EVAluation

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The Capitalist Manifesto

The Transformation of the Corporation
- Employee Capitalism -

- Employees have the potential to create enormous value if given the opportunity
- EU Member States encourage employees to participate in decision making differently
- Tax incentives determine the method – profit sharing or equity – and extent of financial participation
- Extending equity and profit sharing to middle managers and employees has drawbacks
- The British Government strongly supports financial participation while the Trades Union Congress (TUC) has stressed including employees in decision making through its *Partnership for Progress*
- A German case study shows how rapidly employees respond to an invitation to participate

EVAluation is a series of monthly reports from Stern Stewart Europe Limited, drawing on the depth of our experience and internal research, to cover issues of valuation, organisational design, decision making, remuneration, and corporate governance. Our focus is to assist managers in understanding how their actions affect the value of their organisations. We believe that all stakeholders benefit from the creation of value through both innovation and efficiency.

"The trend toward enhanced involvement in decision making and the rewards of ownership across Europe is quite strong. Governments, unions, and executives are seeking effective means of decentralising authority, opportunity, and accountability. We believe strongly in this trend as means of creating more wealth for both human and financial capital providers, but the common means of share ownership, share options, and profit sharing just do not work. We need a framework that captures value, as share prices do, and can be brought down the organisation, as profit sharing does. Our EVA framework can be used to include employees in decision making and owner-like rewards. EVA measures true value creation and can provide a reward mechanism with a close line of sight. The result is more value for both shareholders and employees."

Gregory V. Milano, Managing Director, Stern Stewart Europe Limited

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Executive Summary

Investors will lose when a company does not include its employees in decision making.

Employees have the potential to create enormous value. Globalisation and enhanced competition resulting from information technology require businesses to have a skilled, flexible workforce capable of making informed decisions. Many managers and investors may disagree. The major capital decisions – a new plant, a new assembly line, a new product line, a new brand, an acquisition or divestiture – are determined by the executive committee and group finance. However, for every major decision made by them, thousands of low-level choices faced by employees can lead to large improvements in value. If each employee can conservatively add €1.00 for every €200 achievable by a senior executive, companies should encourage employees to make the right decisions. If a company has 20,000 employees and 100 senior managers, employees can create as much value as the executives. Investors will lose out when a company does not include its employees in pay-for-performance programmes.

Can including employees in this way cause such a large enough increase in value to justify the change? How can managers and investors be sure that employees will make the right decisions? They can be sure if incentives are coupled with decision rights. "By collocating decision rights with the rights to their capital value, alienability provides both a measure of performance for individual decision makers and the rewards and punishments to motivate them to use those decision rights efficiently."[1]

EVA allows a company to give decision rights and incentives to employees.

Economic Value Added (EVA®) provides companies with a measure of total factor productivity, according to Peter Drucker, as well as a business management framework focused on creating value with every decision at every level across every function. EVA can be measured from the corporate level down to the assembly line. Hence, incentives based on EVA provide objective and local targets that link the compensation of employees, senior managers, and investors. EVA allows a company to give decision rights and incentives to employees. When EVA is implemented properly down through the organisation, employees gain without loss to investors or managers; a larger pie – decisions and reward – is simply shared by more people.

Empowerment without accountability leads to poor behaviour just as incentives without empowerment wastes resources.

Cascading decision making to employees usually constitutes a major shift in corporate policy. Executives fear cultural change. Yet, empowerment without accountability leads to poor behaviour just as incentives without empowerment wastes resources. Building a culture of value creation, where corporate governance comes from within, provides companies with a competitive advantage over those which remain hierarchical and compliant. A sense of urgency is required to motivate an organisation in the middle of economic expansion, with patents, trademarks, or brands which currently provide cash flow, and when financial markets continue to skyrocket. If senior executives want to win, they must avoid complacency and provide continuous improvement in performance. Innovation and acquisition may drive most of the potential value enhancement. Employee productivity and sharing best practices will create even more.

The European Union (EU) and the European Trade Union Confederation (ETUC) have stressed the importance of including employees in decision making and financial participation. Companies in each Member State have different approaches, with tax incentives driving the method and extent of financial inclusion. This paper will discuss the general themes identified by the EU and the ETUC, some of the actions taken by Member States, and whether the choices promote value creation.

The British Government, under Prime Minister Tony Blair, has taken a strong stance in favour of employee financial participation and has pressured the Trade Union Congress (TUC) to modernise. The TUC responded with a powerful platform called *Partners for Progress: New Unionism in the Workplace*. This paper will review the potential British business revolution and how EVA can deliver on the current trend.

[1] Michael C. Jensen and William H. Meckling, "Specific and General Knowledge, and Organisational Structure, *The Journal of Applied Corporate Finance*, (Vol. 8, No.2, summer 1995), 9.

Sirona, the German dental equipment business spun off by Siemens, implemented the EVA business management and incentive compensation system down to the shop floor. This paper will introduce the major elements of EVA and present the case of Sirona. The programme contrasts with those currently debated at the European level.

Through the British experience and the Sirona case, this paper will make an argument for EVA as a catalyst for including employees in both decision making and in the benefits of wealth creation.

An EVA Primer

Just the Facts

Since EVA charges for all of the factors of production, continuous improvement in EVA always furnishes investors with an increase in value.

EVA is an approximation of a company's economic profit. Financial statements, based on accounting, are translated into EVA by reversing distortions in operating performance created by accounting rules and by charging operating profit for all of the equity and debt capital employed in the business.

EVA = NOPAT – Capital Charge
EVA = Turnover – Operating Expenses – (Average Capital x Cost of Capital)
Cost of Capital = Weighted Average Cost of Debt and Equity

EVA correlates better with share prices than traditional metrics. Increasing turnover, ROE, operating profit, ROIC, cash flow, and other traditional measures of performance does not necessarily create value for investors. These metrics may be drivers of value, but they are ambiguous. Since EVA charges for all of the factors of production, continuous improvement in EVA always furnishes investors with an increase in value.

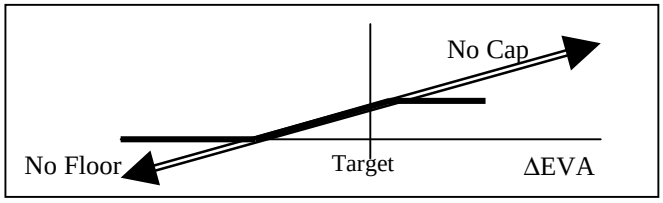
Corporate finance theory defines the value of a firm as the NPV of its present and future free cash flow (FCF). The present value of current and future EVA provides the same answer; yet, discounting EVA rather than FCF gives an annual assessment of total operating performance. The investment is not subtracted in year 0 but is amortised over its expected life. Thus, EVA is useful at the time of a decision <u>and</u> as a measure afterward. Unfortunately, FCF is useless as a period-on-period performance measure.

EVA is related to the share price through market value added (MVA). MVA is the difference between the market value of the debt and equity and the total capital employed in the business. A company's MVA is the total wealth, or NPV, that managers have created as well as the total current and future EVA expected.

Managers and employees can improve EVA in four ways. This can more easily be seen if the EVA equation is rewritten as EVA = [NOPAT/Capital – Cost of Capital] x Capital. They can improve their operating efficiency by increasing NOPAT/Capital with Capital constant. In addition, they can either reduce Capital where NOPAT/Capital is less than the Cost of Capital or increase Capital where NOPAT/Capital is greater than the Cost of Capital. The final choice, mostly exercised by senior financial and treasury managers, is to reduce the Cost of Capital by changing the Debt/Equity mix.

Managers and employees are thus paid like owners, encouraging them to think and act like owners.

Managers and employees can have an incentive to increase EVA. EVA improvement targets should be based on investor expectations rather than budgets and are usually fixed for at least three years. Target improvement leads to a target bonus. More EVA implies higher bonuses, and there are no caps or floors to a declared bonus. This prevents gaming or playing the system and encourages managers and employees to improve EVA *ad infinitum*. To encourage *sustainable* improvements in performance, the declared bonus enters a bonus bank, where a percentage is paid and the rest is held at risk against future performance. Managers and employees are thus paid like owners, encouraging them to think and act like owners. Our research shows that companies adopting EVA have increased their market value over their peers by 8.5% per year for five years after implementation, for a total gain of 51%.



Why EVA Works

EVA facilitates internal corporate governance **… and *external credibility*.**

The coupling of a business management system and an incentive compensation programme based on EVA facilitates internal corporate governance (managers and employees work together and trust each other's motives) and *external credibility* (investors know that managers and employees are working in shareholder's interests). Richard Hilgert, research analyst at Fahnestock & Co., wrote the following about Federal Mogul's CFO in light of the company's interest in Lucas Varity: "'I think that he would walk away from a deal and stick to his discipline if it becomes too pricey on their EVA analysis.'"2 It did, and he stuck to his discipline. Many people focus on the measures of EVA and MVA or the success of motivating senior managers through EVA. Few seriously consider the productivity implications of cascading decision rights and incentives simultaneously. In general, the press has not grasped the power of this link. Friedrich August Von Hayek succinctly wrote why corporations should decentralise decisions:

> *Central planning based on statistical information by its nature cannot take direct account of these circumstances of time and place and that the central planner will have to find some way or other in which the decisions depending on them can be left to the 'man on the spot.' If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them. We cannot expect that this problem will be solved by first communicating all this knowledge to a central board which, after integrating all knowledge, issues its orders. But this answers only part of our problem. We need decentralisation because only thus can we insure that the knowledge of the particular circumstances of time and place will be promptly used. … [However,] the 'man on the spot' cannot decide solely on the basis of his limited knowledge of the facts of his immediate surroundings. There still remains the problem of communicating to him such further information as he needs to fit his decisions into the whole pattern of changes of the larger economic system.*[3]

Unions and governments sometimes stress decision making and financial participation separately without studying the behavioural consequences. No investor or manager should provide decision power without an incentive that promotes results which increase the firm's value. Similarly, no investor or manager should offer an incentive without decision-making authority. In either scenario, the missing element is likely to lead to disingenuous activity and value destruction. When governments and unions demand both, they do not make the argument that this will help their members create greater wealth for investors. Unfortunately, they often choose incentives which do not properly link with an employee's decision and incentive.

A larger pie – decisions and reward – is simply shared by more people.

When EVA is implemented properly down through the organisation, the objectives of most governments and unions are accomplished without loss to investors or managers; a larger pie - decisions and reward - is simply shared by more people. John Shiely, Chief Executive of leading engine manufacturer Briggs & Stratton, explains why:

> *EVA is a very simple but elegant concept. A performance metric has to be two things – it has to be understandable and it has to be well linked to value. With a modicum of training, EVA can be understood by everyone, including people on the shop floor, and it motivates behaviour that translates into a higher stock price for the company.*[4]

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[2] Reuters

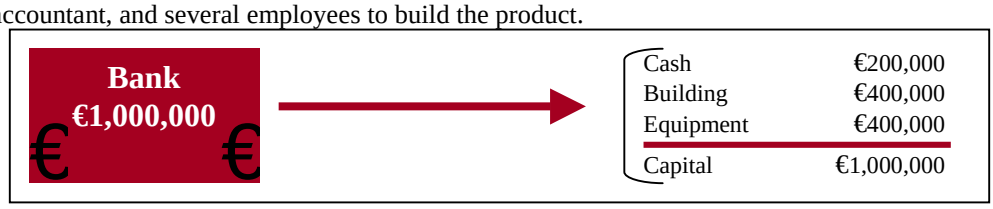
[3] Friedrich August Von Hayek, "The Use of Knowledge in Society," *Austrian Economics: A Reader*, ed. Richard M. Ebeling, (Hillsdale, Michigan, 1991), 254-255. [3] Hayek writes that "the sort of knowledge with which I [am] concerned is knowledge of the kind, which by its nature cannot enter into statistics and therefore cannot be conveyed to any central authority in statistical form."

[4] Quote from John Shiely, President of Briggs & Stratton, in Al Ehrbar, *Stern Stewart's EVA: The Real Key to Creating Wealth* (John Wiley & Sons, Inc., 1998), 223.

The following example will show that EVA is straightforward and well linked to value.

An Example

EVA is a simple concept. An entrepreneur has €1,000,000 in the bank. He invests €800,000 in a building and some supplies/materials to build a product; the rest is cash available for any needs which arise and is part of the business. The entrepreneur hires a manager, a financial accountant, and several employees to build the product.



The entrepreneur is pleased, but what is he going to do with the sales?

At the end of the year, the entrepreneur asks the manager and accountant how the business has performed. They are very positive. Why? They say that the business generated sales of €500,000. The entrepreneur is pleased, but what is he going to do with the sales? He is not going to keep the €500,000, because he has had to pay for supplies and his employees' wages. They say that the company has earned operating profits before tax of €200,000. That sounds good, but the company has had to pay taxes at 40%, which leaves the company with €120,000 after-tax operating profit. They think that the entrepreneur should be thrilled. The company had €500,000 in sales, but it only spent €380,000 (including payment to the government). The output was greater than the inputs. From their perspective, that is true.

Turnover	€500,000
- Materials	€180,000
- Labour	€120,000
Pre-tax Profit	€200,000
Taxes (40%)	€80,000
After-tax Profit	€120,000

Profit over the required return on the capital is called EVA.

However, they have not considered that he had invested €1,000,000 in the business. If the entrepreneur had kept the money in the bank, he would have earned 4%, €40,000 (after tax). They say that the company has still performed better. This is true; however, money in the bank has relatively little risk. The business has greater risk and must produce higher returns to compensate. The entrepreneur calculates that the extra risk is 6%. He requires a minimum return of 10%; that is €100,000. Since the business earned €120,000, he is pleased because the company earned a true profit of €20,000. That profit over the required return on the capital invested (€100,000 on €1,000,000) is called EVA.

After-tax Business Profit	€120,000
- Profit Required for Risk	€100,000
Economic Value Added (EVA)	€20,000

The inputs are the expenses incurred during the year including taxes plus a rental charge on the capital invested. If the output exceeds this, EVA is generated. If the profit does not cover the required return, then the business has lost money! This is true of the family store as well as of the large corporation – no one may know the owners of the large business group; however, their investment in the corporation is the same as the entrepreneur's investment in equipment, supplies, and cash.

The European Commission performed a survey of the different programmes.

Financial Participation around the European Union

European Union

The relationship between employers, unions, and employees differs across Nation States and remains one area where integration has bowed to subsidiarity. The European Union has

studied the different policies and has recommended that employees have greater decision making and financial participation. The European Trade Union Confederation agrees.

The European Union began looking at financial participation as early as 1976; however, other issues prevented further examination until 1992. The European Commission surveyed of different programmes promoted by each Nation State, investigated what common views existed, and published *The Promotion of Employee Participation in Profits and Enterprise Results* (PEPPER) and a *Recommendation* to the Member States:

> The Council hereby invites the Member States:
> To acknowledge the potential benefits of a wider use of employees in profits and enterprise results either by means of profit sharing, or through employee share ownership or by a combination of both.[5]

The PEPPER report summarised the benefits and drawbacks of extending financial participation:

Positive

- **Incentive effect**: participation in profits causes higher labour productivity and improved enterprise performance.
- **Greater flexibility of labour earnings**: rather than have employees earn money when employed and earn nothing during times of poor performance, earnings parallel performance; employment is less cyclical, is less variable, and may even increase.
- If profit sharing or share/options substitute for wages, then this lowers the **marginal cost of employing extra labour.**

Negative

- **Weakening of property rights**: profit sharing and shares/options confiscate wealth and cause managers to lose control.
- **Risk bearing**: the fixed wages of employees are only enough for them to survive; if they have to relinquish some of the fixed portion for a variable and more risky pay-profile, this is an unacceptable degree of risk.
- **Inefficiency of group incentives**: group pay and local performance are not well linked. Many free ride.

Government mandated share or option programmes can lead to unplanned (negative) behavioural

The European Union found that most programmes employed by companies reflected the tax breaks furnished by governments: equity-based plans. Cascading equity incentives normally does not have the effect that the designers anticipate even if they are relatively easy to explain, dispense, and regulate.

Arguments against Shares and Options

Using the table as a guide, here is why equity plans fail to motivate.

1. Shares and share options reward people for 'global' performance – the success of the firm – and provide no line of sight. Those that participated in share or option programmes during the booming market saw their investments soar. Even if markets only return their required return, employees would see their investments rise substantially. Although they may initially give managers and employees great sense of pride, aside from the most senior managers, few people have direct impact on the share price.
   Result: Weakening of property rights, no incentive effect

2. The share price is strongly affected by exogenous factors (macroeconomic and industry) which managers cannot control. Their invested income faces macroeconomic and industry forces and company-specific issues on which they have no impact. How many enjoyed the Asian turmoil and Russian devaluation?
   Result: No incentive effect

3. There is a weak link between pay and performance, especially lower down in an organisation; and thus, their affect on employee actions is limited.[6] Hence, share and options promote free riding, dilute shareholder wealth, and weaken shareholder property rights.
   Result: Inefficiency of group incentives, weakening of property rights, no incentive effect

"Most chief executives know less about how they can affect the value of their stock options …

4. Shares and options, as a percentage of total income, are small. Employees and investors are adversaries: wealth going to employees does not go to owners; if owners make money, employees are often exploited.

[5] 92/443/EEC, 27 July 1992
[6] Unions, however, may strike less if the benefits of a strike are less than the potential fall in the share price.

The Economist published "A Survey of Pay: The best and the rest" in which the author raised the relationship between options and motivation. "Most chief executives know less about how they can affect the value of their stock options than how they can increase the size of their bonus, which may be linked to the company's profitability or to economic value added. Moreover, it is hard to know what kind of option grant might deliver the best performance…. If the incentive effects of performance-related pay for ordinary folk are unproven, the effect of stock options is even harder to demonstrate. 'The market goes up and you clean up,' says Richard Freeman, a Harvard University labour economist."[7] Warren Buffet has commented that executive share options in the United States have a poor effect; they are "wildly capricious in their distribution, inefficient as motivators, and inordinately expensive for shareholders."[8]

…than how they can increase the size of their bonus, which may be linked to the company's profitability or to economic value added…".

Michael Jensen disagrees with the merit of options. He wrote an article in the *Harvard Business Review* on poor managerial incentives which helped bring about the interest in share options as an incentive tool. But in a talk to the EVA Institute, he explained why they fail to motivate the right behaviour. "If you pay people only in terms of large equity positions or large grants of LEP options or phantom stock, what will happen is, because of these imperfections in the human brain, managers will actually lose focus on a day-to-day, quarter-to-quarter, and year-to-year basis. So what we need is a measure of performance that's flow based, period-by-period based, rather than simply stock, a measure of the total effects of anyone's actions."[9]

Managers have demonstrated their own uncertainty. Many accounting systems do not require companies to expense options against earnings. Managers think that investors do not realise the costs of options and that expensing them would cause companies to forgo option grants. In response, Merton H. Miller and Graef S. Crystal wrote that "faced with a charge to earnings, the argument goes, companies heretofore open-handed with their stock option grants will cut off anyone but the most senior executives…. But if granting options to such employees really does pay off in increased motivation, then these companies, which are already bearing the true economic costs of option grants would be foolish to abandon them simply because they now must recognise that reality on their income statements."[10]

Arguments against Profit Sharing

Profits may provide a feeling of ownership and of sharing the gains (reducing the spread between rich and poor), but, like equity, pure profit sharing leads to behavioural problems which the designers may not have expected.

Although most European companies use shares and share options, some have relied on operating profit as a cash-based alternative. Like equity, operating profit is relatively easy to explain, calculate and disperse to employees. Companies do not need to rely on extensive training or communication. This method may provide a feeling of ownership and of sharing the gains (reducing the spread between rich and poor), but, like equity, pure profit sharing leads to behavioural problems that the designers may not have expected.

1. Profit sharing is an option in the good years, if there is profit, there is a bonus. Profit sharing could be very expensive to shareholders and senior managers because their profit is transferred. If the profit would have been earned regardless, why should shareholders relinquish some of it? If employees receive some of their local profits, there should be higher productivity (incentive effect); however, this is typically done company-wide which leads to the line of sight problem.[11]
   Result: Weakening of property rights, inefficiency of group incentives

[7] "A Survey of Pay: The best and the rest", *The Economist*, 8-14 May 1999, 14.
[8] Ibid
[9] Michael Jensen, "EVA and Corporate Governance," speech from The EVA Institute Senior Management Seminar, (Phoenix, Arizona, USA, 19-21 March, 1998), recorded in *EVAngelist*, (vol. 2, issue 3, 1998), 23.
[10] Merton H. Miller and Graef S. Crystal, "The Case for Expensing Stock Options against Earnings" *The Journal of Applied Corporate Finance*, (vol. 7, no. 2, summer, 1994), 90.
[11] The EIU quotes a senior HR professional: "For variable pay to work there needs must be three factors: line of sight, employee design teams, and employees who understand the mechanics. Profit-sharing violates all these rules. If you are just trying to create a sense of affiliation profit sharing is fine, but it's a terribly expensive way of doing this. Most compensation specialists would not consider profit sharing to be true variable pay." Economist Intelligence Unit, *Motivating and Rewarding Managers: Trends in Europe, the Americas, and Asia*, (1999), 40-41. The authors elaborate more on line of sight, which "refers to the degree to which an employee can influence the performance factors which determine his or her rewards. For example, it is usually difficult for individuals to influence overall corporate profits, because so many factors affect them, including factors outside the company. Thus profit share incentives are considered to have poor or long line of sight (although line of sight for such large measures may improve the more senior is an individual's position)." Ibid, 60.

2. Since profit does not account for the balance sheet, employees and managers can increase profit by purchasing capital; playing the system is encouraged which further reduces shareholder property rights. For example, because a focus on annual profit is short term, managers and workers may not make profitable long-term investments which produce lower profit today; they will reduce R&D, marketing and advertising, and training.
   Result: Weakening of property rights
3. The flexibility of labour earnings and risk-bearing nature are related. If employees reduce other demands such as wage increases or social costs, their earnings will be more flexible as they take on more risk. Employees must make an investment – have a stake in the success of the business; they cannot have a fixed income (risk averse) while sharing the pay profile of investors (risk taking).

Results from Member State Programmes

Government policy appears to be key.

In 1996, the European Union revisited the Member States in order to see whether the recommendation to increase employee participation had had any effect. They found that participation caused greater productivity levels in all cases. Cash-based programmes had a greater effect than share-based plans although tax breaks, and thus companies, usually favoured share-based plans, except in the UK and in France. They additionally determined the extent to which companies extended financial participation. The UK and France have the highest level of employee financial involvement in the EU. As the initial report suggested, providing incentives increased the flexibility of wages and employee participation in decision making (these firms had even greater productivity gains). Privatisation, especially in Italy, gave governments the opportunity to increase participation, as employees were given or had the choice to purchase shares. Nonetheless, despite the greater number of employees and the success of the programmes, the total number of employees participating in the financial results of their enterprises is still quite small. Government policy (tax incentives) appears to be the issue; problems with this are discussed in the next section.

Results Reported by the ETUC

Unions should pressure companies to include union members if they are willing to be flexible and work within the framework of increasing value.

The ETUC highlights some of the more encouraging developments in employee financial participation in its Internet site.[12] For example, Audi AG introduced profit sharing for all employees from 1998 with a fixed component based on seniority and a separate variable one. The privatisation of Telecom Eireann (Ireland) will lead to employee share ownership of 15% spread among 11,000 workers while the privatisation of Eurocopter and Usinor, the French steel company, provided a similar opportunity. In addition, company-based agreements exist at BP Amoco, Shell, Mobil, Degussa, and Rosenthal. Finally, the chemical sector in Germany has agreed to wealth creation and stock ownership programmes. Many other cases exist.

Individually, several union organisations have shown strong support for financial participation including the German Trade Union Confederation, CFDT (France), and the TUC (UK). They require that financial participation be coupled with decision making power and changes in the relationship between employees and managers. They demand that all negotiation occur through traditional collective bargaining in order to ensure inclusion across society rather than a discrete set of companies. However, employers prefer discussions at the company level so they can strive for a competitive advantage. The European Union finds that a compromise between employers and employees is to have a general framework developed nationally or by sector followed by a more specific contract (negotiation) at the company level. This makes sense if the general framework allows for several methods, equity and cash, long-term and short-term, less and more risky. Unions additionally must accept differences in corporate culture. Cultural change is feared and fought at the best of times. Although managers fear a long process, a rapid transformation of decision-making power and rewards requires a sense of perspective and time. Unions should pressure companies to include union members *if they are willing to be flexible and work within the framework of increasing value.*

If unions show a desire for value creation and accept their participation as part of that goal, then they should be granted more accountability through a stronger presence at board level.

Employees have the potential to create enormous value if provided with the right tools and incentives. If unions show a desire for value creation and accept their participation as part of that goal, then they should be granted more accountability through being given a stronger presence at board level and employees should have greater direct and financial participation.

[12] The information in this paragraph comes from: Financial Participation, Reflections of the ETUC, www.etuc.org/Policy/Decocratisation/Financial/fipa.cfm.

Another British Business Revolution / New Ground for Unions

Disseminating Decision Rights

In the 1980s Prime Minister Margaret Thatcher radically questioned the structure of British society. She confronted the role of the State by privatising State enterprises. She attempted to defy the class system by making it possible for anyone, regardless of class, to own his/her home. She dared the UK to re-evaluate its place in the world and urged the Americans to talk to Gorbachev. She faced down the unions to the relief of business and to the short term detriment of the working class. Many disagreed with some of her methods and theories; however, her ideas and policies provoked everyone into rethinking cultural norms.

[Blair] has challenged the unions to find where they can add value to the relationship between managers and employees

The New Labour Government, under Prime Minister Tony Blair, has further challenged the public sector, unions, and business to reconsider their roles and relationships. If the Thatcher Government's free market rhetoric acted as the antithesis to the *Labour* welfare state and post depression Keynesian attitude, the Blair Government's Third Way is the synthesis of Labour means and Tory ends. Blair accepted the flaws of State welfare and education management; he wants means testing for welfare recipients and incentives for teachers. He has challenged the unions to find where they can add value to the relationship between managers and employees – "What is your role? Why do they need you? If you can demonstrate competencies and efficiencies on issues like training, pensions, and safety, then you can find a role in workplace partnership. If you can't, don't be surprised if you're not invited to the party."[13] He and Gordon Brown, Chancellor of the Exchequer, have urged business to open decision making and ownership to employees. Although many of Blair's policies remain in the idea stage, several practical steps point toward another business revolution in British business.

During Blair's first speech to a Trade Union Congress (TUC) conference in 1997, he presented the unions with "a challenge to modernise, a challenge to become part of the solution rather than the problem, a challenge to join the Government in facing the future."[14] The TUC's paper *Partners for Progress* at the same Congress listed six principles of partnership:

1. Commitment to the success of the enterprise (shared understanding of and commitment to the business' goals)
2. Recognising legitimate interests (differences between the priorities of the partners)
3. Commitment to employment security (flexibility but not at the expense of security)
4. Focus on the quality of working life (personal development – strengthening talent pool)
5. Transparency (sharing of information and future plans)
6. Adding value (taps into sources of motivation, commitment and/or resources not previously accessed)

Workplace partnerships focus on decision-making rather than compensation, involving front-line employees in problem-solving, training (lifelong learning, bringing out their creativity), and building trust with management. Unions believe that they add value to the enterprise because "genuine consultation with workers about change is essential in delivering commitment and motivation … 'the unions see things that we [employees] miss.'"[15] They are correct. Employees should have some type of representation even on board level; however, they should not obstruct relations between managers and employees. The representatives should be company-specific and focused on the employees and issues of their company. Furthermore, employees should have the opportunity to make decisions and to have training which helps them to improve their productivity *only* if the training adds value to the firm; transparency needs to parallel decentralisation.

In May 1999, the TUC held a conference to reiterate the principles outlined in 1997 and supply cases of how the principles work in practice. As part of the conference, the TUC published a paper called *Partners for Progress: New Unionism in the Workplace*. In the paper, the TUC depicts how far the unions' reputation has fallen since before the Thatcher years. The TUC writes that, "trade unions should be seen as part of the solution to the UK's

[13] Prime Minister Tony Blair, *Speech to the Partners for Progress Conference*, published 24 May 1999.
[14] Ibid.
[15] Revisted in the TUC', *Partners for Progress: New Unionism in the Workplace*, May 13 1999.

problems rather than as a problem themselves."[16] The objective is to promote employee job security and facilitate the improvement of the workplace – to furnish the opportunity for workers to have "a worthwhile, interesting, and fulfilling job."[17] However, the TUC admits that security and better jobs can only happen if their members are "employed by successful organisations."[18] As a result, the TUC strategy has changed:

> The rhetoric of struggle, strikes, and strife … has little resonance in today's world of work. Of course, it is an essential part of the trade union to continue to expose the bad employer – the bullying boss, the boss who discriminates or the boss who fails to observe fundamental legal rights. But most workers do not believe that their employer is a bad employer. They may think that their employers could be better managers and they certainly want a greater say in how decisions are made.[19]

Rather than a confrontation between employer and union, the TUC emphasises a relationship between them.

This is new ground for unions. Rather than a confrontation between employer and union, the TUC emphasises a relationship between them. This relationship or partnership is meant to foster trust and transparency. However, as Tony Blair stated in his speech to the TUC conference, the changes must be genuine. John Monks, TUC General Secretary, has written that this is a once-in-a-generation opportunity. But he will need to make sure that deeds follow words. If the unions and employers work together in order to extend decision making through trust and partnership, the result could be another British business revolution, a transformation of British society, especially if comparable compensation parallels the cascading of decision rights.

What is partnership in practice? According to the TUC, case studies show that partnership delivers change management, communications, the development and mobilisation of in-house talent, the dissemination of best business practice, and improves the performance of the personnel function. These are valid objectives, but they often fail.

1. *Change management* – Change management often fails because the objectives are poorly articulated and implemented. In addition, too many changes are attempted simultaneously without management commitment throughout the projects. A partnership allows the workers to be informed and mobilised, with workers gaining a sense of ownership over the change process. The Inland Revenue and the Co-operative Bank illustrate successful change management exercises.
2. *Communications* – Top-down communication with poor upward (reactive) response mechanisms characterises most corporations. The result is distrust and suspicion rather than commitment and motivation. Partnership promotes employer-union channels. This improves the level of trust as employees can have their questions answered. The TUC found that partnership provides this at Tesco and British Gas.
3. *The development and mobilisation of in-house talent* – The TUC and the government want more productive workers. British workers lag behind their Continental peers. An emphasis on training and development of skills and talent helps current employers (flexibility) and employees (security and development). Thus, companies build learning organisations and a high-performing workplace. Partnership at National Power accomplished this.
4. *The dissemination of best business practice* – Most companies fail to encourage their people to share their best practices. Unions have wide networks through which they can facilitate this sharing, including the sharing of workplace partnership best practices. Alsthom mobilised the best in its people though the workplace partnership.
5. *Improving the performance of the personnel function* – The human resource function has moved further from the reality of the workplace. Theoretical approaches to personnel fail to cover actual problems. Partnerships allow human resources professionals to recognise the employee voice. Partnership improved personnel issues at UDV and Legal and General.

Convincing employers that employees should participate in decision making may prove difficult.

Companies need to improve all five of these key processes. Including employees in the ways illustrated by the TUC strongly makes the case for inclusion. However, despite the powerful arguments, convincing employers that employees should participate in decision making may

[16] Ibid, 8.
[17] Ibid.
[18] Ibid.
[19] Ibid.

Managers and employees require a common framework, a common language, and a similar set of tools in order to evaluate choices and reach the right decisions.

prove difficult. The TUC admits that cascading decisions will cause duplication in middle management. What happens to middle managers? What role should they take? Are employees more qualified to make these decisions than middle managers? This radical change in who has the right to make decisions must coincide with greater productivity, and thus value creation, if it is worth the destabilisation. Moreover, whilst the unions talk about and show in case studies what their inclusion will provide, the only way that executives and owners can be sure that their interests are aligned with employees and unions is if compensation is linked. Decision making without compensation threatens owners with employee choices which destroy shareholder value. The TUC writes "partnership means that unions must associate themselves with best practice, continuous improvement, high productivity, and enhanced competitiveness."[20] Many senior managers say similarly appealing words; yet, if managers are not properly aligned with owners, empire building replaces sharing best practices and productivity enhancement; continuous improvement does not mean the share price but power and perquisites. Hence, decision making and incentives need cascading together. Managers and employees require a common framework, a common language, and a similar set of tools in order to evaluate choices and discern the right decisions. If they have the same incentive, they will come to comparable conclusions and want to 'win' together.

The TUC may yet achieve its goal of doubling the number of companies dedicated to partnership since it has backing from powerful supporters who represent a Who's Who of British business. Those who have lent their names and statements of support include:

John Hougham, Chairman, ACAS
Ian Robinson, Chief Executive, Scottish Power
Derek Green, Chief Executive, United Utilities
Sir Peter Davis, Chief Executive, Prudential
Mike Kinski, Chief Executive, Stagecoach Holdings
Sir Richard Evans CBE, Chairman British Aerospace
David Jefferies CBE FREng, Chairman, National Grid
Lord Simpson, Chief Executive, GEC
John Rose, Chief Executive, Rolls-Royce
Sir Peter Middleton, Chairman, Barclays
Sir Ronald Hampel, Chairman, ICI
Sir Peter Bonfield, Chief Executive, BT
Niall Fitzgerald, Chairman, Unilever

Two succinct statements summarise how British business has embraced the principles of partnership and raise the prospects of co-operation at the employer level.

> *"We passionately believe that the effective contribution of our people is not an optional extra, but an imperative to deliver the business strategy."*[21] Niall Fitzgerald, Chairman, Unilever

> *"I am convinced that no enterprise, no matter how big or how small, can hope to succeed in today's competitive world without the combined support of all stakeholders – customers, shareholders, and every one of us employed in the organisation. Sharing a common vision of success for the business and working to a clear set of values, every individual member of the team must be encouraged and given the opportunity to make maximum contribution."*[22] Lord Simpson, Chief Executive, GEC

Without moves to decentralise decisions *and* incentives, the current climate will look like a period of lip service.

With this support, partnership should rapidly permeate and change British business. Yet, as Tony Blair said, "today we all pay lip service, at least, to the notion of partnership. But, we still need to encourage and deepen the change, and rather than concentrate simply on rejoicing in having removed the negatives, celebrate the potential a new era of partnership could unleash… This calls for an extraordinary amount of vision and clarity in future industrial relations… But it will be down to unions and management working together in a new way."[23] They can prove their commitment by finding a common goal and a powerful and simple incentive, one that aligns their interests with investors. Management and unions can use this goal or performance metric to facilitate inclusion and determine its marginal effect. Without moves to decentralise decisions *and* incentives, the current climate will look like a period of lip service.

[20] Ibid, 31.
[21] Ibid, 4.
[22] Ibid, 5.
[23] Tony Blair, *Speech to the Partners for Progress Conference*, published 24 May 1999.

Cascading Compensation

As mentioned earlier, home ownership became a reality for the middle and working class during the Thatcher government. Share ownership of one's company may become commonplace for these same classes under the Blair Government. On 3 November 1998, Gordon Brown presented his Pre-Budget Report to the House of Commons. In his remarks, he made a bold statement challenging British business to encourage greater employee ownership.

> *As our productivity discussions with business have also revealed, Britain can do more to remove the barriers to opportunity and ambition. The opportunity not just to acquire the best skills but the ambition to work your way up and use your creative talents, the ambition to start and build successful business, the ambition to see the firm in which you work succeed and you succeed with it. Today, only a fraction of British employees and an even smaller minority of those outside senior management owns shares in the companies that they work in and yet the evidence is that employee commitment is a vital strength for companies competing and succeeding in the global economy. And I want, through targeted tax reform, to reward long term commitment by employees and I want to remove, once and for all, the old 'them and us' culture in British industry. I want to encourage the new enterprise culture of teamwork in which everyone contributes and everyone benefits from success. So, in the Budget we will make it easier for all employees – and not just a few – to become stakeholders in their company.*[24]

Why must the government promote ownership?

If companies and employees follow the Chancellor's request, the Blair government will revolutionise British business and class culture even further than that of Margaret Thatcher by democratising private enterprise ownership. This, coupled with the decision potential emerging from the partnership programme, could transform the work environment and the relationship among stakeholders.

If spreading ownership were to increase value creation, why have companies not already done this?

Although the UK, like France, originally pursued a policy of profit sharing above share ownership, this speech suggests a government move in favour of share ownership.[25] The problems with widespread employee share ownership were addressed earlier. However, the Chancellor's leadership demands a question: why must *the government* promote ownership? More specifically, if spreading ownership were to increase value creation, why have companies not already done this? If it destroys or confiscates wealth (without tax incentives, see footnote 25), why should companies even consider this? These queries could additionally be asked about the need for government support for the TUC partnership programme. Here are three possible answers.

First, many senior executives have a "headquarters" view of the world: the CEO or executive committee makes all the decisions, period. These companies are hierarchical, with entrenched empires and emperors (by function or level). Thus, unless the company's product requires many intelligent "knowledge workers", executives do not value their company's human capital. Senior managers delegate as little as possible to their subordinates, let alone employees. They do not trust others to make decisions, or do not want to relinquish them. Power dictates prestige and wealth. No one wants to relinquish something that took a career to accumulate. Consequently, neither decisions nor financial participation are delegated – and if employees are not making decisions, why give them a share of the wealth? Partnership may transfer decisions from low middle managers to employees (minimal requirement) while shares and options are deemed free. An EIU study gleaned that performance appraisal fails in two areas. "First, accountability, because managers are often unwilling to take responsibility for the fate of others they work with, and because organisations are unwilling to risk giving responsibility and decision making ability that goes with it. Second, communication, because

[24] Gordon Brown, Pre-Budget Report, 3 November 1998.

[25] In his Budget on 9 March 1999, the Chancellor explained what would garner positive tax treatment:
"To open Britain's economy to the enterprise of all, we propose employee shares for all. Britain can and must become a democracy of enterprise, that gives all who create wealth a greater stake in the wealth they create. Under our new programme of shares for all, employees will be able for the first time, to buy shares in their own companies from their pre-tax income. Every employer will be able to match, tax-free, what each employee buys. This will be the most tax-advantaged all-employee share ownership scheme Britain has ever had. Our only stipulation is that it really must be shares for all – offered across the company's entire workforce."

Managers do not think that employees contain hidden value-creating potential.

appraisal fails where employees do not have clear or understandable objectives for which they feel a sense of ownership."[26]

Second, senior executives and managers demonstrate ignorance or have no interest in creating wealth for investors. They may write that they focus on shareholder value, but very few manage their companies this way. Executives remain obsessed with period-to-period earnings rather than returning a required return to investors. They do not view employee involvement and training as an investment in the business. Managers do not think that employees contain hidden value-creating potential (productivity enhancement). As a result, they do not think that the decentralisation of decisions and the wealth consequences of those decisions are pertinent or necessary.

Neither employees, unions, nor employers question the tax benefits or the generalist approach taken by governments as it reduces the accountability of all parties.

Third, law and accounting standards dictate how wealth can be shared among managers and employees. Governments and accounting standard boards do not consider the behavioural consequences when formulating policies. Neither employees, unions, nor employers question the tax benefits or the generalist approach taken by governments as it reduces the accountability of all parties.[27]

These are three reasons why it appears that governments must provide the impetus for extending financial participation to employees. They suggest two conclusions. Executives managing companies with a hierarchical corporate culture and a passive interest in shareholders do not think that decentralisation of authority and wealth is worth the potential increase in value, especially as this dilutes their power and financial rewards. Government and unions have affected business to the degree that negotiation with unions is done sparingly in order to reduce the privileges which could become rights and eventually destroy value.

The New Labour government has accepted that financial markets can overpower governments while strong markets which trust government allow companies to more easily raise capital, improve profits, and hire more people. Including employees in the equation is the Chancellor's objective. Bill Callaghan, the Trade Union Congress (TUC) Chief Economist, responded positively to the Chancellor's remarks.[28]

> *The Chancellor's 'Shares for All' plan is an important step forward. While share ownership can help to increase employee financial involvement, it is vital that this is accompanied by genuine involvement of employees in the company's decision making processes. Employee involvement is a key in improving performance of companies.*

If employees retain a risk-return profile which differs markedly from investors, there is no reason to believe that they will act in the best interests of investors.

The partnership programme reveals that the unions have accepted the power of markets and the importance of employees' working for successful firms. They recognise the importance of profits and are in favour of wealth creation. This support of profit sharing or shares/share options for employees takes the partnership idea further and is a revolt against past ideology. Human capital, their representatives, should participate in creating (decision making) and sharing (incentives) the value. It will facilitate real improvement in productivity for British companies.

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[26] EIU, *Motivating and rewarding managers: Trends in Europe, the Americas, and Asia*, (1999), 57.

[27] A close look at the birth of the option craze in America would reveal humble beginnings – options were meant to reduce the wealth accumulated by managers. Plain options do not affect earnings and thus are the most common although their link to shareholder gain is small.

[28] Remember the old perspective: Marxism. Passages come from Friedrich Engels and Karl Marx, *Communist Manifesto*, 1848.

The history of all hitherto existing society is the history of class struggles…. Society as a whole is … splitting up into to great hostile camps, into two great classes directly facing each other – bourgeoisie and proletariat…. The bourgeoisie cannot exist without constantly revolutionising the instruments of production, and thereby the relations of production, and with them the whole relations of society…. In proportion as the bourgeoisie, i.e. capital, is developed, in the same proportion is the proletariat, the modern working class, developed – a class of labourers, who live only so long as their labour increases capital…. The essential condition for the existence and sway of the bourgeois class, is the formation and augmentation of capital; the condition for capital is wage labour. … These labourers, who must sell themselves piecemeal, are a commodity, like every other article of commerce, and are, consequently, exposed to all the vicissitudes of competition, to all the fluctuations of the market. Owing to the extensive use of machinery to division of labour, the work of the proletarians has lost all individual character…. He becomes an appendage of the machine.

Despite their acceptance of shares and options, this type of incentive demonstrates strong risk aversion – a gain when a company does well and no loss when a company performs poorly. Risk aversion is understandable at low levels of income; however, it limits the scope of any programme. Why should investors and executives provide employees with an upside without any of the downside risk which they themselves may and should face? If employees retain a risk-return profile which differs markedly from investors, there is no reason to believe that they will act in the best interests of investors. Hence, companies should couple employee participation in decision making and wealth creation to the extent that the wealth consequences will encourage employees to make value-creating decisions. This is the objective reason for inclusion, sharing a larger pie – otherwise employees are simply confiscating wealth and authority from those who have it now. To repeat a comment made on European unions, if the TUC shows a desire for shareholder value creation and accepts union participation as part of that goal, then the unions deserve a stronger position at Board level as they are protecting and promoting shareholder interests.

EVA Case Study in Germany - Sirona

Despite Sirona's strategic position, the new management faced difficulties.

Sirona Dental Systems de-merged from the Dental Division of Siemens AG on 1 October 1997. In one of the largest private equity buy-outs in Germany, a group of international investors led by Schroders Ventures bought the former Siemens dental activities including the trading organisations both in Germany and abroad. The new company is one of the worldwide leading suppliers of high-tech equipment for dental practices and clinics. Sirona's digital X-ray systems and the CEREC process (which allow computer-controlled dental restoration based on ceramics) offer innovative products and a strong technological edge.

Despite Sirona's strong strategic position, the new management board, headed by Dr. Franz Scherer, the former Rank Xerox CEO in France and Germany, faced difficulties after the spin-off. Changes in the German public health system caused a significant sales decrease in the company's home market and required even stronger international growth. In addition, new procurement contracts were now signed without the backing of Siemens, and administrative tasks, which were previously undertaken centrally, were handed to Sirona. Finally, competitors used Siemens' decision to dispose of Sirona to raise doubts about the delivery of replacement parts.

Scherer announced that all employees, from the top management down to the shop floor, would earn a significant share of the value created.

Under these conditions, Dr Scherer, who invested personally in the company's equity, defined a restructuring programme with three main tasks: stabilisation of sales, improvement of procurement conditions, and reduction of payroll costs. He gained wide acceptance for his extensive plan after he announced that all employees, from the top management down to the shop floor, would earn a significant share of the value created. At his first meeting with Stern Stewart, Dr Scherer explained that "the management and the works council are convinced of Sirona's intrinsic value. And both agree that the realisation of this value needs motivation and entrepreneurial behaviour at all levels of the company." He additionally outlined the main milestones for the incentive phase of the EVA implementation project:

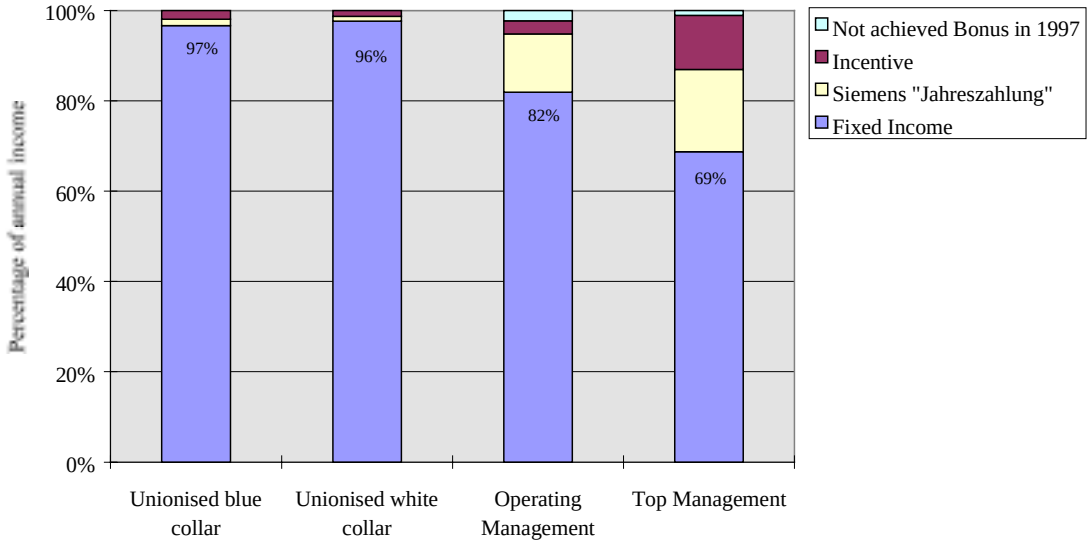
1. Design a comprehensive programme – allowing for the participation of *all* employees
2. Achieve full acceptance of the workforce
3. Gain acceptance of the shareholders

1. Design a Comprehensive Programme

Stern Stewart began the design process by working with the Sirona team[29] to analyse existing incentive schemes. The investigation revealed that the current level of variable pay, especially for unionised workers, was far from significant (Exhibit 1). Hence, the implementation process initially appeared more complicated since additional personnel costs would have to be incurred. However, this issue eventually allowed Sirona to change a nearly fixed incentive payment, the Jahreszahlung[30] (significant especially at management levels) into a fully variable EVA incentive payment.

[29] Including employees from the controlling, accounting and personnel departments as well as operative managers.
[30] The Siemens "Jahreszahlung" was an incentive programme based on the dividend paid out to the shareholders.

***Exhibit 1**. Average fixed and variable payment in % of total income with 1x bonus in 1997 (excluding top level employees)*



A change in corporate culture, without considering these employees, would prove very difficult.

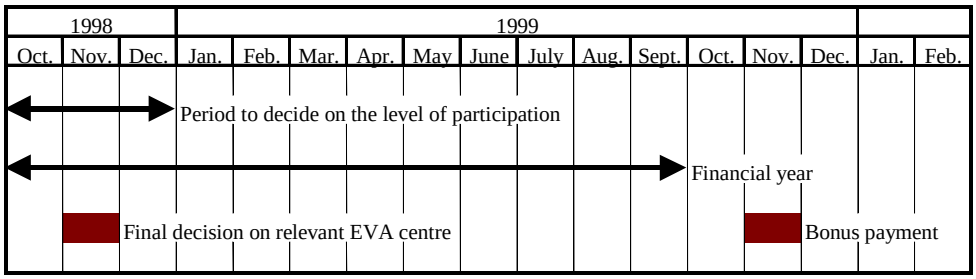
The initial analysis additionally underlined the necessity of extending the EVA incentive system down to the shop floor. More than 90% of Sirona's total workforce was unionised or had an income settled by collective agreement. A change in corporate culture, without considering these employees, would prove very difficult.

The EVA team designed a programme for the unionised employees, allowing them to join on a voluntary basis and, at the same time, providing them with a great opportunity for extensive participation and significant variable income. The team felt that this was vital for achieving milestone two, a full acceptance of the workforce. The main features of this method are:

- Employees determine their target bonuses individually, by making 40% to 80% of their fixed November salary permanently variable and linking it to EVA.
- Sirona adds to the amount placed at risk by 50%. The sum of employee and Sirona contribution equals the annual target bonus.
- In order to increase acceptance, there exists a one time "drop-out" possibility; the employee does not have the opportunity to re-enter. Hence, employees cannot participate in good years and not in harder years.

By December 31, 1998, each employee had to make the final decision about how much of his or her November salary was to be put at risk from 1999 onwards. This allowed the employees to have a first guess at the operating performance of the year and the management to present its future strategies and push the confidence in Sirona's growth.

***Exhibit 2**. Voluntary EVA participation of unionised employees as effected in 1998*



In order to increase the long-term view of the bonus system, Sirona decided to use a *threshold bonus bank*[31] with a payout ratio of 33%. The bonus bank's effect of smoothing annual bonuses allowed the EVA team to propose an aggressive bonus range (high leverage), which not only made double and triple bonuses possible, but also increased the downside risk of the system. Exhibit 3 shows two possible outcomes of the bonus system in 1999.

Exhibit 3. Bonus examples[32,33]

Monthly salary:	DM 5,000
	40-80% EVA linked Example: 80%
Invested part of the salary:	DM 4,000
Increase from Sirona (50%): +	DM 2,000
Target Bonus: =	DM 6,000

	Case 1		Case 2
Bonus acc. to EVA improvement:	130%	Bonus acc. to EVA improvement:	60%
Target bonus: x	DM 6,000	Target bonus: x	DM 6,000
Actual bonus: =	DM 7,800	Actual bonus: =	DM 3,600
Payout:	**DM 6,600**	**Payout:**	**DM 3,600**
Excess Payout:	**DM 2,600**	**Lower Payout:**	**- DM 400**
Bonus Bank balance:	**DM 1,200**		

All management will have a variable income fully linked to the value creation of their operating unit up to a level of 20%-30% of their fixed annual income. Unionised shop-floor employees are free to participate in the value creation of their EVA centre up to a level of 10% of their fixed annual income.

In autumn 1998, Sirona's works council agreed to the programme, and in October 1998, it started together with a fully implemented EVA management and incentive system. Another decision was made in co-operation with the management; with the transfer of existing incentives and Jahreszahlung partly into fixed income and partly into variable income, depending on the development of EVA. The final agreement states that all management[34] will have a variable income fully linked to the value creation of their operating unit (expressed in the development of EVA) up to a level of 20%-30% of their fixed annual income and that unionised shop-floor employees are free to participate in the value creation of their EVA centre up to a level of 10% of their fixed annual income.

2. Achieving Full Acceptance of the Workforce

Mr Klaus Bauer, the head of Sirona's Works Council, discussed the workforce's expectations for the new incentive system. Dr Scherer's announcement to have the employees participate in Sirona's value creation actually met an old demand of the works council, which had considered bidding for Siemens' dental activities but retracted as the purchase price was too high. In addition, participating in the value creation of a private company appeared too abstract. "With EVA, Stern Stewart offered us an operating measure where the drivers are very well known from everyday business and which directly reflects the value created by each business unit."

The Works Council wanted to avoid a system where different agreements and targets would prevent the comparability between different levels.

Mr Bauer emphasised that "another important condition for the works council to agree to any new incentive system was the uniformity of the system for all levels – from the board down to the shop floor." He wanted to avoid a system where different agreements and targets would prevent the comparability between different levels. Mr Meyer, the EVA project leader added: "Already during the training sessions, we saw how important it was to implement the single

[31] The EVA system allows a choice of two basic types of bonus banks, which need to correspond with the rest of the EVA management and incentive system. One way to calculate a threshold bank is detailed under Exhibit 3.

[32] Bonus bank calculation: Up to the threshold (target bonus) 100% of the calculated bonus is paid out in the same year (DM 6,000). The additional bonus increases the bonus bank balance and is paid out at the ratio of 1/3 every year. For the year 1999 this means DM 1,800 is put into the bonus bank. 1/3 of DM 1,800 = DM 600 is paid out and the rest remains in the bank. In comparison to the DM 4,000 invested DM 6,800 is paid out in total (additional payout = DM 2,600) and DM 1,200 remains in the employee's bonus bank.

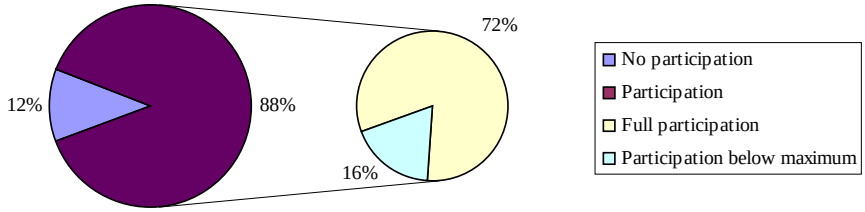
[33] In comparison to the DM 4,000 invested only DM 3,600 is paid out (lower payout = DM 400).

[34] A slightly different agreement was made with board members.

target of value creation for all employees in our company. Today, people pull together… There is simply no other way any more but working efficiently together in order to maximise your annual bonus and fill up your bonus bank."

Despite very positive feedback from the training sessions, the final test of the workforce's acceptance of the new system could only be the level of the unionised workers' voluntary participation. The results exceeded the expectations by far. As Exhibit 4 shows, 87% of the unionised employees chose to participate in the value creation of their operating unit, and 81% invested the maximum of 80% of their November income.

***Exhibit 4*. Level of voluntary participation of unionised employees**



3. Gaining Full Acceptance of the Shareholders

As many examples show, aligning the interests of employees and shareholders through a new incentive system is a difficult task. Poorly balanced systems result in public discussion about the cost of the incentive or the adverse effects within the company. By starting with the market value,[35] the EVA system establishes exactly how much improvement is necessary to create value for the owners of the company.

Stern Stewart, Schroder Ventures, and the management board differentiated between stretch goals set for the new management, and improvement based on market expectations (the basis for the incentive system). Extensive simulations showed to what extent shareholders and employees would profit if the company out-performs expectations and to what extent they would suffer if they under-perform. If employees achieved their EVA target (justify market price), their bonus and salary will give them the same income earned under previous schemes. This method guaranteed a fair distribution of value creation between shareholders and employees.

EVA has become not only the most important internal performance figure for all operating units but also the most valuable single item of information for investors.

EVA has become not only the most important internal performance figure for all operating units but also the most valuable single item of information for investors. Dr. Scherer told analysts at the annual press conference that "today, EVA allows me to explain to owners with only one figure whether we are on the right track to meet their expectations contained in the takeover price and thus are able to create value for them."

The ability of EVA to align the interests of shareholders and employees and to measure the real value created within the company convinced the shareholders to implement the EVA management and incentive system in the whole company. They made the right decision. Following acceptance by employees, numerous initiatives were started with a level of participation hitherto unknown within the workforce. For example, the project "Offensive 2000" aims to decrease Sirona's average inventory. It was launched as a result of a series of operating manager meetings on how best to improve the EVA figures, and thus, the annual bonus. The board began by publicly and actively communicating the project company-wide. Then, it was discussed in several seminars and eventually was published in Sirona's employee magazine. The active support of the whole workforce resulted first in new ideas[36] and then in excellent results – remarkable inventory improvements have occurred after only six months.

Bonuses of up to 250% are possible for some EVA-centres.

[35] Either from share prices, takeover prices, or from EVA simulations to calculate the market value of a company.
[36] One of the more creative ideas realised was to organise several "factory outlet days" products over a year old were offered at a discount.

Projects like "Offensive 2000" not only motivated and skilled employees but also helped to increase Sirona's EVA dramatically in the first half of 1999. After only six months, last year's EVA has already been achieved. Bonuses of up to 250% are possible for some EVA centres.

Conclusion

Employers and employees have a great opportunity to pursue greater partnership and solidarity. They should encourage the European Union, their own governments, and unions to develop a common European framework within which they can operate effectively. The framework should be a set of guidelines like those on corporate governance, which list the main objectives to be considered by companies and Member State governments (such as tax incentives). Incentives should include the short and long term, more and less risky options, and cash and equity choices. The guidelines should stress a coupling of decision making and incentives. To be implemented with corporate governance guidelines, the new framework should stress a of linking decision making and incentives, employee participation and greater productivity, with the ultimate focus on value creation.

Executives, middle managers, and employees would benefit by using the same measurement of performance, the same goal, and the same language, providing a line of sight from local to global.

On the company level, employers and employees should determine how cascading decisions would enhance value creation. Executives, middle managers, and employees would benefit by using the same measurement of performance, the same goal, and the same language, providing a line of sight from local to global. Continuous communication should move along this line. They should have similar tools for discerning decisions depending on the type of choices covered. They should share the same incentive system and cash/equity pool. Senior managers may have a greater risk-reward profile and a greater equity stake; yet employees should have the opportunity to take on as much risk as they and their colleagues wish. Their short-term and long-term balance may additionally differ from those making greater long-term decisions. Nonetheless, decisions and incentives should be linked to value creation even if current tax incentives affect the final plan.

Companies which utilise their human and physical capital productively will have a tremendous comparative advantage over peers.

While innovation and brands will provide strong future profitability, which utilise their human and physical capital productively will have a tremendous comparative advantage over peers, whether they are in heavy industry or branded consumer goods. Admitting the value of motivated employees is a start. Starting to include them in interactive communications and asking their opinions about local decisions encourages the process further. Identifying the areas or drivers of value, over which they have, or should have, control, and then linking these to incentives, completes the design process. Commitment to value creation and management of physical and human capital from the board and at executive level must continue beyond the initial enthusiasm. Transforming the corporation requires a sense of urgency and understanding toward those involved.

EVA allows employees to make decisions which impact their future wealth; they earn the wealth consequences of making superior decisions.

The aim of this paper was to survey the implementation of effective business management and incentive systems down to the shop floor in the European Union. Several frameworks for decision making and employee financial participation exist. This paper presented some of them, discussed the problems with equity and profit sharing, and more specifically studied the changes occurring in direct and financial participation in the UK. Companies can choose dozens of possible programmes, and each has its strengths (even if the benefit comes from tax incentives). However, only EVA offers a shareholder value incentive programme backed by a complete and proven business management system. This paper made the argument in favour of EVA using a case study from Germany. Sirona and several American firms have proved that EVA motivates not only senior managers but also employees to make the right decisions. EVA allows employees to make decisions which impact their future wealth; they earn the wealth consequences of making superior decisions.

Finally, executives naturally think about how they are going to improve the prospects of their firms. Employees need to think in the same way. Including employees in the value-creating process will change their entire view of themselves, their colleagues, their superiors, and their company; they will think and act like owners and want to win together with managers and investors. EVA makes them equal partners in the value creating process. EVA encourages them to enlarge the pie, from which they earn their share.

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