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Protecting Employee Entitlements

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Introduction

Through employers' liabilities for employees' accrued annual and long-service leave entitlements (henceforth 'entitlements'), Australian workers are significant providers of funds to Australian companies. In aggregate these entitlements probably exceed $50 billion[1], an amount approximately equal to total lending by all Finance Companies. Payable only when employees take leave or resign, the timing of these entitlements is uncertain, as are the ultimate amounts which are typically linked to employees' remuneration at the time liabilities become due rather than to the time at which they accrue.[2] Table 1 shows entitlements for selected Australian corporations. Predictably, entitlements tend to be relatively higher in more labour-intensive firms.

Table 1

Employee Entitlements of Selected Australian Companies*

Company (year)	Assets ($m)	Shareholders' Equity ($m)	Accrued Employee Entitlements	
			($m)	(% of Assets)
Coles Myer	8,278	3,246	480	5.8%
Woolworths	5,083	1,526	288	5.7%
Qantas	12,514	3,316	617	4.9%
Telstra	37,473	13,722	1,013	2.7%
WMC	10,012	4,853	59	0.6%
Boral	4,001	1,855	102	2.5%
Fosters	5,007	3,817	93	1.9%

*Source: 2001 Annual Reports

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[1] This ballpark estimate can be derived either by extrapolating the figures for individual companies given in Table 1 or applying an average entitlement per employee of around $6,000 (within the range quoted by Bickerdyke et al (2001) for amounts lost per employee) to 9 million employees, yielding a figure of $54 billion.

[2] Corporations normally only classify accrued annual and long-service leave as 'entitlements', with unpaid wages and salaries shown as 'sundry creditors and accruals'. Future long-service leave entitlements are invariably discounted to a present value in accordance with the relevant accounting standard.

Labelling entitlement liabilities as 'provisions' in balance sheets may suggest to non-accountants that specific assets or cash flows are reserved to meet the eventual claims. In fact, these provisions simply represent claims against assets in general and are vulnerable to any diminution in asset values in the event of financial distress. Recent 'headline' corporate collapses of National Textiles, Cobar Mines, Oakdale Colliery and Ansett (where unpaid entitlements amounted to around $140 mill) illustrate this risk,[3] and have prompted several policy responses.

In 2000 the Federal Government introduced the Employee Entitlements Support Scheme (EESS), replaced in 2001 by the General Employee Entitlements and Redundancy Scheme (GEERS) and, for Ansett Group Employees, the Special Employee Entitlements Scheme. These schemes provide limited protection for employees and impose costs on taxpayers (and, in the Ansett case, air travellers). It is doubtful that they are optimal either from societal or employee perspectives. GEERS is, effectively, a government (partial) guarantee scheme for a particular group of creditors of failed institutions. Such an approach has been deemed unsuitable for protecting bank depositors, partly because of adverse effects on stakeholder monitoring and governance of the institutions concerned. Similar concerns in relation to entitlements are only partially addressed by the *Corporations Law Amendment (Employee Entitlements) Act 2000* which makes it an offence to take actions designed to avoid payment of employee entitlements.

The argument of this paper is that employees are significant providers of finance to companies, by way of entitlements, and that such provision always involves risk, return and governance considerations. However, because of a 'crisis-induced' focus on protecting employees from loss, inadequate attention has been paid to finance and governance issues in deriving a package of policy

[3] Estimates of the number of employees affected annually and the aggregate amounts involved vary. Bickerdyke et al (2001) discuss various estimates. Ballpark figures are in the order of 20,000 employees suffering average losses of around $7,000 each or $140 million in aggregate.

instruments.[4] Once it is recognised that employee entitlements are a significant source of business finance, with particular risk and contractual characteristics, it can be questioned whether current legal and institutional arrangements involve an appropriate role for these financial stakeholders in the corporate governance process.

Herein we examine various policy instruments which might be used to protect entitlements and propose a Deferred Benefit (DB) Account scheme which, we believe, merits a place in an optimal policy package. The DB scheme would provide effective and efficient protection of entitlements whilst enhancing corporate governance. Although critics such as Bickerdyke et al (2001) have dismissed similar schemes as sub-optimal, we believe that such analyses have not focused sufficiently upon financial-management and corporate-governance issues[5]. In resolving a complex problem, the DB scheme merits inclusion in a package of policies which includes legislation such as the *Corporations Law Amendment (Employee Entitlements) Act 2000* and a GEERS-type scheme.

Financial Policy Issues

Because they arise from lags between the utilisation of labour and ultimate payment, entitlements are a source of company finance, particularly of working capital. While, like trade credit, entitlements ostensibly represent a 'free' source of capital, i.e., they are available at a zero explicit interest rate, this is to overlook the impact of nominal-wage growth[6]. A week of long-service leave which accrues in year 0 but which is taken in year 10, will be paid at the remuneration level applying in year 10. Hence, the implicit cost of entitlements as a source of capital (and equivalently, the rate of return to the providers of such finance) is approximately the annual rate of remuneration growth.

In a perfect no-tax capital market, changing the financial structure of a firm makes no difference to its total value or cost of capital. Thus, if the cost of

[4] Legal and public-policy aspects of protection of employee entitlements have attracted the attention inter alia of the Australian Law Commission (ALRC, 1988), Campo (2000), Hughes (2000), and Noakes (2001).
[5] Hughes (2000) discussed securitization of employee entitlements, but it is difficult to see how this technique could be implemented cost-effectively.
[6] Likewise with trade credit, the better price terms which may be obtained for immediate payment imply that it also is not " interest free".

entitlement-funding reflects the risk borne by the suppliers of these funds, replacing such financing by an alternative would have no significant valuation effects. If a firm placed assets of equivalent value into an income-earning trust established to pay entitlements, and raised equivalent funds (to replace the working capital so lost) from the financial markets, in a perfect capital market this would have no effect on company value.[7]

In practice, capital markets are imperfect, and managers may believe that working capital provided through employee entitlements is 'cheaper' than other financing alternatives. One reason may be a myopic view which ignores the implicit cost of employee entitlements previously explained. Alternatively, it may be that entitlements *are* a cheap cost of finance. But if so, it is important to the design of optimal policies to understand why that is the case.

Three arguments can be advanced that entitlements are a cheap source of funding. First, because accrued entitlements emerge 'naturally' from company operations, the transactions costs associated with raising such finance may be lower than for alternatives. Second, the cost of such funds may not adequately compensate suppliers for the risk they face. Because the provision of credit by employees is largely non-discretionary and the implicit rate-of-return equals the rate of wages growth, there is no guarantee that the cost reflects an appropriate rate-of-return for the risk involved. While the return could, in principle, be too low or too high, in practice it is likely to be too low. Risk-averse employees, without well-diversified asset holdings, could be expected to demand a very high rate-of-return on loans to their employer because default on those loans will occur simultaneously with loss of wage-income following company failure.[8]

The third reason why management might perceive such funding as low cost is that financing of this form does not involve capital market discipline or monitoring. If so, substituting external financing for entitlement-funding would involve the substitution of external creditor-monitoring for non-existent monitoring by employee-creditors. Management may regard that as a cost, but

[7] If, as assumed here, the company has no liability beyond the assets held in the trust, this is equivalent to the technique often referred to as 'defeasance'.

that view would not be shared by other stakeholders, for whom improved external monitoring is advantageous.

If entitlements are a cheaper form of financing because of lower transactions costs, policy proposals affecting entitlements should aim to retain that advantage. However, employer preferences for 'cheap' entitlement-funding arising from inadequate risk premiums, or absence of creditor oversight, should not be seen as impeding alternative policy proposals.

Corporate Governance

Crucial to good corporate governance is the monitoring and disciplining of companies by financial stakeholders. Although the interests of equity-holders and creditors are not always aligned, both have incentives to monitor management and corporate decisions to promote efficient operations. Price movements in publicly-traded corporate securities, as available information is digested, are one manifestation of this role. Equally important, however, is pressure from lenders such as banks whose role is sometimes interpreted as that of delegated monitor acting on behalf of end-suppliers of credit (bank depositors). Social benefits arise whenever specialist institutions (such as banks) exert monitoring and disciplining influences upon borrowers which individual providers of finance are unable or unwilling to replicate.

Also important to good corporate governance are mechanisms which prevent controlling stakeholders from inappropriately transferring value from other stakeholders. In credit markets, debt covenants are one mechanism for protecting creditors. Similarly, short-term credit instruments limit scope for expropriation by requiring firms to regularly access financial markets. Unfortunately, such mechanisms are most efficacious for ongoing, viable firms where reputation is a valuable asset to be protected. In cases of emerging financial distress, incentives for insiders to attempt to transfer value from other stakeholders can be expected to increase.

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[8] In theory, if not in practice, employees could seek implicit compensation for the risk borne on finance provided via deferred benefits through higher wage rates.

Employees as creditors for entitlements are, in principle, in no different position to other creditors. A good corporate governance regime should involve implementing, with legislative backing if necessary, procedures which ensure that the reasonable expectations of employee-creditors are met even when companies suffer financial distress. It is, however, clear that management (acting primarily in the interests of other stakeholders) may, when confronting financial distress, take actions (including corporate restructuring) which adversely affect entitlements[9].

In this context, it can be asked whether is desirable on governance grounds for a large number of individual creditors (employees) to provide, somewhat involuntarily (through industrial awards or employment contracts), significant amounts of finance to corporate borrowers. Individual employee-creditors will rarely understand a company's financial position. Even if they do, their ability to exert any governance influence is limited. At the individual level, withdrawal of ongoing provision of credit will require resignation from employment with that company. Alternatively, sanctions through industrial action will aggravate the poor financial position of an employer and, counter-productively, increase employees' credit risk.

In principle, discipline can be exerted also by potential employees who avoid working for, or demand higher remuneration from, firms which inadequately protect deferred benefits. In practice, costs of information acquisition and a high rate of time preference (for current income relative to deferred benefits) by unemployed workers make this scenario unrealistic.

We conclude that the current financial arrangements for providing for employee entitlements are not optimal from a corporate governance perspective.

Objectives of Intervention and Options for Reform

The preceding discussion indicates that a case of market failure exists in the 'market' for employee entitlements. Government intervention or regulation in

[9] Noakes (2001, p125), observed that the Patrick Stevedores dispute with the Maritime Union of Australia in 1998, involved 'a restructure allegedly designed to avoid obligations owed to employees upon one or more group companies becoming insolvent'.

some form may then be warranted, provided it can be justified on cost-benefit grounds. It is thus important to outline the objectives of such intervention/regulation to provide a framework for assessing alternative possibilities. Noting that issues of creditor risk, firm financing, and corporate governance are all involved, we propose that desirable objectives are:

- reducing the credit/default risk faced by employees to some "optimal" level;
- limiting the costs incurred by taxpayers or third parties;
- minimizing the compliance and financing costs to employers arising from government intervention or legislation;
- enhancing corporate governance and management accountability.

Benchmarked against these objectives, we now explore a variety of policy options which have been proposed for safeguarding entitlements, drawing where possible, on experience elsewhere with such schemes.

Priority secured-creditor status

Both unions and company directors have proposed that entitlements should be given priority over secured creditors. From the standpoint of our objectives the advantages of this concept are that default risk is reduced, there is no cost to taxpayers and company costs of administering entitlements would be unaffected.

However, as the Parliamentary Library (2000) points out, this concept 'would represent a fundamental change in the nature of business lending for financial institutions'. In effect, entitlements would become first-ranking claims over all business assets and all other lenders would have no control over nominally secured assets in the event of borrower default. Accordingly, higher rates of interest would be sought. From the standpoint of corporate governance this proposal provides no (and perhaps less) incentive for managers to improve provisioning practices for future claims. However, conceivably, hitherto secured creditors may insist on actions, through debt covenants, which force improved governance as a condition of obtaining finance.

Industry guarantee fund/insurance

In this option, employers in an industry collectively insure against default-risk by member firms. Possible mechanisms include collectively-bought insurance, or industry-controlled trust funds similar to the Travel Compensation Fund (TCF), which operates in the travel industry to safeguard pre-payments made for travel services. A practical problem with this approach is determining the appropriate level of coverage which, presumably would lie somewhere below the aggregate entitlement liabilities of all industry participants. The riskier the industry, the greater the desirable level of coverage. Clearly, premiums charged by commercial insurers would be both coverage- and risk-related. For an industry-controlled fund, participants would incur the costs of creating and operating the particular structure used. They would also need to determine a formula for levying members.

This system would reduce, but not necessarily eliminate, the default risk faced by employees, with the key factor being the level of insurance coverage purchased or resources provided by the industry-controlled vehicle. In the latter case, the Ansett collapse provides a salutary lesson. The TCF was resourced to safeguard against the failure of a modest number of travel agencies, not a major industry player such as Ansett's Traveland subsidiary, to whose clients the TCF could pay only 40c in the dollar. Further, while this approach involves no call on the taxpayer, it creates no incentive to improve corporate governance, if anything, the opposite because industry funds or industry-purchased insurance, involve the outsourcing of what would otherwise be management's responsibility to make adequate provision for claims.

Government Bail-Out

Traditionally in Australia, parties injured by commercial failures look to governments for redress. Responding to several high-profile corporate collapses, in which corporate restructuring and contrived transactions were used to avoid responsibility for entitlements, in February 2000 the Commonwealth introduced the EESS. Designed as a joint Commonwealth-State initiative to safeguard basic employee entitlements to a maximum of $20,000, the limitations of this scheme were exposed by the failure of most States to participate and by the magnitude of

the Ansett collapse in which accrued employee entitlements (including redundancy payments and superannuation) totalled $730 million, with many individual amounts exceeding $20,000. In the replacement GEERS scheme, established in 2001, the Commonwealth assumed the obligation for virtually all entitlements, with only redundancy pay (maximum 8 weeks) and applicable remuneration rates (maximum $75,200 p.a.) capped.[10]

This scheme obviates most default risk faced by employees, with exposure limited to entitlements exceeding the capped amounts. However, GEERS passes the whole cost of protecting entitlements to taxpayers, with the Commonwealth replacing employees as a claimant in any liquidation process. While this scheme involves no new obligation in relation to record-keeping, thus is cost-neutral from employers' standpoints, it provides no incentive for improved corporate governance directed towards upgrading systems and strategies to better provide for future entitlement obligations.

Within-Firm Statutory Funds.

One possible means of removing the credit risk associated with entitlements would be the creation of 'ring-fenced' statutory funds within companies. Such funds, similar to the statutory funds found in life offices, would hold financial assets with market values at least equal to entitlements. As entitlements accrue, employers would be required to purchase appropriate financial assets to match those liabilities.

Several problems exist with this approach. One is the administrative and transactions costs associated with regular acquisition and sale of appropriate financial assets. A second is that unless the set of acceptable financial assets is limited to those with low market risk, some credit risk associated with the value of assets held remains. A third is that employers may draw-down funds dishonestly. Finally, verification of asset holdings could prove difficult and increase audit costs.

[10] In the Ansett collapse, the cap on redundancy pay had the greater effect as some employees were entitled to up to 100 weeks of redundancy pay. Complicating the Ansett case was the

The Manusafe Approach

Manusafe[11] is a union-sponsored scheme which requires each participating employer to create an individual account for each employee in a trust fund operated by Manusafe. Funds are transferred monthly by employers into employees' account to match increases in provisions for entitlements. When employers pay entitlements they claim reimbursement from employees' trust accounts. Any credit risk faced by employees relates only to Manusafe. Provided that Manusafe holds low-risk assets, the credit risk is reduced.

The Manusafe option was rejected by the Howard government partly on the political grounds that such a scheme would limit employer choice and place funds under union control. However, there are other reasons for rejecting this option, although it may be suitable in some industries (such as where employees change jobs frequently within the same industry). One is the additional administrative cost caused by employers having to deal with Manusafe each time an employee draws entitlements. The scheme involves outsourcing the entire process of managing entitlements, not just providing a method of protection for employees. Moreover, the creation of individual accounts is an unnecessary complication when the concern is company failure which will impact simultaneously upon all employees.

The Manusafe concept of focusing on highly-contingent individual benefits (such as long-service leave) has other problematic aspects. First, it is much more difficult to estimate accurately liabilities at the individual compared with aggregate level (where errors may net out). Second, administrative costs are incurred in crediting individual accounts with specific amounts which may never become actual. Third, to the extent that contingent benefits are never actualized, providing for all contingencies will involve over-provisioning relative to a level based on a reasonable estimate of aggregate expected liabilities.

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company-controlled defined-benefit superannuation scheme which was reported to have a shortfall exceeding $100 million.

[11] Details about the Manusafe scheme can be found at http://www.manusafe.com.au .

The Deferred Benefit (DB) Account Proposal

The DB-account is a simple concept which requires employers to maintain balances at least equal to reasonable aggregate provisions for entitlements in designated DB accounts at financial institutions. Financial institutions would register as providers of DB Funds, which would be no different in structure from Cash Management Trusts (CMTs). The DB Funds would invest only in short-term high-rated financial assets. Similar to CMTs, DB Funds would credit employers' accounts with the returns earned on assets held, less (competitive) management fees. Crucially, amounts held in DB accounts would, by enabling legislation, be available only to meet the entitlements in the event of company failure.

Each company would choose a participating financial institution and make regular monthly payments into (or withdrawals from) the DB fund to ensure that the balance was at least equal to the provision for entitlements shown in its monthly management accounts. Withdrawals would be made only in the form of payments to the company (when the matching provision declined) or, if the company was ceasing business, directly to employees of amounts advised by the company or by an adminstrator/receiver. Other than the requirement that payments to individuals (in the event of a liquidation) would require the financial institution to retain the relevant information, there would be no other administrative requirements for the financial institution.

As well as requiring each company to maintain a DB account, it would be desirable to mandate that Boards/Audit Committees had to confirm that DB account balances were maintained monthly at levels at least equal to balance-sheet provisions. Likewise, auditors would monitor compliance with the legislation, a relatively straightforward task given the regular provision of DB balances by financial institutions.

Note that the scheme, requiring only monthly transfers from employers' general accounts to DB accounts, involves minimal administrative costs and is suitable to both small and large employers. It also facilitates better financial management,

by ensuring that changes in accrued entitlements have matching cash flows, alerting Boards to financial difficulties through liquidity effects.

What about the effect on working capital? When the scheme is implemented, firms will need to replace cash deposited in DB accounts with other sources of working capital such as bank borrowings. Note, that the interest cost of these bank borrowings will, to some degree, be offset by interest earned on DB accounts. Indeed, the extra borrowings may be slightly less than the amounts of DB accounts, since some liquid assets may already be held specifically to meet future entitlement claims. Overall, the scheme should have little impact on the cost of working capital. To the extent that it does, it reflects the fact that employees previously received inadequate returns on the funds they provided to employers – a market imperfection warranting correction. However, because of the aggregate magnitude of entitlements, an extended phasing-in period would be a desirable element of this proposal to allow time for financial markets to adjust to changes in the flow-of-funds pattern.

What about the possibility of dishonest management withdrawing DB balances inappropriately, or not maintaining them at an appropriate level? Implementing appropriate penalties to deter such behaviour would seem preferable to placing the onus on account providers to monitor account balances. The *Corporations Law Amendment (Employee Entitlements) Act 2000* which makes it an offence to take actions designed to avoid payment of employee entitlements, already covers this problem. Boards would require monthly sign-offs by management, and regular reports from auditors, that DB account balances and provisions for entitlements were adequate.

What about the risk employees face associated with unpaid wages, payments-in-lieu-of-notice, or redundancy pay, in the case of a sudden collapse? The DB scheme does not pretend to cover this risk, focusing only on entitlements for annual and long-service leave. This is where it would usefully complement the government's GEER's approach. That scheme could be continued in conjunction with the DB proposal, with the role for GEER's (and the taxpayer risk) limited to non-payment of current payroll, additional entitlements triggered by insolvency

(such as redundancy payments), and cases of shortfall in DB accounts arising from employer non-compliance with legislative requirements.

Finally, note that the DB Scheme involves the substitution of external capital market financing (and consequent external monitoring) for funds involuntarily provided by entitlements, currently subject to little monitoring. Given current concerns about standards of corporate governance and the crucial role played by financial stakeholders in that process, the change envisaged here provides a positive (albeit small) benefit in this regard, as well as reducing employee risk and taxpayer costs.

Conclusion

We have argued that past policy approaches for protecting employee entitlements have inadequately addressed finance and corporate governance issues. In particular, proponents of other schemes have not fully appreciated the merits of a scheme such as the DB Account which, we argue, is cost-effective and conducive to good corporate governance. It is not the complete policy solution, nor should it be, but is an appropriate part of a policy package which would include, inter alia, (i) a GEERS-type scheme to cover residual risk at lower cost to taxpayers, and (ii) appropriate legislation and penalties to deter employer attempts to diminish the value of entitlements in the event of liquidation.

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