continuing cost-of-capital. The results of the reserach reported in Chapter Five established that the order cost for raising new equity capital through rights offerings or public offerings ranged from 2% to 15% of the gross proceeds depending on the size and type of offering (section 5.4). Further, as also reported in Chapter Five, the responses

to the questionnaire suggest that when the new equity capital was raised through the employee savings plan there were no order costs involved.

#### 6.6.1 Interviews

This concept of no order cost was specifically identified in the written analysis by Company "A" presented earlier in this chapter. This report stated that selling newly issued shares to meet the plan's requirements provided ". . . an economical way of raising equity capital as no distribution costs are involved," and also that ". . . Full market value of shares is realized, as contrasted to public offerings where a concession must be made from market price."

#### 6.6.2 Questionnaires and Letters

In response to the question of what was the primary advantage to the company in using the savings plan as a source of equity capital, the advantage most often mentioned (seven of thirteen listing advantages) was the ability to raise funds without flotation cost. This was expressed in various phrases such as: ". . . inexpensive means of raising equity capital," ". . . reduces the cost of issuance," and ". . . eliminates payment of high flotation costs." The elimination of order costs was also seen as an advantage to the employees by two additional respondents. These two replies indicated that the primary advantage was the opportunity through the elimination of

commissions to provide stock to employees at lower cost, thereby improving employee relations without additional cost to the company.

In contrast, one reply stated ". . . the possible savings in underwriting costs would be more than offset by the disadvantages." These responses indicate at least a few of the financial managers involved recognized the savings plan as a vehicle to obtain equity capital at no order cost.

#### 6.7 Other Findings

The questionnaire was utilized to investigate two additional areas beyond the new considerations in financial planning developed by the analytical process in Chapter Three. The first additional area of investigation was an attempt to determine the policy and procedures for incorporating the funds from the savings plans into the planning for supply and demand for funds by the managements that utilized the plans as sources of capital. The second additional area of investigation was directed toward the areas of employee relations affected by the employee savings plans. This investigation was conducted to compare management's opinions of the effects on employee relations with the effects cited in published articles on this subject summarized in Chapter Two.

#### 6.7.1 Policy in Those Companies that Did Use the Savings Plan as a Capital Source

The respondents were directed to separate questions based on their reply to whether they had ever allowed the trustee of the savings plan to purchase newly issued stock directly from the company or made the company contribution in newly issued stock instead of cash (question 3). The fifteen that replied in the affirmative were directed to questions regarding company policy and the effect on financial planning of utilizing the employee savings plan as an equity capital source. Some of the responses to these questions on company policy have been cited previously in this chapter where appropriate.

These financial managers were asked to explain how their company decided the number of shares to be offered to the trustees of the savings plan. The responses to this question were rather disappointing as little of the financial planning procedure was revealed. Of the nine written responses, four explained the procedure incorporated in the plan description for determining the valuation of the newly issued stock sold to the plan. Two explained that newly issued shares were sold to the savings plan only when a common stock rights issue was offered to all common stockholders. One company's policy was to use only treasury stock for stock sales to the savings plan. Two financial managers did supply the desired information,

but merely stated that the board of directors had authorized issue of new common stock to meet the stock requirements under their employee savings plan.

A question was posed on how the decision was made whether the stock to be sold to the trustee would be newly issued or treasury stock. Nine financial officers provided answers to this question. Six replied that the company did not purchase any of its capital stock for its treasury or had any treasury stock. One answered that sufficient shares of unissued stock had been authorized and available for the plan. Another stated this had been a policy decision of the board of directors. The final reply said the decision had depended upon the conditions existing: if treasury stock was available, it was used; however, if there was a necessity to conserve cash, unissued stock was used.

#### 6.7.2 Areas of Employee Relations Affected

The subject of whether the savings plan has a positive effect on employee relations was posed as a question to involve the recipient of the questionnaire. It was assumed that all would answer "yes" and be led into the next question which asked what areas were directly affected. However, three financial officers checked "no" and another added a third selection, "not sure." There were no explanations on these three questionnaires as to why the company would support such a

costly program if management did not think there were some favorable effects on employee relations.

Fifty-two respondents did reply in the affirmative to question 6 and listed the areas of employee relations considered to be directly affected. These replies may be classified into five groups: (1) greater personal interest in the company's affairs; (2) savings and retirement for the employees; (3) recruiting and retention; (4) attractive form of compensation; and (5) necessary to be competitive. It should be noted that in most replies there was more than one response to part a of question 6 and accordingly, the number of times each area of employee relations affected reported herein will total to more than the number of questionnaires received.

The most often mentioned area of employee relations considered to be directly affected was the creation of greater employee interest in the company's operations. This effect was mentioned in some form in forty-one of the replies. Sixteen of these explicitly stated that the plan increased interest in the improvement of company operations due to the employees being stockholders. The vested interest in the company's growth was cited four times and identification with the company as stockholders was listed five times. Other comments suggesting that management viewed the savings plan as increasing employee awareness of company problems included the following:



". . . positive employee loyalty," ". . . identifies employee with corporate aims," ". . . economic education of employees," and ". . . increases interest in corporate profits and market value of the stock."

The creation of a savings fund for the employee was listed twenty-two times as one area of employee relations affected. This usually was expressed in one of two approaches. The enforced, regular savings through payroll deductions was one approach cited by eight financial managers as a favorable method to promote employee thrift. The provision of present and future security for employees was mentioned in another eight replies, with retirement pension supplements cited by three companies. The remaining replies referring to the creation of a savings fund for the employee used such phrases as: ". . . creates employee investment assets with a favorable tax impact," and ". . . gives employees a source of funds for emergencies."

The savings plan was considered as having a favorable impact on recruiting new people and retaining existing employees by seventeen of the financial managers responding. An additional eight mentioned that morale was improved. Retention of employees was mentioned nine times with such phrases as: ". . . reduces turnover," or ". . . tends to hold employees." The area of recruiting was seen as being aided by the savings plan as was

indicated by responses mentioning easier procurement or help in hiring. The following is typical of the replies mentioning morale: ". . . improved morale particularly among younger employees who do not fully comprehend the value of a pension program."

The consideration of the company contribution as additional compensation was expressed by five respondents. The sponsoring of a savings plan with partially matching company contributions was viewed in these replies as an attractive form of compensation in that the plan provided a continuing effect whereas an increase in wages was immediately forgotten.

Three financial managers expressed the opinion that the savings plan was offered more in order to keep abreast with competition for employees than to directly affect employee relations. All three of these replies are quoted as they obviously express the true feelings of the respondents and are possibly representative of the guarded opinion of others.

. . . I seriously doubt that employees view such a plan as more than another fringe benefit - one which they could acquire via employment at another firm of equal or larger size.

. . . The employee savings plan is just one part of the total package of fringe benefits offered to and generally expected by employees. Rather than having a particularly positive effect on employee relations, it is felt that the lack of such a plan would have a negative effect in attracting employees.

. . . All areas are more or less affected. This is a reverse situation--if we do not have a Savings Plan, recruiting, labor relations, etc. are affected--but we get little advantage for meeting or even bettering competition in any one area.

If the opinions of these three men are correct, more companies could be expected to adopt such plans in the future to meet competition in the labor market, thus increasing the number of companies having available this potential source of equity capital.

The responses to whether the company had measured the impact of the savings plan on any area of employee relations (part b of question 6) was revealing because, in spite of all the supposed areas of employee relations affected by the savings plan that were listed by the financial officers, there had been very little attempt to measure this effect. Fifty-two respondents checked "no" to part b with only three replying in the affirmative and only one of these described the measurement procedure. This company officer stated, ". . . An employee sample was taken in order to measure the impact of the savings plan. The result of the study showed that the plan was well accepted by employees." Such a survey could hardly be labeled as a measurement of the impact on employee relations.

The areas of employee relations suggested as being directly affected by the savings plan in the responses to question 6 of the questionnaire were basically the same

as those mentioned in the literature summarized in Chapter Two. The writers in this field did put more emphasis on the income tax advantages of the plan than was revealed by the respondents to the questionnaire.

#### 6.8 Summary

The purpose of the second phase of the research reported in this chapter was to investigate the effect on financial planning the existence of a savings plan as a source of capital had in those companies sponsoring such a plan. The investigation was based on certain effects postulated to be present and was accomplished by gathering opinions of financial officers through a questionnaire and interviews.

Now that the responses to the opinion survey have been thoroughly analyzed, several general conclusions can be stated regarding the effect of the existence of the savings plan as a source of capital. First of all, for most of the companies the need for new external equity capital had not arisen in recent years. Thus, the question of consideration of alternative sources of equity capital had not been evaluated. This lack of necessity to consider how new equity capital might best be acquired probably affected the responses to the questionnaire. Some managers may not have considered the savings plan as an equity capital source until prompted to do so to answer

the questionnaire. The responses from those companies that had utilized the plan as a source of capital, and therefore had fully evaluated all advantages and disadvantages, were frequently in direct opposition to the responses from companies that had not so used their plans.

The best examples of this conflict in opinions were the responses regarding the flow of funds from the savings plan which were presented in the section on timing of funds to match supply to demand. The responses from managers that had sold newly issued stock to the plans considered the gradual accumulation of funds as desirable. However, the managers that had not sold newly issued stock to the plans expressed the opinion that the available funds at any one time were not sufficient when compared with the needs. These managers that stated the available funds were inadequate did not appear to have considered the small, continuous accumulation over the entire period the funds might be used. The amount available only in the period the demand for funds would begin was compared to the total funds required.

Aside from this problem of adjusting the plan to accommodate the flow of funds available from the savings plan, the decision of whether or not to use the plan as a source of equity capital may be expressed in terms of risk and returns. The risks most prevalent in the responses were the fear of unfavorable employee reactions, the concern

for maintaining good stockholder relations, and the desire to avoid unfavorable action by the Securities and Exchange Commission and the Internal Revenue Service. The returns mentioned were the savings of order costs and the smoothing of market price fluctuations through dollar averaging. The consensus of opinion of the respondents was that the risks outweigh the returns, but this could be attributed to the lack of previous need to raise equity capital and thus, consideration of the plans by many financial managers, as mentioned above.

## CHAPTER SEVEN

### 7.1 Summary of the Research

#### 7.1.1 Problem and Purpose of the Research - Restated

#### 7.1.2 Research Methodology

- (a) Theoretical Model
- (b) Phase One of the Field Research
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### 7.2 Conclusions and Results of the Research

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#### 7.2.3 Optimum Employee Savings Plan Design

- (a) Qualified Plan
- (b) Maximum Amount Available
- (c) Retain Flexibility
- (d) Planning

## CHAPTER SEVEN

### 7.1 Summary of the Research

The purpose of this summary is to present in broad terms the problem investigated, the purpose of the research, and the research methodology. Each phase of the research described in the preceeding chapters has been summarized at the end of each major section and at the end of each chapter. These detailed summaries will not be restated. Instead, the following presentation is a review of the entire research conducted without detailed explanations. This summary of the entire research is followed by a presentation of the major conclusions, the results of the individual issues analyzed, and an optimum employee savings plan design to raise equity capital.

#### 7.1.1 Problem and Purpose of the Research - Restated

In 1951 the Internal Revenue Service granted certain employee benefit programs favorable income tax treatment which allowed companies to make contributions to an independent trust for the account of their employees. Such contributions were considered allowable expense deductions by the companies in determining their taxable income in the year in which made, but were not considered



as taxable income to the employees until received by the employees at termination of employment. The tax advantages of deferring the employees' compensation encouraged many companies to adopt new employee programs. The most frequently adopted form of the new employee programs was the employee savings plan because of the dual features of accumulating an emergency savings fund for the employees and providing a stock purchase plan whereby the employees could invest in the stock of their company. The feature of the employee savings plan providing for investment in the stock of the sponsoring company became the focus of this research. In those companies supporting an active savings plan, a new market existed for the company's equity shares through which new equity capital could be raised without flotation costs.

The introduction of this new supply of equity capital could not be properly evaluated by the financial manager until the characteristics of this new source and its effect on other sources of capital were known. The research was directed toward the problem of incomplete knowledge concerning the characteristics and effects on financial planning of this new equity capital source through employee savings plans. Therefore, the primary purpose of the study was to examine the implications of this new equity capital source on financial planning. It was postulated that the effects on financial planning

would be caused by those characteristics of employee savings plans which were different from other equity capital sources. Thus, the secondary purpose of the study, which by necessity preceeded the primary purpose, was to identify and completely describe those characteristics unique to the savings plan as an equity capital source.

#### 7.1.2 Research Methodology

A review of the literature of the related disciplines revealed that the problem had not been adequately identified nor investigated. Further, there was very little in the literature that could be applied directly to the primary or secondary purposes of the research. Therefore, an analytical model was formulated to provide the basis for the empirical research.

(a) Theoretical Model: To provide a systematic analysis, the theoretical inquiry was organized into three separate phases. The first phase was to summarize existing financial theory applicable to the inflow of funds into a firm. To allow for an evaluation of the effect of employee savings plans on financial planning, the theory was presented in the form of a descriptive model. The goal of financial management in decisions involving the provision of funds, minimizing the cost of capital, was described as a function of two decision variables: dividend policy (internal funds) and financing policy (external funds).

Each of these decision variables was envisioned as being constrained by various considerations that could affect the overall decision.

The second phase was to define the characteristics of equity capital sources in general and the characteristics considered to be unique to the employee savings plan as a source of equity capital. The purpose of this phase of the analytical model building was to identify the features of an employee savings plan which, when considered as an equity capital source, could affect financial planning decisions regarding new equity capital financing.

The final phase of the analytical inquiry was to reexamine the considerations constraining the decision variables in light of the availability of an employee savings plan as an equity capital source with certain unique characteristics. From this inquiry, several concepts were developed which were envisioned as being present in financial decisions involving new equity financing and which could be tested through empirical research. These concepts were divided into two groups: (1) certain unique characteristics of the savings plan as an equity capital source; and (2) certain effects on financial planning.

The characteristics postulated to be unique and to influence financial planning were: (a) the accretion type of flow of funds; (b) the stability of this source;

(c) the limited flotation costs; (d) the employees and trustee as voting shareholders; and (e) the frequent market purchases by the trustee. The first phase of the field research was designed to investigate and evaluate the features considered most relevant to any ultimate effect on financial planning.

The effects on financial planning that appeared most clearly definable were the following considerations described as constraining the external financing variable: (a) flexibility; (b) timing to reduce the cost of capital and timing to coincide supply with the need for funds; (c) control; (d) risk, and (e) order costs. The second phase of the field research was formulated to evaluate the extent of change in these considerations in financial planning due to the presence of an employee savings plan.

(b) Phase One of the Field Research: Through secondary sources, 126 companies were identified that met the following conditions: (1) an employee savings plan existed which allowed the plan trustee to purchase the common stock of the sponsoring company; (2) the plan specified the company contribution be based on employee savings; (3) the company was listed on the New York Stock Exchange continuously during the study period of 1962 through 1966; and (4) the savings plan had been ruled qualified to receive deferred income tax treatment by the Internal Revenue Service. A letter was mailed to the financial

vice-president or treasurer of each company requesting a description of the plan, financial statements covering the operations of the savings plan during the study period, and the completion of an enclosed questionnaire.

The information from the financial statements and the descriptions of the plans constituted the source data utilized to evaluate the characteristics of the plans as equity capital sources. This information was supplemented by the responses to the questionnaire and for some companies, by information obtained from savings plan registration statements filed with the Securities and Exchange Commission.

The objective of the analysis of the accretion type flow of funds available from the savings plan was to evaluate whether these funds were of sufficient magnitude to be considered as an equity capital source. The analysis for each company consisted of making two comparisons of the funds available through the plans to the actual funds utilized by the company during the study period. First, the total funds raised by each company from all sources (retained earnings, depreciation charges, new debt, and new stock issues) were compared to the available funds from the savings plans as evidenced by purchases of the company stock. Second, the equity capital actually utilized was compared to the available funds. Equity capital utilized was limited to earnings retained and new

stock issues. To provide a guideline to evaluate the comparisons, the aggregate funds inflow for all U.S. corporate businesses for the prior eleven years was utilized. A further comparison was made, where applicable, of the amount raised in the most recent new equity issue (excluding the new stock issued to the savings plan) to the funds available from the savings plan in the last year of the study period.

The stability of the savings plan as a source of new equity capital was defined as the continuous existence of available funds in relatively equal amounts and thus subject to reasonably accurate prediction. The analysis of the stability consisted of computing for each plan the average annual growth rate in available funds over the study period. In addition, the annual growth rate of reinvested dividends was computed to illustrate the compounding effect of the available funds as the plans mature.

Due to the establishment of the savings plans as employee benefit programs, the expenses of operating the plans were considered compensation expenses. Thus, raising new equity capital by sales of new issues to the savings plan would involve no flotation costs. The analysis of flotation costs consisted of: (1) a review of published studies to ascertain the flotation costs in new equity issues; and (2) the responses to a question

regarding the accounting of funds obtained through the plans.

To qualify for the favorable income tax provisions, the employee savings plan must be administered by an independent trust. The trustee, when given voting rights over the company stock held for participating employees, could thereby become a factor to be considered in issues put to the vote of shareholders. The objective in the analysis of trustee voting power was to determine the voting powers accorded the trustee and the degree of power available. The provisions of the savings plans' descriptions pertaining to voting of stock held in trust were summarized to provide an indication of the voting power granted the trustees. To establish the degree of control available, the percent of total outstanding stock held in trust was computed for the last year of the study period for those companies where the savings plan trustee could exercise voting rights.

Although this research was involved in evaluating the employee savings plan as an equity capital source, the fact that most of the company stock for the savings plan is purchased on the open market and not from the sponsoring company could not be overlooked. The analysis of the plans' trustee trading on the open market included a summary of the Security and Exchange Commission's interest in company sponsored programs that purchased

company stock. The action by the SEC in two cases established an implied trading volume limitation on purchases by such programs. The actual open market purchases by each plan were compared to the total trading volume on the New York Stock Exchange for the last two years of the study period. This comparison on an annual basis gave an indication of the relative size of trustee purchases and of how many companies were in danger of SEC investigation.

(c) Phase Two of the Field Research: The information evaluating the effects on financial planning resulting from the availability of new equity capital through an employee savings plan was obtained by responses to a questionnaire and interviews with financial officers of companies sponsoring such plans. The questions were carefully designed to gather the desired information with a minimum influence on the responses. Accordingly, specific questions were not directed toward the effects postulated in the theoretical model which were listed above. Instead, broad questions were asked regarding the reasons the savings plan had or had not been used as an equity capital source and requesting the primary advantage and disadvantage in so using the plan. The responses to these leading questions were then separated and evaluated in terms of the postulated effects on financial planning.



## 7.2 Conclusions and Results of the Research

The conclusions and results of the research will be presented in three subsections in order to draw together the implications derived from the many facets analyzed and to provide continuity to the summary of the results of the individual issues investigated. The general conclusions will be presented first to allow the reader to grasp the overall significance of the research. Second, the results of the individual analyses which support the general conclusions will be detailed. Finally, a description of the features of a hypothetical employee savings plan designed solely to provide an internal market for new equity issues will be explained.

### 7.2.1 General Conclusions

The general conclusions from the reserach of a non-homogeneous population such as existed for this study must be qualified by acknowledging that such conclusions were derived from the majority position of those plans analyzed and therefore do not necessarily apply to the situation in any individual company. There are two general conclusions that can be drawn from the research.

The first general conclusion is that the funds invested in stock of the sponsoring company by the trustees of the savings plans during the study period represented an equity capital source worthy of serious consideration by the financial officers of many companies involved in the

study. The funds available through the savings plans could have provided substantially all of the resources normally obtained through issuing new stock. However, the long term needs of a firm must have been anticipated requiring careful planning to match expenditures to the slow, steady accumulation of funds. Alternatively, non-equity sources could have been utilized which then could be systematically liquidated with the funds obtained from the savings plan. The attributes of this source of equity funds which would have made it preferable to other sources of new equity capital were the absence of flotation costs and the predictability of the amounts and timing of available funds.

The second general conclusion is that during the time period studied, only a small minority of the companies did consider their employee savings plan as a potential source of new equity capital. For many of the companies surveyed, the need for new equity capital had not arisen during the study period and therefore, the question of alternative sources of equity capital had not been considered by many financial officers prior to encountering the questions on the questionnaire or during an interview. The majority of the responses to the questions may be summarized as a rejection of the employee savings plan as an equity capital source. This majority rejection was based primarily on the opinion that the available funds

at any one time were not sufficient when compared with the requirements of the companies involved. In contrast, the few companies that had sold newly issued shares of stock to their savings plans considered the funds available as sufficient and preferred the gradual accumulation of funds from the plans to the alternative of a single large, discrete issue. For the majority, however, the additional administrative requirements and the risk of creating unfavorable employee or stockholder relations were considered as outweighing the savings in flotation costs.

These two general conclusions appear to be contradictory. The resolution of the inconsistency of these two statements expressing the general conclusions of the research depends upon how the savings plan is incorporated into the financial planning of a firm. The majority of financial officers responding apparently considered equity financing only in terms of the amount that could be raised at one time. The small amounts available from the savings plan at any one time excluded the plan from this type of consideration as an equity capital source. When the equity financial planning was expanded to include small amounts over a long period of time, as has been done in a few companies, the savings plan became a desirable source. Likewise, when considered over a long period of time, the available funds did constitute a sizeable sum

for most companies and appeared large enough for consideration when viewed in terms of the relative requirements for new equity funds.

#### 7.2.2 Summary of Results of Individual Issues Analyzed

(a) Flow of Funds: The primary issue evaluated was whether the amount available was large enough to warrant consideration as a source of equity capital. Due to the individual policies and demands of each company, the results of the analysis do not allow an unqualified statement applicable to all companies having savings plans. However, the investigation conducted did imply that the funds were large enough to be considered in many companies. The amount of funds raised from new equity issues expressed as a percentage of total sources of funds of all U.S. corporate businesses over an eleven year period was established as a standard (2.8%). Over 50% of the companies studied (46 of 88) had a source of new equity capital available through their plans that was a greater percentage of total capital actually used than the standard established by the aggregate data. Likewise, when expressed as a percentage of the equity capital utilized (retained earnings and new equity issues), the available funds of the majority of the companies' plans (55 of 88) exceeded the aggregate standard (funds from new equity issues expressed as a percent of funds from retained earnings and new equity issues - 9.4%). The implication

is that while new equity capital supplies only a small portion of the total capital requirements of corporations, the funds available from the savings plans were large enough to have been considered as a source of new equity capital in most of the companies studied.

The comparison of the amount available from the savings plan in the last year of the study period to the total amount raised on the new equity issues through normal channels was limited to those companies that had sold newly issued stock through rights issues to existing shareholders or cash issues to the general public. The funds available from the plans in one year were found to average 8.3% of the amount raised by twenty-six companies in their last discrete new issue. This percentage seems small until the infrequency of new equity issues by the companies in the research sample is illustrated by the fact that it was necessary to go back twelve years to include enough new issues to make a meaningful analysis, and then only twenty-six of eighty-eight companies had floated new equity issues during that time.

(b) Stability: The stability of the funds was analyzed by computing the annual rate of change in the amount of funds available as evidenced by the trustee purchases of stock of the sponsoring company. The average annual rate of change in funds available was found to be a small increase in almost all plans with the average between

5-10% growth per year. The compounding effect of reinvested dividends was the main reason for the increase in available funds. The reinvested dividends averaged a growth rate of over 20% per year in the majority of plans. This analysis indicates the funds were available in fairly even amounts and subject to reasonably accurate prediction.

(c) Flotation Costs: The results of previous studies indicated that the flotation costs of raising new equity capital through traditional sources varied with the type of company, the size of the issue, and whether the issue was sold through existing shareholders or to the general public. The highest flotation costs (21% of net proceeds) were associated with small subscription issues offered by manufacturing companies and the lowest flotation costs (4% of net proceeds) were found in large public issues sold by utility companies. The responses to a question regarding the accounting treatment of funds from sales of newly issued stock to the savings plan disclosed that the funds raised by this method were free of flotation costs. The results of this investigation indicate the flotation costs could consume a sizeable portion of the proceeds of an equity issue and these costs could be eliminated through sale of newly issued stock to the savings plan.

(d) Trustee Voting Power: The majority of plans provided the employee with the right to instruct the trustee how to vote all or part of the shares held in trust and specified

the trustee had the power to vote uninstructed shares. Thus, trustees had voting power over all or part of the shares in 84% of the companies for which the information was available (77). However, at the end of the last year of the study (1966), the stock held in trust as a percent of outstanding shares averaged only 2.7%. This indicates that trustee voting power was limited and unlikely to have much implication for financial managers until the plans age and the stock left in trust due to income tax requirements increases.

(e) Trustee Trading in the Open Market: The Security and Exchange Commission is watching the degree of trading in company stock by company sponsored employee benefit programs as evidenced by action against the Georgia-Pacific Corporation and Genesco, Inc. The restrictions imposed suggest that 10% to 15% of the weekly trading volume is the maximum the SEC considers appropriate. The percent of annual New York Stock Exchange volume accomplished by the trustees of the savings plans studied averaged 4.6% in 1966 and 3.9% in 1965. However, in both years the purchases of seven plans (of fifty-one) accounted for over 10% of the annual trading volume. The impact on the market price of the stocks involved depended upon the timing of the purchases, the effect of the marginal increase in demand, and the general market conditions. The purchases on individual days could have accounted for a

much larger percentage of the trading volume than the annual figures indicate. The implication of this analysis is that the constant purchases of company stock may be large enough to affect the market price of some stocks, especially when the plan purchases are maintained throughout the short run price swings of the stock. In addition, some companies may have to limit the plan purchases at any one time to avoid the danger of SEC investigation.

(f) Flexibility: Flexibility in financial planning was defined as the ability of a management to expand or contract the firm's use of sources of funds or changes in the cost of these funds. The responses to the questionnaires indicated that during the study period the financial managers did not consider flexibility to be increased by the existence of a savings plan. However, in interviews with financial officers the possibilities of greater flexibility were expressed, especially by the management of the firms that had raised new equity capital through sales of unissued stock to the savings plan.

(g) Timing to Reduce the Cost of Capital: The savings plan was envisioned as minimizing the cost of capital by allowing the planning of new financing to take advantage of favorable market conditions. This aspect of timing was mentioned only in interviews where the ability to issue debt capital when interest rates were low and then rebalance the capital structure through the savings plan



was described. Additionally, in one company, the management expressed during an interview that the dollar-averaging price from constant sales to their savings plan was preferred to the uncertainties of the forthcoming price of a single issue.

(h) Timing to Match Supply with Demand: The financial manager must regulate the inflow of funds to coincide as nearly as possible in amount and time with the projected requirements for funds. The slow, steady accumulation of funds from the savings plan was postulated as increasing the use of new equity capital by providing a source to match with investment projects demanding a steady flow of funds over time. In the interviews, the financial officers of the companies using their plans as a source of capital stated they preferred the slow accumulation of funds because their experience indicated that when equity capital was raised through public or subscribed issues, the funds could not be put to use all at once, thereby reducing total profitability until capital improvements were completed and in operation. The general opinion of the financial officers responding to the questionnaire indicated that they considered the funds available from the savings plan only on a short term basis and accordingly, found these funds insufficient for the needs of their companies.

(i) Control: The use of the employee savings plan as an

equity capital source would result in dilution of control for owners and therefore, would require additional consideration in financial planning. The question of control was not a major concern of the financial managers interviewed, but did appear in the responses to the questionnaire. Several respondents expressed the necessity to protect existing shareholders and a few considered the unfavorable impact on shareholder relations the primary disadvantage of using the plan to raise capital.

(j) Risk: In the analytical process of identifying the changes in financial planning that could occur due to the existence of a savings plan, two effects on risk were anticipated. The increase in employee stockholders was expected to increase management's overall aversion to risk. The reduction in the uncertainty in the volume of funds forthcoming from a given number of shares issued due to the stability and predictability of available funds from the plans was anticipated to be acknowledged. Except for a few favorable comments regarding the flow of funds, these two effects were not found. However, two new kinds of risk introduced by the use of the plans to raise capital were frequently mentioned. Many financial officers expressed the opinion there was the risk of creating ill will among the employees and/or unions by using the plans in any way that would directly benefit the company. Further, a smaller number of respondents indicated that

to sell newly issued stock to the employees through the savings plan would endanger the qualified trust established under the Internal Revenue Code and perhaps violate Securities and Exchange Commission regulations. However, as pointed out in the dissertation, such sales are allowable under IRC and SEC regulations if the proper administrative procedures are followed.

(k) Order Costs: The primary advantage to the company in using the savings plan as a source of equity capital, in the opinion of the respondents to the questionnaire, was the ability to raise funds without flotation costs. These responses indicate that some of the financial managers involved recognized the savings plan as a vehicle to obtain equity capital at no order cost.

### 7.2.3 Optimum Employee Savings Plan Design

The review of pertinent literature, summarized in Chapter Two of the dissertation, established that employee savings plans were adopted by companies primarily for reasons of their incentive value for prospective and existing employees. It was only after the plans were in operation that some managers became aware of the potential source for new equity capital through sales of newly issued stock to the plan's trustees.

The employee savings plan can be an important source of new equity capital when financial planning is expanded to accommodate the slow availability of funds.

The following is a description of the features of an optimum savings plan designed to raise new equity capital. This design is based on the research conducted for the dissertation. It is not anticipated that the management of any company would establish an employee savings plan solely to raise equity capital. However, should the anticipated need for equity funds be a consideration, the following should be helpful in designing the plan and would of course, be evaluated in conjunction with considerations of maximum employee response, cost, stockholder acceptance, and the other employee benefits offered.

(a) Qualified Plan: The employee savings plan established to provide a source of equity capital should be designed so that it will meet the requirements for qualification under Internal Revenue Code section 401. One of the objectives of such a plan would be to raise as much cash as possible, which implies maximum employee participation. One of the features of the savings plan most appealing to employees is the opportunity to defer income taxes on company contributions to the plan. Thus, the income taxes on company contributions and the income from the invested funds are deferred until retirement. Additionally, if the total funds accumulated in an employee's name are received in a lump sum, the tax rate is reduced by one-half under capital gains treatment. Therefore, it is imperative to have a qualified plan to secure maximum

employee participation. The qualified plan, while deferring taxes for the employee's compensation, still allows the employer in computing the company's taxable income to deduct the company contributions as a business expense in the year made.

The requirements for establishing a qualified plan are many and involved. Only the more important can be mentioned here; the company's tax counsel should be consulted regarding the detailed requirements. The majority of the requirements for securing qualification of a plan are established to protect the employee and his investment. These requirements include the following:

1. A domestic trust must be established for the exclusive benefit of the employees or their beneficiaries.
  - a. The trustee can not purchase investments at a cost which would exceed the fair market value.
  - b. Sufficient liquidity must be maintained to permit distribution in accordance with the plan.
2. The plan must not discriminate in favor of officers, shareholders, supervisors, or highly compensated employees (employee contributions of up to 6% of gross wages have been ruled by the Internal Revenue Service as not too burdensome to keep out lower paid employees).
3. All company contributions must be ultimately vested (become the property of) to the employees. However, company purchased securities can not be vested or distributed until the securities have been in the fund at least two years.
4. The plan must be permanent, in writing, and a copy available to the employees.

The sale of newly issued stock by the sponsoring company to its savings plan has been ruled allowable by the Internal Revenue Service without jeopardizing the qualified status of a plan, provided all other requirements are adhered to. Therefore, the plan must contain written instructions that the independent trustee may purchase stock of the sponsoring company directly from the company. Further, the description of the plan must set forth a means of setting the price of company offered shares which will guarantee the price will not exceed market value. The qualified plans examined satisfied the market price requirement by establishing a price based on an average of previous exchange prices, e.g. the mean average of the high and low closing price for the week prior to the date of sale.

(b) Maximum Amount Available: The plan should be designed so that the maximum amount of funds possible will flow into the savings plan to be invested in company stock. The plan should, therefore, contain features which will encourage maximum employee participation, allow the greatest employee contribution possible under tax qualification limitations, require all investments to be in company stock, and keep the funds in trust as long as possible. Maximum employee participation can be encouraged by insuring the plan is tax qualified for reasons detailed in the previous section. Further, the entry

requirements should be very lenient and all employees included. The entry requirements should be set so that an employee can join the savings plan soon after being hired. However, the entry requirements must stipulate a limited period of employment to prevent the temporary employee from joining and then leaving the company, requiring a liquidation of his trust fund.

Employee participation can further be encouraged by a large employer contribution rate. Several of the plans investigated set their contribution rate at 100% of the employee's contribution and had over 90% of eligible employees participating. If the plan is set up to raise new equity capital, the employer contribution would not utilize funds regardless of the contribution rate, as the funds would flow back into the company. Mechanically, the cash would be sent to the trustee periodically as required to meet the specified contribution, and subsequently, the trustee would return the employer's contribution plus the employees' contributions to purchase company stock. Alternatively, the employer's contribution could be in the form of shares of stock as was found in a few of the plans investigated. This would eliminate any company funds channeled through the trust fund, but requires the company to purchase stock on the open market when new equity funds are not required. The degree of company contribution must have some limit to qualify as

a reasonable business expense deduction in computing the company's taxable income. The 100% contribution rate was allowed as a reasonable business expense in several companies.

The new equity funds generated from the employee savings plan would come from the employee contributions (the company contributions represent merely "pump priming"). Therefore, in addition to encouraging employee participation, the plan should contain features to encourage the employees to contribute as large a percentage of their salary as possible. The limit on employee contributions set by the Internal Revenue Service is 6% of gross wages. Any percentage higher than this is considered to discriminate against the lower paid employee and would require submission of evidence to the IRS that such discrimination would not occur. Therefore, the maximum saving rate of the plan designed to raise capital should be 6%. In addition to the maximum, a series of allowable saving rates should be established to encourage those employees who could not save the maximum to join the plan, e.g. 2%, 4%, and 6%. The higher the company contribution rate, the more the employees are likely to save.

The plan should specify that all investments must be in the stock of the sponsoring company. This feature would insure that the maximum amount would be available to the company. When other factors such as safety of



employee funds are considered, this feature regarding investment of funds would most likely be altered.

The plan should be designed to keep the funds in trust as long as possible and require all dividends to be invested in company stock. The dividends, when paid, would not constitute a drain on company resources for the stock held in trust if these dividends were reinvested in company sold stock. In several of the older plans studied, the reinvested dividends amounted to more than the company contribution. The funds should be kept in trust as long as possible to have the dividends available for reinvestment. The easiest way to accomplish this would be to limit full vesting of the stock purchased with the company contribution to retirement. The long waiting period for full vesting to retain stock in trust must be evaluated with a shorter period to encourage greater employee participation and more employees saving at the highest rate. The deferred tax feature of a qualified plan encourages employees to keep their funds in trust as any withdrawals while still employed are taxed at normal tax rates and not the capital gains rates.

To enable the trustee to invest the maximum amount in company stock and maintain the liquidity to qualify under the Internal Revenue Code, all employees who terminate from the plan should be required to take their investment in full shares of company stock. This

requirement would allow the trustee to invest almost all of the available funds in company stock as there would be no necessity to maintain uninvested funds sufficient to distribute cash to employees leaving the plan.

(c) Retain Flexibility: The features described would provide an employee savings plan which would generate the maximum amount of new equity capital for the sponsoring company. However, the company must retain some flexibility should new equity capital not be desired. Accordingly, the plan should specify that the trustee is to buy stock from the company if offered, otherwise purchases on the open market are to be made. Further, the plan should specify that the company may sell to the trustee either treasury stock or newly issued stock, at the option of the company's management. These features would allow the company to regulate the new equity capital forthcoming.

(d) Planning: The management of a company setting up such a savings plan as has been described would need to know the amount and timing of available new equity capital. To determine the amount available, forecasts would have to be made of the following:

1. Employee participation rate by wage, class, i.e. number of employees expected to join and their gross pay.
2. Employee saving rate, i.e. the percent of each participating employee's pay expected to be saved.

3. Dividends that will be reinvested. After the plan is established, the number of shares in trust at a dividend pay date must be estimated and multiplied by the dividend per share.
4. The percent of available funds the trustee will invest in company stock or alternatively the amount the trustee must keep in cash to maintain the required liquidity.

The timing will depend upon the pay periods of the participating employees and the frequency of investment by the trustee. In addition, an estimate must be made of the market price of the stock to divide into the projected funds to be invested to determine the number of shares that must be available.

In summary, the savings plan designed to provide the sponsoring company with an internal source of new equity capital should contain features which will meet the Internal Revenue Service requirements for qualification as a deferred compensation plan, generate maximum employee participation and savings, keep the funds in trust as long as possible, and still retain some flexibility for the company.

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