EMPLOYEE OWNERSHIP IN OUR PUBLIC SERVICES -

MAKING IT HAPPEN

EMPLOYEE OWNERSHIP ASSOCIATION

BETTER BUSINESS TOGETHER

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CONTENTS

FOREWORD

Employee owned businesses are partly or entirely owned by their workforce.

It is the fastest growing form of business ownership in the UK. An important part of this growth is within our public services. More and more employees are spinning out the services they run from their original public sector host body to create fully fledged independent businesses that are employee owned.

Employee owned public service spin outs currently operate, or are developing, in at least ten different spheres, including health, children and adult social work, fire and rescue services and youth services. There is compelling evidence that these spin outs raise the quality of the public services received by users; improve outcomes; increase returns on investment for funders; and for employees improve their well-being and the conditions within which they work. We should celebrate this emerging revolution and the public service pioneers who are its protagonists.

If you have begun to think about creating an employee owned public service spin out this guide is for you. It will navigate you through the process as well as giving solutions to every challenge you might face along the way.

I would like to thank colleagues at Prospects, Fieldfisher and CIPFA for all their work in helping to produce this guide and their kind sponsorship of its production.

I wish you well in your journey towards employee ownership.

I also look forward to welcoming you into the EOA in the future. The vast majority of people who create employee owned businesses in the UK join the EOA in order to do so.

Iain Hasdell
Chief Executive
Employee Ownership Association

1. INTRODUCTION

This is a guide to setting up employee owned public service spin-outs – services that have been part of the public sector and which the parent authority and the employees agree should transfer out and become an independent business, owned wholly or mostly by the staff who work for it.

For easier reading the guide uses a shorter term – e**mployee mutuals** – to refer to such spin-outs. The term 'mutual' simply means an enterprise owned by its members, who could be its customers, users or employees, or a combination. In this guide the focus is on mutuals owned by their staff.

The guide is not meant to be comprehensive. It's designed to give a quick overview of the key steps in spinning out a public service. Because people who use the guide will be at different stages of the process, we have organised it in roughly sequence order – from the exploratory stage right through to making sure the spin-out flourishes as a business – so it's easy to dip into the parts most relevant to you.

The growth of employee owned public service mutuals has been one of the most striking and productive aspects of public sector reform over the past decade and beyond. The result has been an astonishingly diverse spread of new enterprises – in sectors as varied as social care, health, libraries, youth services, schools support, leisure and justice – united by their public service ethos, commitment to innovation and improvement, and successful delivery of savings to their parent authorities.

Ongoing pressure for public sector efficiency and expenditure reductions will ensure that momentum continues. But so will the hard emerging evidence that employee owned public services are at the cutting edge of new and better ways to serve the community.

2. EXPLORE

Whether or not an employee mutual is the answer will depend mostly on what the authority's needs are and whether mutuals can meet those needs better than other options. Throughout the public sector, any employers considering alternative delivery models are likely to weigh each one up as a possible solution to challenges such as:

- Reduction in the cost of service delivery
- Efficiencies
- Innovation
- Quality improvement
- Higher staff engagement and productivity

Assessing the mutual 'fit'

So the initial test for employee mutuals will be the extent to which they can help the authority address such challenges better than options like these:

- Closing or reducing the service
- Cutting costs and innovating in house
- Giving the service quasi-independence by turning it into a trading arm of the authority
- Conventional outsourcing to an external supplier
- Sharing service delivery with one or more other authorities
- Joint venture with, eg, a private sector partner or even the authority itself
- Outsourcing to a charity or non-employee owned social enterprise

2. EXPLORE

There is now wide agreement about the potential advantages of the employee ownership business model – in certain situations. But in assessing which delivery options to go for, authorities will be heavily influenced by the risks each pathway seems to offer.

The Table below compares risks that authorities will need to plan for with the emerging evidence – notably research collated by the Cabinet Office – about how employee mutuals are likely to perform.

Delivery model risk factor	**Employee mutuals' record**
No sustainable savings achieved	Most employee mutuals are achieving target savings and beyond
Externalised service fails	Business failures among employee mutuals are negligible
Supplier gains excessive price leverage	Most employee mutuals are small enterprises without the corporate weight to exploit price leverage
Supplier lowers quality	There is wide agreement that employee mutuals lift service quality
Supplier removes many jobs from the local area	Because they tend to be based in the area they serve, employee mutuals are relatively unlikely to move jobs outside the locality
Difficulty bringing the service back in house if needed	A contingency planning challenge with any switch of delivery model
Supplier makes and keeps excessive gains from contract	Unlikely given the public service ethos and roots of employee mutuals
Service users respond negatively to supplier's methods	Especially with more 'sensitive' services such as social care, employee mutuals appear to enjoy more public trust than, say, conventional outsourcing
Delivery model complex to implement	With dozens of spin-out contracts completed, there is no evidence that contracting with employee mutuals is more complex than other options

2. EXPLORE

Financial factors

Take time early on to consider what financial success would look like. Look at your ideas for setting up an employee mutual and see if you can identify:

- Key ingredients for achieving financial viability
- Any areas of financial weakness and how these can be fixed

It will save time later if you can get an early impression of the extent to which the proposal will require modification or whether financial issues identified make the proposal unviable.

Consider:

- What sorts of financial consequences do you think spinning out will have?
- Can existing services and outcomes be delivered more efficiently?
- Are there opportunities to expand existing services or develop new ones?
- Are there opportunities for widening the purchaser/customer base?

Consider what this might mean in financial terms for the different stakeholders.

- What would be the likely financial benefits and for whom (list them)?
- Will spinning out offer new ways for rewarding staff or other stakeholders?

Start identifying sources for further financial information and advice:

- What are the financial lessons from other spin-outs?
- Where can you find out about the tax implications for the spin-out?
- Who can you ask about the financial implications of TUPE and pensions commitments?
- How have other spin-outs managed those and other aspects?

Ask yourself what financial skills you expect the management and board members to have, and how any gaps in knowledge or experience will be addressed.

While you won't have all of the answers straight away, and certainly not all of the detail, you should start to get a sense of whether the idea is worth pursuing further.

Legal factors

You should consider legal issues among those other issues considered at the outset, as they can have a considerable influence in shaping your approach. A key decision will be how you plan to incorporate employee ownership (or influence) into the new business.

In addition to those matters that any company introducing employee ownership has to consider, spin-outs have to contend with an array of specific legal concerns which include:

- Whether you have powers, as a public body, to spin-out – if, for example, you have been set up by statute, you may be unable to create some types of new corporate structure;
- How you would involve any partner in your venture, such as an independent sector partner;
- The impact of any regulatory restrictions, for example delays or perceived complexity in addressing important procurement issues; and
- Whether a particular legal vehicle is needed to meet tax, contractual or other requirements.

2. EXPLORE

Key tasks

- Expect and plan for relatively low awareness about what employee mutuals are and what they can offer.
- By definition, employee mutuals can't successfully be imposed 'top down'; aim to involve service managers and staff as early as possible in the discussion of options.
- All the key stakeholders need to be kept in the picture while the options are being explored; change makes people nervous and silence will breed rumours and hurt morale.
- Do some research on employee mutuals and if possible try to meet counterparts from authorities and spin-outs with experience of them.
- Try to get access to specialist support from within the authority – for instance with financial, accounting, legal and HR technicalities.

3. MAKE THE CASE

Having explored employee mutuals, the next challenge is to work out if there is a convincing case for that route.

Key questions that will need answering include the following:

Whose responsibility is it to make the case? – this should not automatically be left to the service's own staff to solve for themselves. Most successful spin-outs have involved a leadership team on the employee 'side' working together collaboratively with the parent authority. Both partners should consider whether they need expert help at this stage from outside the authority.

Which services might be mutualised? – with authorities increasingly looking at all services in terms of potential alternative delivery models, the Table below offers a simple method for evaluating which services display most 'mutual readiness'. The column totals should give you a rough and ready sense of whether a spin-out looks viable or the potential hurdles that need to be overcome.

Mutual readiness tester

Mutualisation readiness factor	Likely	Unlikely	Not sure
1. Service's leaders have the vision and drive to make it happen			
2. The service's line manager is/would be supportive			
3. Political support will be forthcoming			
4. Specialist functions, like finance & HR, will be supportive			
5. The staff of the service already feel engaged and committed			
6. Unions are likely to prefer a mutual to other available options			
7. Staff are or will be fully consulted and involved from early on			
8. Users of the service will be supportive or not anti-mutual			
9. There's definitely a market out there for this service			
10. There's scope to grow a profitable business and new services			
11. The competition is beatable			
12. There are clear reasons why a mutual is preferable to other options			
13. Enabling mutuals is a clear part of commissioning strategy			
14. The service can be improved at lower cost			
15. A mutual spin-out will meet the authority's need for this service			
TOTALS			

3. MAKE THE CASE

What's the vision? – it is very important for the survival of the potential business that a spin-out is not seen as simply transplanting the existing service into the private sector. Without real growth, and diversification beyond one or two initial contracts, the spin-out business is unlikely to be sustainable. Its leadership team must show they have a clear, inspiring, convincing vision for where they want to take the new business.

Is it a business? – at this stage, there has to be some sound market intelligence about whether there is enough demand for what the venture will try to sell, and whether it can really compete with whoever else is selling the same service locally. Very detailed market research can come later, provided this first commercial evaluation is realistic about the product to be sold, the prices it can be sold at, the profit that can be made, the demand for it now and in the medium term, and how truly competitive it will be.

Does it solve the authority's problem better? – depending on the authority's attitude, there may be three stages to making the case for an employee mutual:

- A feasibility paper or outline business plan, probably drafted by the service's leadership team, with possible input from the authority and/or external specialists; leading, if approved, to:

- An options appraisal – drafted by the authority itself for the decision makers who will decide whether an employee mutual is the preferred option; leading, if approved, to:

- A business case – a full evaluation by the authority of why and how an employee mutual fulfils its objectives for the service in question, and explains how the service will be procured and on what contractual terms.

Financial factors

All new ventures, whether a private company funded by venture capital or a mutual spun out of a public sector organisation, need to show that they are viable and that the proposition is based on robust evidence and careful analysis.

As part of your initial exploration, you will already have started to identify some of the features and factors that will go in to making the case. The next step is to take forward a proposal for consideration by your parent organisation. You need to present a strong **business case** for an employee mutual that can deliver improvements in quality and efficiency.

The business case is usually one step before producing a more comprehensive **business plan** and it provides an early test of your proposal. If successful, you may receive support from your parent organisation to go on to produce a more detailed business plan for 'spinning out' as an employee mutual. Your parent organisation will have guidance on what they expect to see in the business case.

3. MAKE THE CASE

Public sector business cases - the five case business model

The Treasury **five case business model** is well established as a part of the HM Treasury *Green book: Appraisal and evaluation in central government*. As the name suggests, it includes five components: strategic case, economic case, commercial case, financial case and management case.

While not required for all potential spin-outs, it is a useful tool. The latest version of supplementary guidance provides a practical "step by step" guide to the development of business cases, using the five case model.

The business case should reflect the type of proposal being considered. As such each case will be different in scope and detail. One size does not fit all. Using the five cases business model approach, areas covered could include:

- The strategic case – the rationale for the mutual, its objectives and how they fit with wider public service strategic and policy goals. This could include an analysis of the potential service users and purchasers and how the mutual will address their needs and deliver value to them.
- The economic case – a cost benefit analysis extending beyond the particular proposed mutual to consider its impact on the wider community. The costs and benefits to society as a whole.
- The commercial case – the commercial viability of the proposed mutual and its ability to succeed as an independent service provider. Linked to this would be an analysis of competitors and where the new mutual fits in terms of providing a better service, as well as the trends within the particular market and the wider sector.
- The financial case – the financial viability of the mutual including analysis of income sources and costs, cash flow characteristics and likely capital requirements.
- The management case - management and staff skills and capacities; legal form, governance and operating model.

3. MAKE THE CASE

Making the financial case

Making the financial case includes addressing all four of the following elements:

- **Income** – Who will pay for services and products provided, how much, and when (including frequency and whether before, during or after delivery of services or goods)?

- **Costs** – What are the direct costs of delivering a particular service or product and what are the overhead (or indirect) costs? Part of this is getting an understanding of how much it costs to deliver one unit of a service or product.

- **Cash flow** – How will cash flow in and out of the new enterprise, month by month, through the year?

- **Capital requirements & financing** – What money will you need to set up the enterprise, to buy major assets (fixed capital) and to operate day to day (working capital)? Having made a good case for the capital required, then set out where you think that capital will come from (financing).

Remember that the financial elements draw on the other information going into the business case – things like: demand for services or goods, expected future income mix, how services are to be delivered, and the response to competition.

Consider changes in income and costs resulting from spinning out as an independent enterprise. What will be different and how will this impact financially? For example:

- What are the main income streams and how will these change over time?

- Is payment linked to service provided, or performance against outcomes, or both?

- Where will the enterprise operate from and what are the associated costs?

- What are the tax implications? Are the services partially or fully exempt from VAT and how will this impact on costs? What about corporation tax and business rates?

- TUPE – what are the expectations going forward regarding staff costs?

- Pensions – what are the anticipated costs of pension commitments?

- Charitable status – if the mutual is a charity, what impact will that have on tax?

- What are governance and audit costs likely to be?

- Will the mutual buy services from the original parent public sector body?

Sensitivity analysis

Sensitivity analysis tests how robust the organisation's financial model is when faced with change. Potential changes are applied to the forecast figures to see what the result is for the financial performance of the organisation. So for example:

- What if purchasers buy 10% fewer services from the organisation?
- What if key purchasers want to increase the period between service delivery and payment for those services?
- What if premises costs rise by 15%?

'What if' analysis also helps with identifying those costs and income streams most likely to require careful monitoring and management.

3. MAKE THE CASE

Legal factors

Legal vehicle for the spin-out

As part of the business case, you should evaluate the various legal vehicles available and choose the one that is most suitable. A commercial company in the private sector that converts to employee ownership frequently takes the form of a **company limited by shares**. This type of limited company is the default legal vehicle for business. It is more appropriate for employee ownership than, say, a **limited liability partnership**. Some spin-outs may, however, suit an alternative legal vehicle that is not wholly for private advantage (a **company limited by guarantee**) or also contains asset-locks for community benefit (a limited company established as a **community interest company**) or charitable objects (a **charity**) or to benefit people other than the members (a **community benefit society**). If co-operative principles are important, you can be an employee owned **co-operative**. Other factors such as tax, pension or regulatory requirements may also influence your decision.

Ownership structure

If you have identified employee ownership as your goal, you will need to consider the level and type of employee ownership. Ownership structures could include:

- **A "Teckal" company** – which is wholly owned (at least in the early years) by the public authority before a staged transformation to mutual ownership, but nevertheless involves employees in the governance arrangements;

- **An employee owned business** – where staff own a meaningful stake in the business. This can be a majority stake or may be "co-owned" with other shareholders; and

- **A joint venture with employee ownership** – where different parties collaborate to achieve the venture's objectives and ownership is shared between the staff and one or more additional parties (this could be the public authority and/or an independent sector partner).

Employee ownership model

A key decision for the employee mutual will be the form that employee ownership will take. The degree of flexibility that an employee mutual has in this regard will be driven by the legal structure adopted. Broadly, there are three forms of employee ownership:

- Indirect trust model – where an **employee benefit trust or employee ownership trust** holds the employees' shares. No individual allocations of shares are made. Employees are **beneficiaries** of the trust, which means they have an indirect ownership interest. The trust will act through a **trustee** (typically a **corporate trustee**) with its own board of directors to manage the trust;

- Direct ownership model – where employees hold shares in the company directly; and

- Hybrid model – a combination of direct and indirect ownership.

Broadly speaking, these are three benefits that "ownership" can deliver:

- Income receipts (i.e. dividends);

- Votes; and

- Capital gains (on sale).

Structuring an employee mutual as a **company limited by shares** can provide all three of these benefits and gives the most flexibility when choosing the right form of employee ownership. The relative importance of these three benefits will drive the decision as to whether direct or indirect ownership (or a combination of the two) is most appropriate. For example, income receipts and voting power can be achieved by direct ownership and replicated with employee trust (indirect) ownership, but capital gains are in practice only achievable where employees hold shares directly.

Employees of a **company limited by shares** can also benefit from participation in **tax-advantaged share plans** (a form of direct ownership). Such companies may also benefit from the new income tax relief on qualifying bonus payments which is available to companies who adopt indirect share ownership and are controlled by **employee ownership trusts.**

3. MAKE THE CASE

Governance structure

An incorporated business will have a conventional board of directors, chosen for their skill set. Matters to consider when designing the governance structure include:

- Whether there should be restrictions on the board's powers;
- The maximum/minimum number of directors;
- **Executive director** roles and responsibilities;
- The number of **non-executive directors** and their roles;
- The extent to which **board committees** are utilised to assist the board; and
- The involvement of a wider stakeholder group such as customers and members of the community.

In a company with employee ownership, the employees' stake in the business must underpin meaningful employee engagement. An important decision to make will be how much (if any) influence staff as a whole have on the board of the employee mutual (for example, will there be a staff-appointed director on the board). An **employee council or employee committee** may be appropriate to promote a strong sense of ownership amongst the staff.

4. PLAN

If an employee mutual gets 'green light' approval, the next stage is to finalise the plans that will turn it into a business. Essentially, two core plans are needed:

• A business plan; and

• A financial plan and 5-year model

It is unlikely that the service side's leadership team will be able to generate both these plans unaided.

Given that it wants a successful spin-out, the authority should consider supporting both plans with in-house expertise – particularly financial and legal. It may also decide to commission external support where in-house knowledge is weak – for instance, on commercial issues; business development and marketing; public-to-private transitions; mutualisation and so on.

Due diligence

Before producing the business plan it is prudent to carry out an investigation of the existing business in preparation for the transition to the employee mutual. Known as "**due diligence**", this can be a key process because a sensible starting point for the employee mutual is to build up an accurate picture of its business so that it can take an informed approach to assessing what assets it needs to be successful in its new guise. This process involves:

• Gathering together all relevant information relating to the business (e.g. on contracts, past and present pensions, employees, premises, assets and equipment, liabilities and claims, and intellectual property rights such as copyright, trademarks and patents).

• Prioritising, categorising, reviewing and checking this information.

• Identifying the key assets and liabilities, any gaps in provision from suppliers and issues and risks which need to be addressed urgently.

The public authority and/or employee mutual may require a **due diligence report** to be prepared which reports on:

• Key assets.

• Key risks.

• Onerous contracts.

• Any constraints on the transfer to the employee mutual.

This report can range from a "red flags" risk-based report (highlighting only key risks) to a more comprehensive review of the employee mutual's prospective property, rights and liabilities. Your legal adviser can discuss with you what level of report is right for you, based on your particular circumstances.

4. PLAN

The Business Plan

There is no single blueprint for a business plan, which has to be designed to fit the type of service and local economy concerned. However, typical content will include the following:

- **Vision, purpose, values and core objectives** of the new business.
- **Growth and diversification plan**, underpinned by market analysis.
- **Ownership and governance model** – e.g. how ownership will be distributed between stakeholders such as employees, the community or users, possibly even the authority itself or an external partner.
- **Leadership and management** of the new business, including Board composition and the expected role of non-executive directors (NEDs).
- **Transformation and culture change** – turning a public service into an employee owned business that can fail requires a culture change plan that explains how co-owners will be truly engaged in the new business, so that it achieves the potential that employee ownership is acknowledged to release.
- **Marketing and branding** – including target audiences, competitor analysis, marketing channels, how the service will be positioned and differentiated from competitors, and its new name and branding.
- **Skills** – analysis of skills the business will need, those it is short of, and how skill gaps will be addressed.
- **Risk analysis** – explanation of the key risks the new business faces, their relative likelihood and importance, and how each can be mitigated.
- **Transition plan** – moving staff, equipment, stock, leases, contracts and more from their public sector ‘home’ to a new base is a large logistical challenge. A transition plan is needed to ensure all those transfers happen smoothly and that the new company is fully operational and efficient from day one. Transition plan examples are given in the next section of the guide.

4. PLAN

The Financial Plan

The financial plan builds on the information you have already put together in the business case but goes into more detail. It includes a number of financial forecasts:

- Forecast income and expenditure over the next three to five years
- Forecast balance sheets for the next three to five years
- Forecast cash flow for the next three to five years
- Financing required for the organisation, including financing of significant assets.

The further into the future the plan goes, the more unpredictable things become. While a detailed forecast broken down into months or quarters is useful in years one and two, it becomes progressively less useful for later years because of difficulty in accurately predicting to that level of detail.

Income forecast

The income forecast is a useful first step in producing the financial forecasts. Changes in the level and patterns of income will influence the costs. Factors include: number and size of purchasers, percentage of future purchases already confirmed, purchasing patterns, trends in demand, what triggers payment (e.g. per output, per outcome, per period), and the capacity of the mutual to meet demand.

Forecast income and expenditure statement

This is also referred to as the 'profit and loss statement' or the 'income statement'. The income and expenditure statement shows the financial performance over a particular period. Revenues and expenses are matched to the period to which they relate, rather than the period that cash is received or paid by the mutual. Because of this, the statement is able to indicate the profitability of the enterprise for a particular period.

Balance sheet forecast

This is also referred to as the 'statement of financial position'. The balance sheet provides a snapshot on a particular day (usually the financial year end date) of an enterprise's assets (in general, what it **owns**), liabilities (in general, what it **owes**) and members' equity or funds (the **difference** between assets and liabilities; in some cases, these funds are held in trust).

Cash flow

The cash flow forecast is critical to the enterprise because even an enterprise making a healthy profit is likely to fail if it has insufficient cash on which to draw. Both anticipating and managing cash requirements is essential for the employee mutual's long-term success.

Breakeven analysis and **activity-based costing**

Two areas of management accounting that may prove useful to the business planning team when compiling its forecasts are **breakeven analysis** and **activity-based costing**.

Breakeven analysis

Breakeven analysis involves comparing sales against fixed costs (those that can't be changed in the short term, such as overheads) and variable costs (those that vary in proportion to volume of service output) at various levels of activity in order to determine the level of services or products that must be sold before a profit (or surplus) is achieved.

It provides a clear indication of the point at which the organisation becomes financially sustainable.

In some cases, of course, the breakeven analysis may be of less use, especially where total volumes of service or product have been agreed as part of a contract and where there is expected to be little or no variation from that agreed volume.

4. PLAN

Activity-based costing

Activity-based costing (ABC) provides valuable information on the cost per unit of service or goods (e.g. cost per hour or per service delivered). The four steps to implementing ABC are:

1. Identify activities
2. Assign resource costs to activities
3. Identify outputs
4. Assign activity costs to outputs

ABC can help with reviewing pricing, identifying which service or products are net income generators and highlighting areas where improvements are needed in order to stay competitive.

Financing

Your plan should communicate clearly: what the money is required for, the types and mix of financing being sought, and the timetable – what is needed and when. Any significant asset purchases identified earlier in the plan that require financing should be in this section.

Types of financing include: grants & donations, loans & bonds, shares, quasi-equity, and – as the enterprise generates profits – retained earnings.

The options available to a new enterprise will vary depending partly on the type and legal form of the organisation, as well as the characteristics of the market in which the enterprise will operate. There are choices to be made regarding the funding mix, diversity of funders and investors, length and types of financing and the relative importance placed on building retained earnings.

4. PLAN

Legal factors

Procurement rules

At this stage, it is prudent to consider the extent to which procurement law applies to the spin-out of the employee mutual and, therefore, whether you need to run a procurement competition.

Unless an exemption applies, procurement law applies where the new business is given the benefit of a contract with a public body, either at the time of establishment or later on. Even where this is not the case, the public authority may nevertheless wish (or be bound by its internal rules) to run a competition to select an independent sector partner.

New **Procurement Regulations** were introduced in 2015 containing a new right for public authorities to "reserve" contracts for mutual spin-outs in the health, education and social care sectors, provided that certain conditions are met. Contracts reserved in this way must be no longer than three years in duration. It is possible, therefore, that you will be able to benefit from this exemption from complying with the procurement rules.

Public bodies are developing their approaches to meet the new procurement rules and in time we will see what practices emerge. Under the previous, more restrictive regime, public authorities used a variety of routes where they were spinning out a new business and a new contract was being awarded. These included:

- **Tender** competition – using a full competition to select a new service provider with the employee mutual bidding against other suppliers. Many mutuals will involve the provision of social or related services, such as health, community, educational or cultural services. The Procurement Regulations have introduced mandatory tendering for such services where the estimated contract value exceeds €750,000. However, a new light touch tendering regime has been introduced which leaves the detailed design of the procedure to the public authority to determine in accordance with the principles of transparency and equal treatment of suppliers;

- **"No market"** – making a direct award to the employee mutual after taking the view that there is no market for the service because no other suppliers would be capable of bidding for it. This is a route that should be relied on only in exceptional cases where an objective analysis of the market clearly demonstrates that there is no other actual or potential supplier capable of performing the contract;

- **Teckal "company"** – where the public authority retains control over the employee mutual similar to that which it exercises over its own departments, and more than 80% of the activities of the mutual are carried out in the performance of tasks for the public authority, there does not need to be a competition and the new mutual can be awarded the contract. Note that for the mutual to qualify for Teckal status there can be no employee ownership at this stage, although this can be used as the first stage in the journey to employee ownership;

- **Service concession** – if the employee mutual is offered a concession to charge third parties (for example, operating a toll road), there is no contract with the public authority and a competition is not currently a legal requirement. However, services concessions with an estimated value of around €5 million or more are due to be made subject to mandatory tendering by 16 April 2016. In addition concession contracts which might attract interest from suppliers in other EU Member States must be advertised and tendered on a pan-EU basis. ;

- Mutual **joint venture** – here the public authority procures a partner for the employee mutual through a competition, rather than procuring a supplier of the desired service. As a consequence, the employee mutual will be the supplier subject to the involvement of the joint venture partner, and the procurement rules are complied with.

Procurement law is a complicated area and we recommend that you obtain legal advice at any early stage to ensure that you are making the right choices for your project.

4. PLAN

Key tasks

- Ensure the potential mutual has the capacity – in terms of time, resources and expertise – to create a robust, credible business plan and accompanying financial plan. That may mean making use of the authority's own specialist resources, such as Finance, Legal or HR; or can involve commissioning external expertise.

- The spin-out of a public sector service throws up many potential communications issues – internally within the service and the authority, as well as externally, with service users, the wider community, and the local or trade media. The communications challenge affects the potential spin-out and the authority itself equally, as each needs to keep their respective stakeholders appropriately in the picture and be able to answer their questions.

- Prepare for the point when the interests of the potential spin-out and those of the authority begin to diverge – and working together has to change. This will happen as the authority prepares to draw up any contract to be awarded to the potential mutual.

5. IMPLEMENT

Two factors make implementing an employee mutual more challenging than a big in-house change programme. First, as in a conventional outsourcing, the employees will be entering the private sector – for most, an immense culture change. Second, unlike in a conventional outsourcing, employees are becoming co-owners of the business they work for – with no external authority or owner to blame if it goes wrong.

Transformation and transition challenges

For those reasons, an implementation plan is much more than simply a logistical challenge. It's equally about transforming the culture, ownership and the way people work.

The implementation or transition plan for an employee mutual spin-out should include the following factors – with 'day one effectiveness' being the overriding objective:

Commercial readiness – plans to address critical skill shortages; manage the contract(s) with the authority; procurement and bidding expertise; business development and marketing plans including new website, social media presence, branding, positioning and naming the new business; risk management and continuity plan in place.

Mutualisation readiness – information provided to employee shareholders about ownership rights and responsibilities; employee 'voice' structure established; leadership and management development plan in place; shareholder process, e.g. Employee Benefit Trust, established; employee engagement plan in place.

Communications – external communications planning should cover stakeholders such as the authority, existing clients and users, suppliers and contractors, local and specialist media, unions, and relevant local business and other bodies; internal communications planning should ensure a constant flow of two-way information between the business and its new co-owners.

HR & staffing – HR accountabilities clarified; management of TUPE and pensions issues; transfer of personnel records; union consultation; plans for review of employment terms and conditions; new staff handbook; production of new job specifications and contracts; HR policies and procedures adapted and in place; recruitment and induction process in place; any training needs analysis planned.

Contracts and legal matters – ongoing legal support arranged; intellectual copyright covered; novation and variation of contracts managed; accountability for performance standards and risk management allocated; company secretary role allocated; licences, insurance and leases reviewed and managed; any regulatory compliance secured and managed.

Premises, ICT and equipment – review, refurbish, prepare any new premises; transfer licences, insurances, fire certificate, waste and cleaning contracts; review and change signage; review all ICT hardware and software suitability and security; transfer computer, phone, mobile etc licences and contracts; internal ICT support in place; rebrand and stock stationery; stock ordering process in place.

5. IMPLEMENT

Financial factors

Financial management, planning and control

Accounting touches nearly every aspect of an enterprise and its activities. Managers and board members need to be able to make informed decisions, and accounting is a means for communicating relevant economic information to them to support their decision making.

A good accounting system is one that can meet the needs of various users, both internally and externally.

Two types of accounting

Accounting designed for users inside the organisation is referred to as **management accounting**, while accounting geared to users outside of the enterprise is referred to as **financial accounting**.

Are the right skills and expertise in place?

Robust financial procedures and controls, budget setting and reporting processes must be in place and working. Accounting systems must enable healthy financial analysis, planning, investment and financing functions within the mutual.

A key element of success in the longer term is ensuring good levels of financial literacy within the mutual.

- Are the skills and expertise in place to manage the accounting in-house or will some or all be provided externally?
- Do the board and management have the required skills and techniques to understand and act on the financial reports presented to them?
- What information is needed and when in order to make informed decisions?
- Engaging with members – how will staff be kept informed about and be able to contribute to the financial performance of the new mutual?
- Have internal and external audit requirements been considered?

Managing the cash

Often cash flow will not have been an issue for the management in an internal public sector department or service. The new mutual's management must stay on top of the cash flow characteristics of their enterprise. An important element of this is managing credit control and ensuring they know the purchasers' payment systems.

Profits and reserves strategies

The mutual must have a strategy in place for building sufficient reserves to sustain and develop the enterprise. While profitability may not be the only or primary goal, retained earnings (profits kept in the enterprise) are an important component of a mutual's capital base. Think through the level of profit retention required to fund: working capital requirements, future investment in assets, and development of services. Also consider whether some profits should be available for distribution to members and, if so, what form that should take and how that should be managed.

Tax matters

The potential tax consequences of proposed activities can influence the success or otherwise of the enterprise. For example, whether or not the service is VAT exempt can have a significant impact on the cost of services provided. The legal structure can also matter here. A charitable mutual, for example, will benefit from tax exemptions available to charities.

Larger businesses will have specialist tax-planning staff looking at the effects that business decisions have on taxes paid. Smaller businesses may need to look to external advisors for help with this. Whatever the option, make sure that tax aspects of decisions are understood.

Annual financial reporting

There are differences between public and private sector accounting and these differences do impact on the structure of the accounting records and reports. Make sure this is understood early on and that budgets, accounts structure and reports are aligned as much as is possible. Also keep abreast of developments in regulators' reporting requirements, financial reporting standards and other guidance.

5. IMPLEMENT

Legal factors

Establish the employee mutual

Building on the decisions taken in the business case, your first legal step will be to establish the employee mutual with the desired legal, ownership and governance structure. The mechanisms for doing this will depend on which model you choose, but it is likely to involve the development of a new **constitution** for the employee mutual, incorporating and registering the new organisation at the appropriate official registry and the preparation of a **trust deed**, if required, to create the necessary employee ownership structure.

Rationalise and allocate assets

Next, armed with the knowledge gleaned from the due diligence exercise, you can take steps to rationalise the existing business's asset base and take any necessary action to address issues that have emerged.

The results of this exercise can be documented in an "**asset and liability plan**" or "**vesting plan**" which is the "root of title" for the employee mutual.

This process is valuable to both the employee mutual and the public authority. It helps them understand what liabilities and risks are in the business so that these can be dealt with in advance of transfer. It also identifies gaps in what is transferring and where the employee mutual needs to secure interim support. Most importantly, it helps the employee mutual to assess what assets it needs so that it can be sure that it has the right "tools" to do the job from day one.

Employees

Any spin-out will need to consider appropriate arrangements for staff transferring to the employee mutual and, in particular, the application of the **TUPE Regulations** and the need to undertake an appropriate information and consultation exercise in compliance with the duties that the **TUPE Regulations** impose.

It is also advisable to consider the **Cabinet Office Statement of Practice on Staff Transfers (COSOP)**, which sets out best practice and protections for staff where there is a transfer from the public sector.

You should identify any proposed changes to staff terms and conditions under the employee mutual (which may be unenforceable under the **TUPE Regulations**), any potential loss of statutory or other existing policy benefits (which may cause staff dissatisfaction), and devise a strategy to minimise and/or mitigate the associated risks. You should also review any existing union recognition or collective agreements and consider what strategy should be adopted in relation to those in the context of the planned transfer.

If there is a need for immediate organisational change, consider how any staff restructuring or redundancies should be handled, bearing in mind potential statutory and contractual obligations to undertake a minimum period of consultation, and the impact such restructuring or redundancies may have on staff morale/support for the transition.

In order to both comply with the **TUPE Regulations** and to ensure proper understanding of the potential risks and liabilities connected to transferring staff (i.e. as part of the due diligence), it is necessary to gather together a detailed assessment of key employment terms, costs and potential issues (referred to as the "employee liability information"). The relevant report which is generated will be key to ensuring an appropriate contractual allocation of pre and post-transfer employment liabilities.

5. IMPLEMENT

Pensions

Ensuring that appropriate pensions provision for staff is maintained and protected is a crucial part of any spin-out of an employee mutual. We suggest that you consult with a pensions expert to ensure that this area is adequately dealt with. This includes considering:

- Any required **admission agreement** for the public sector pension scheme which the employee mutual wishes its staff to continue to participate in;
- The application of **Fair Deal (2004)** and **New Fair Deal (2013)** where staff transfer under the **TUPE Regulations** from the public sector;
- The extent to which bonds, indemnities or guarantees are required to enable the employee mutual to have continued access to the public sector pension scheme; and
- What pensions provision is required for new employees if they cannot join the same public sector pension schemes as existing staff.

Transfer Mechanics

Finally, the transfer of the business and assets from the public authority to the employee mutual needs to be formalised through appropriate legal documents. The preceding activities are designed to give you the content, analysis and rationale on which you can prepare the legal documents, and these documents will vary depending on your particular circumstances.

The main document is normally a **business sale agreement** or **asset transfer agreement**, setting out:

- Which assets transfer to the employee mutual and which are excluded from the transfer;
- The position taken on liabilities (including tax);
- How land and buildings are being dealt with;
- What financial provision is made or working capital provided;
- Any provisions for the transfer of staff;
- Any warranties or indemnities; and
- Whether or not VAT is payable.

There may also be the need for various ancillary documents to support the **business sale agreement** as certain assets need special legal treatment when they are transferred. These may include:

- **Assignments** or transfers relating to land and buildings or trademarks and copyright;
- **Facilities management agreements or transitional support agreements**; and/or
- Contract **novations**.

6. SUCCEED

Critical success factors

Sustainability in employee mutuals is anything but guaranteed, but there now are well-established steps spin-outs can take to ensure they succeed. Most such spin-outs are small to medium sized enterprises, with average revenue of about £15m according to research for the Cabinet Office. They may also be reliant on a single contract from their parent authority and are likely to confront larger competitors with much stronger balance sheets.

In the longer term – like any business – commercial and financial success will depend at least partly on the extent to which:

- Purchasers buy what you are offering
- You are able to compete with other providers
- You are able to capitalise on a key differentiating characteristic
- There is successful management of change; both predicted and unpredicted.

Financial information plays a key role in supporting planning and decision making and ensuring that trends, challenges and opportunities are spotted and acted on. Part of this involves ensuring that managers, employees and those charged with governance are provided with the relevant financial information at the right time in order to play an active and effective part in the mutual's success.

On top of the 'standard' financial disciplines, experience of employee mutuals to date suggests there are a number of other **critical success factors** for these spin-outs from the public sector:

- **Inspirational leadership** – arguably the single most important factor in whether or not employee mutuals survive is the ability of their leaders to inspire, communicate a compelling vision of the business's future, and lead by example.

- **Managers who 'get' co-ownership** – managers must adapt to an entirely new dynamic in which the colleagues whose work they manage are shareholders, not subordinates.

- **Balance between commercial and democratic** – the new business must be genuinely accountable to its shareholder employees but must allow executive management to run the day to day operation decisively.

- **Making employee ownership feel real** – an ownership transfer on its own will do nothing to transform how employees work, behave and relate to the business. Leaders must invest time and resource in extensive knowledge sharing about how the business is doing; developing managers' employee engagement skills; establishing a 'voice' structure and process which represents and channels employee shareholder views; and institutionalising regular, meaningful dialogue between executive management and employee shareholder representatives.

- **Address skill gaps** – few employee mutuals will start life with all the skills they need. There are almost certain to be some critical skill gaps in, for instance, finance and accounting; legal; sales and marketing; business development; customer relationship management; contract management and bidding. Potential gaps like these should already have been identified in the business plan, but there must be clear accountability and a timescale for addressing them.

- **Access to finance** – research by Boston Consulting Group for the Cabinet Office showed that few employee mutuals are aware of the importance of access to finance for their future growth and stability. Funding growth organically from profits is a big challenge for what are typically fairly small businesses with thin balance sheets. However, the market for social finance is growing rapidly, offering an increasing volume of 'patient capital' willing to support employee mutuals.
- **Use support networks** – with well over a hundred employee mutuals now established, new ventures can draw on a wealth of knowledge and experience from counterparts already trading. The Employee Ownership Association brings that expertise together in its annual Conference and offers other networking opportunities to employee mutuals.

Conclusion

This aim of this publication has been to give practical, concise guidance on creating successful employee owned public service spin-outs – employee mutuals. It is not a blueprint because circumstances will vary so much from authority to authority, and from service to service. But it should give you the essential building blocks to construct a business with what it takes to succeed in your market.

The employee mutual you form will be joining a rapidly growing and flourishing community of public service enterprises owned by the people who work for them. Experience has shown that there is a huge fund of experience and goodwill to draw on when assessing whether an employee mutual is right for your authority and your service. Government funding and specialist experts have their role to play in encouraging the formation of employee mutuals. But the richest vein of expertise is the hands-on experience of authorities and employees already creating this vibrant new part of our economy.

7. GUIDE TO KEY TERMS

Admission agreement means an agreement under which a service provider is admitted to the Local Government Pension Scheme (**LGPS**). This enables employees previously transferred from a public authority to remain members of the LGPS.

Assets means, in accounting, the economic resources controlled by the organisation and which will give rise to future economic benefits. While it can prove difficult to define, in general it includes things like: premises, equipment, vehicles owned by the mutual, stock, debtors, and cash.

Asset and liability plan or v**esting plan** means a plan recording the property, rights and liabilities of an organisation identified through a due diligence exercise and setting out what will transfer to the employee mutual and what will be retained by the public authority.

Assignment means the transfer of one party's rights under a contract to a third party, normally effected through a legal assignment agreement.

Balance sheet means a snapshot of the assets, liabilities and equity (or funds) of the organisation at a point in time.

Beneficiary means the person who receives a gift from a benefactor, often held on trust for the beneficiary.

Board committee means a committee made up of members of the board of directors which is tasked with overseeing a specific purpose (such as approving accounts or reviewing remuneration).

Board of directors means the directors of a company who deal with day to day management activities.

Budget means a financial plan expressed in money and divided into periods.

Business case means a case made for initiating a particular project. It can identify whether a project is feasible and assess costs and benefits of various options.

Business plan means a detailed plan setting out the objectives of an organisation and expected performance over a number of years.

Business sale agreement or **asset transfer agreement** means a contract for the sale of the business and assets of an organisation.

Cabinet Office Statement of Practice on Staff Transfers means the Cabinet Office policy governing staff transfers between the civil service and the private sector, or within the civil service.

Cash flow means the amount of cash flowing into and out of an organisation over a particular period.

Charity means an institution which must have a solely charitable purpose. A charity can be incorporated as a company or a charitable incorporated organisation but can also be unincorporated.

Constitution means the set of rules adopted by an organisation which govern its internal operations and its relationship with the outside world.

Company limited by guarantee means a limited company in which the members' liability is limited to an amount they have guaranteed to contribute on a winding up of the company. This type of company model is often used for not-for-profit organisations such as charities, clubs and schools.

7. GUIDE TO KEY TERMS

Company limited by shares means a limited company in which shareholders' liability is limited to the amount unpaid on any shares they hold. This type of company model is generally used for commercial organisations as it provides the means to raise capital and distribute profits.

Community benefit society means a mutual society run primarily for the benefit of people who are not members of the society and that must be in the interests of the community at large. It is formed under the Co-operative and Community Benefit Societies Act 2014 and formally known as industrial and provident societies.

Community interest company means a limited company established with the aim of benefiting a community. It must satisfy the community interest test and use its profits and assets for the benefit of the community. It is required to impose an "asset lock" restricting how assets may be distributed. It is regulated by the Community Interest Companies regulator.

Corporate trustee means a trustee which is a company rather than an individual.

Co-operative means a co-operative society, i.e. a mutual organisation which is run for the mutual benefit of the members and which adopts a number of Co-operative principles. It is formed under the Co-operative and Community Benefit Societies Act 2014 and formally known as industrial and provident societies.

Co-operative principles means the principles set out in the International Co-operative Alliance statement of co-operative identity.

Due diligence or **due diligence exercise** means the investigatory process undertaken by a buyer of a company or business to identify risks or liabilities which could affect the value of the company and/or which must be resolved prior to completing the acquisition.

Due diligence report means a report recording the findings of the due diligence exercise.

Employee benefit trust means a trust which holds assets for the benefit of the employees of a company or a group of companies.

Employee Council means a body set up within an **employee owned business** to represent the views of employees and ensure that their voice is heard by management.

Employee mutual means a **mutual** in which the employees own all or a substantial proportion of the equity.

Employee owned business means a business in which staff hold a meaningful ownership stake.

Employee ownership trust means a type of employee trust which has the benefit of special tax advantages, such as the ability to award staff an annual bonus which is partly free of tax.

Equity means, in accounting, the amount of the owners' interest in an organisation which is the balance sheet value of the organisation's total assets less the total liabilities. In some employee mutuals, the governing document may place certain restrictions on equity and profit distribution aimed at protecting the mutual's long-term social goals.

Executive director means a director who is an employee of the company and normally carries out an executive role.

Facilities management agreement means a contract under which one party agrees to supply or manage services to another party in respect of a building such as property management, cleaning, catering and administration services.

7. GUIDE TO KEY TERMS

Fair Deal (2004) means a policy governing pension protection for public sector staff who are compulsorily transferred to the private sector.

Financial accounting means accounting and reporting designed to address the needs of outside parties and required by law, in line with accounting standards. Outside parties include, for example: suppliers, customers/purchasers, and external investors.

Income and expenditure statement (aka income statement, and profit and loss statement) means the statement that summarises the organisation's revenue, expenses for a particular period and the resulting profit or loss (aka surplus or deficit).

Indemnity means a commitment by one party to another to meet, on a pound-for-pound basis, the liability or loss arising from a specific event.

Joint venture means an agreement between different entities to work together for a specific purpose or project, generally where the collaboration between the parties is vital for the venture to work.

Liabilities means, in accounting, obligations arising from past events to transfer resources to another party. In general, these are claims against an organisation's resources. Examples include: loans, bank overdrafts, and money owed to suppliers.

Limited company means a company where the liability of the shareholders is limited.

Limited liability partnership means a partnership formed as a corporate entity in which the members' or partners' liability is limited.

Management accounting means accounting designed specifically to address the needs of the managers and board members of the enterprise, and to support internal financial planning, control and decision making.

Mutual means an enterprise operated for the benefit of its members, who may be its customers, users, employees, or a combination of those.

Mutual joint venture means an enterprise in which employees and/or customers own a significant proportion of the equity alongside a private sector partner and/or the parent authority.

New Fair Deal (2013) means the reformed policy governing pension protection for public sector staff who are compulsorily transferred to the private sector.

Non-executive director means a director who is not an employee of the company. Typically a non-executive director will work with the company part time in a consultancy or advisory capacity.

Novation means the transfer of both the rights and liabilities under a contract from one party to a third party.

Procurement Regulations means the Public Contracts Regulations 2015, which incorporate into English law the 2014 European Procurement Directives. Procurement law regulates the purchasing by public bodies and certain utility sector bodies of contracts for goods, works or services.

Service concession means a concession offered to a body to charge third parties for the provision of a service without the need for a contract with the public body or a competition to select the provider.

Social enterprise means an entity which trades for a wider social purpose, as distinct from one which trades primarily for the benefit of shareholders.

Tax-advantaged share plan means a plan which can provide shares or share options to employees which benefit from certain statutory tax reliefs.

Teckal company means a company in which a public authority has control, similar to that which it exerts over its own departments.

7. GUIDE TO KEY TERMS

Transitional support agreement means an agreement governing the provision of services on a transitional basis, normally to fill a temporary gap in a body's requirements for a particular service or services.

Trustee means the legal owner of property held in trust for a **beneficiary**.

Trust deed means a legal document that creates a trust. The document sets out the terms which govern the trust.

TUPE Regulations means the Transfer of Undertakings (Protection of Employment) Regulations 2006.

Warranties means a contractual promise or assurance in relation to a company or business, normally given by one party to another in a written agreement. A breach of warranty gives rise to a potential claim for damages.

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