ESOPs & Employee Productivity

The PRO-Productivity System™

Menke & Associates, Inc.

ESOP ADVISORS AND INVESTMENT BANKERS

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Using ESOPs to Improve Employee Productivity

You've read about them—companies that seem to have found the key to success in an unstable business environment:

- "Sales Jump 312% as Employees Learn Rules of the Game" at Springfield Remanufacturing Corporation in Missouri. *Management Accounting.*

- *Inc.* magazine awards its Entrepreneur of the Year award to all 240 owner-employees of the Connecticut firm Reflexite, Inc. Out of 2,700 private companies evaluated, 4 of the 5 finalists had substantial employee ownership. *Inc.*

- "Improving Productivity Earns Dalton Foundries Senate Award"–"The Warsaw, Indiana foundry was presented the United States Senate's highest honor, its Productivity Award...[Employees] bet their jobs and retirements on the ESOP and knew they had a lot to lose if the buyout failed." *Modern Casting.*

- The National Center for Employee Ownership contrasted private companies before and after installing an Employee Stock Ownership Plan: 73% "**significantly improved their performance.**" *Harvard Business Review.*

Even if you don't subscribe to *Modern Casting,* it's hard to overlook results like these. Over 11,000 of America's most successful companies are currently using Employee Stock Ownership Plans to increase productivity and profitability, to grow the company, and to cash out shareholders tax-free.

The increasing popularity of ESOPs as a business tool stems from their flexibility. How the program will be applied by managers and understood by the employees depends almost completely on the choices of current shareholders. Owners can legitimately utilize ESOP-based productivity enhancement programs whenever they're concerned about any one of the four Ss: Success, Survival, Satisfaction, or Succession.

Success

In most well-managed American companies the last significant opportunity for increasing profitability lies in enhancing employee productivity.

All successful managers know that low-cost producers have a competitive edge. Cost control is a never-ending task. By and large, however, mature industries confront external cost structures which are not readily altered by any individual company. Prices, on the other hand, are governed by competition. This tight combination of external factors seems to leave the average company little maneuvering room for increasing overall profitability.

One great opportunity retains its potential. Unlike most other components of the profit equation, the productivity rate is an internal resource which can be developed or neglected at the discretion of management. A company that increases its productivity rate enjoys a continuing cost advantage which competitors can hardly overcome. Higher profits follow increased productivity, and higher stock values follow higher profits.

Relatively small changes in the productivity rate can have a huge impact on profits.

Assume, for example, a company with $10 million of annual revenues and pre-tax profits of $400,000, If the company can decrease its internal expenses by a mere 2% of sales ($200,000) while maintaining gross revenues, the company's profits grow by 50%. And since the value of a company is generally a direct multiple of profits, a stable 50% hike in profits usually translates into a 50% increase in shareholder value.

Effect of Small Productivity Change on Corporate Profits

	Before	After	% Change
Revenues	$10,000,000	$10,000,000	0%
Expenses	(9,600,000)	(9,400,000)	2%
Profit	$ 400,000	$ 600,000	50%

After explaining that you don't have to work a lot harder to improve things by only 2%— just be a bit smarter—the leadership at Austin Industries, a major Dallas-based construction firm, cemented the idea by handing out 2-inch green buttons for each employee-owner saying: "I'll do my 2 cents worth!"[1]

Given that the result is well worth the effort, how then can employee productivity be increased?

For most companies, changes of this magnitude can be achieved more readily by maximizing the effectiveness of each compensation dollar than by any other means. The phrase "employee productivity," classically defined as output per unit of labor, can just as easily be understood as output per dollar of compensation. If revenue can be increased or expenses reduced without any change in the compensation dollars leaving the company, productivity and profits increase.

> A 1992 ESOP Association analysis of IRS filings covering 2,776 U.S. ESOP companies discovered a mean rate of return of 15.2% for public ESOP companies in contrast with 10.2% for a representative sample of non-ESOP companies during the same period.[3]

The term *employee productivity* actually confuses the distinct inputs of labor and capital. The U.S. Senate Productivity Award mentioned above defines productivity broadly as "an organization's most efficient and effective use of the resources available to it to produce a high-quality product or perform a high-quality service at lowest cost. These resources include employee knowledge and labor, modern technology, raw materials, energy, plant and equipment, money and time."[2]

A carpenter with a power hammer will fasten ten more lumber than the same carpenter with an old-fashioned claw hammer. Is the worker more productive? Yes, but only because of a capital investment. Another carpenter, nailing away like crazy to fix *his own* roof before the next hurricane strikes, may exceed the productivity of the first despite a lack of power equipment.

The ideal productivity enhancement technique would thus have the capacity to boost both capital investment and employee motivation. An *Employee Stock Ownership Plan* is just such a technique. Designated by statute as a "tool of corporate finance," an ESOP establishes an incentive system that is rooted in ownership while simultaneously assisting the employer company with capital formation or conservation.

Under an ESOP, the company's tax-deductible investment in employee productivity remains invested in the company as capital stock and as a motivation for the employee's productivity. The investment is applied by the trustee to purchase shares directly from selling shareholders or to amortize a loan for the purchase of such shares. Alternately, the investment is utilized to purchase new shares or to amortize a loan for the purchase of new shares from the corporation itself. In this case, the total capital value of the company increases and the employees acquire part ownership approximately equal in value to the new growth.

No particular amount of employee ownership is mandated by law, though the value of the average stock account obviously must be significant enough to command employee attention if the company hopes for measurable results.

As the company expands, both the initial shareholders and the new employee owners share proportionally in the increasing corporate value.

The combined financial and incentive effect of employee ownership provides the foundation upon which thousands of successful companies have developed programs to increase productivity and profitability.

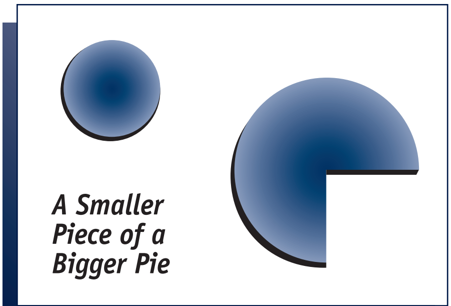
As early as 1927, the founder of the Bank of America, A.P. Giannini, recognized that:

"Ownership by employees is the only successful system for big business. A man has to have more interest than his salary to produce the best that is in him."

The same is true today. At Menke & Associates, Inc., our experience with over 2,500 companies since 1974 has convinced us that there is no greater productivity bang for your buck than the adoption of a well-conceived and consistently executed employee stock ownership program.

- A study performed by the National Center for Employee Ownership indicates that, after controlling for industry-wide variables, employee-owned companies grew 5.4% faster than comparable non-employee owned companies. Over a decade, this differential would result in the ESOP companies having sales 70% higher than their non-employee owned competitors.

- When ESOP companies encouraged more employee participation, they increased their growth differential to 8-11% more than comparable non-ESOP companies in the same industry.[4] As a result, shareholders end up owning a smaller piece, but of a much bigger pie.



Survival

Over 97% of the nation's ESOPs are in successful private companies. While press accounts naturally focus on exciting stories of companies trying to use employee ownership as a tool to stave off failure, such dramatic rescues are rare. Nevertheless, they do occur.

For example, Oregon Steel Company went from near bankruptcy in the early '80s to making millionaires out of many of its employee-owners. According to the *Wall Street Journal,* its productivity rate after a 100% employee buyout climbed to double the industry average.[5] Even the unflappable editors of the *National Enquirer* were impressed: "Company gave them worthless stock years ago—now it's worth a fortune."[6]

The survival issues confronting the average private company are no less crucial for its shareholders and employees. With luck, management will recognize developing problems and institute remedial steps such as an employee ownership plan before current owners and employees confront the stark alternative of collapse versus a 100% buyout.

If a well-conceived employee ownership program is introduced during a period of reduced profitability, the employees have a strong incentive to salvage the company before it needs to be sold or liquidated. As a turnaround tool, employee ownership can help retain experienced, productive employees at a time when the company cannot provide increased cash compensation. By funding the ESOP with convertible preferred stock, the company guarantees the employees some current return and preference if the company is forced into liquidation. After the company returns to profitability, the employees who helped it survive the tough times will own a preestablished percentage of the common shares upon conversion of their original preferred stock.

Even thriving U.S. companies, however, confront survival issues in a long-term global sense. The collapse of Communism—which strove for 70 years to destroy individual economic incentives for higher productivity, and succeeded quite well in this objective—has not been followed by a renaissance of the capitalist economies. Many American business owners quietly acknowledge a disconcerting lack of entrepreneurial energy among their employees nowadays. Who will carry on in the next generation?

Productivity was no problem one or two hundred years ago, when virtually every American was an independent entrepreneur—a farmer, a shopkeeper, or a craftsman. In only a few generations, however, we have transformed ourselves from a nation of entrepreneurs into a nation of employees as larger and larger enterprises became the necessary norm. If we are to reassert ourselves economically, we must reactivate the entrepreneurial enthusiasm of working Americans.

Given our modern corporate economy, the most feasible way to unleash those energies is through employee stock ownership.

Employee ownership can transform us again into a nation of entrepreneurs.

Over the past decade, much has been written about American productivity, total quality management, and competitiveness. All these concepts are different aspects of the same fundamental economic need: the value added by each individual employee must increase so that Americans can maintain a world-class standard of living. We have no future in the global bidding for low-wage, low value-added jobs. Perceptive analysts recognize that productivity growth is the key to success for the nation as a whole.[9]

While U.S. output per unit of labor is still high by international standards, our slow rate of productivity growth may soon leave us staring at the wake of international competitors. The battle to maintain a high-earning, consumer-driven economy is waged on the productivity front. In the decades to come, success will follow nations which learn to excel at magnifying employee productivity.

Even if this global perspective seems far flung, smaller private companies cannot afford to ignore the lessons taught by stumbling giants like General Motors, IBM, and Sears.

In Japan, 91% of listed companies and 60% of all companies have employee ownership plans.

The average employee account value, $16,000, equals 95% of the employee's stock investments and about 1/3rd of total household net assets.[7]

"Where the average number of improvement ideas per worker in Japan was 4 in 1974, it had increased to 24 in 1987. That same year the average for the American worker was 0.14."[8]

— John Simmons

Can this be the reason that the lights burn late in the office towers of Tokyo?

Flexibility, responsiveness to fluid consumer demand, consolidation of the decision hierarchy and bottom-up information flow are no longer optional enhancements to success.

Unless all employees are trained to accept more responsibility and exercise greater autonomy, even the apparently lithe and limber smaller company will be inadequate to the rapid pace of change. The startling transmogrification of the personal computer from toy to indispensable tool in less than a decade stands as an emblem of the flux that all businesses must cope with from now on. Precisely because careers are fluid and companies must change rapidly to remain viable, it is necessary to tie compensation more closely to the risk and reward of the enterprise. Employees whose only vested interest is in the status quo are no longer an asset for companies in the 1990s, if ever they were. For the last several generations, the rational goal of labor has been to seek guarantees from management. For good or ill, guarantees are no longer valid. Fairness therefore requires that employees share some of the upside potential of the business, since they know they are not protected from the downside risk. Unless some balance is restored to the employment compact, it is hard to see why an employee should plumb the depths of his energy for a company.

> *"It took us a while to understand we actually owned part of the company ourselves. But that part gets more exciting every year, especially for longer-term employees."*
>
> *— Pat Napolitano*
> *Quality Control Supervisor*
> *Reflexite*[10]

The goal of employee ownership is to align the self-interest of all stakeholders in the business so that everyone shares the same motivation to achieve higher profits.

Satisfaction

All companies have a corporate culture, even if no one is aware of it. Corporate culture is nothing more than the way we do things around here." The only question is: Will management shape a culture that insures the company's success, or leave things to chance?

> *"So what's the limiting factor? The answer, I realized some years ago, is people. We are the limiting factor on this company."*
>
> *— Cecil Ursprung*
> *Reflexite*[11]

Training a staff of adaptive, energetic, motivated employees to make informed, coordinated decisions in "real time" has become the essential task of management.

Learning how to exercise leadership in this environment is a challenge. Conventional top-down command and control leadership styles may bring compliance, but they have lost the ability to inspire loyalty and enthusiasm. And without that spark of extra energy, the company forsakes a vital competitive advantage. For managers, too, working in an environment without that spark of reciprocal energy is draining. The satisfaction that comes from coaching a winning team does not need to be confined to the playing field. While hierarchy will always be part of business life, companies which develop a participative culture often achieve a level of shared enthusiasm that equals the financial benefits of the program in its contribution to all the people who spend their working lives at the company. Working together can actually be fun.

Conventional managers treat labor as a cost to be minimized. Yet, actually, a company's work force is an asset to be developed, an asset with extremely high profit potential.

Many shareholders implicitly act as if they fear that the growth potential of their company is limited. Apparently, they regard their business as a zero sum game. They seem to feel that sharing ownership with others, even with the very employees they depend on to expand the success of the business, will reduce the value of their own ownership. This attitude itself may be the greatest limiting factor in the growth of such companies. In their anxiety not to kill the goose that lays the golden eggs, they starve it—not to death, perhaps, but into enfeeblement. Why, after all, should an employee strive to grow the company for the sake of the shareholders' future wealth?

Employee indifference to profitability is potentially more damaging than outright hostility. Apathy and cynicism are much harder to identify and correct.

In today's economy, no company can afford to neglect its most valuable resource: the talent of its employees. The **PRO**-Productivity System provides a step-by-step approach for any company to act on the most obvious lesson of the entire American economic experience:

People work best when they work for themselves.

In the end, there is no substitute for the internalized motivation based on shared stock ownership. **Self-interest does not need to be taught.**

A great deal of systematic effort, on the other hand, is required to assure that employees—who have often had little financial education and even less information about the inner workings of their company—come to recognize their own long-term self-interest in sharing ownership of a flourishing enterprise.

A well-planned, systematic approach to employee education and the development of an ownership culture is indispensable to success. By designing and effectively implementing an employee ownership system, existing shareholders can tap into a natural reservoir of employee energy, ingenuity and commitment that few leaders could hope to stimulate by pep talks, picnics and quality circles alone. For many managers, the satisfaction they gain from creating a work environment that respects and expands the potential of each employee is reason enough to adopt the **PRO**-Productivity System.

In private companies, the adversarial model of labor-management relations is seldom so deeply ingrained as in the industrial giants which claim most of the space in the media or academic theories. Bureaucratic layers of management are not much of a problem. Founders often know all their employees by name, and they know their spouses and kids too. (Despite this easy familiarity, however, many founders are surprised at the result of confidential employee surveys which expose the actual attitudes of employees towards the company and the working environment.) Entrepreneurs are cost-conscious not because of some business school theory, but because they are spending their own money.

> ***"Ownership is not a set of legal rights, it's a state of mind. You can't give people that state of mind in one fell swoop. You can only nurture it through education."***
>
> ***— Jack Stack***
> ***Springfield Remanufacturing***[12]

Yet entrepreneurial companies frequently do suffer from a distinctive labor-management tension of their own: the very experience and stature of the founders inhibit junior family members, successor managers and rank and file from developing their full potential as decision makers, a process which includes the opportunity to make some mistakes. This is a principal reason why **only 40% of well-established family businesses survive the transition from the first generation of management to the second.**

Carefully implemented, the **PRO**-Productivity System is designed to train the company to function as a self-sustaining enterprise which values, but does not depend exclusively, on the unique capacities or secret knowledge of its founding managers. The very existence of an Employee Stock Ownership Plan can help attract and retain professional managers who are prudently wary of tying their careers to a company without a succession plan. Menke & Associates, Inc. frequently designs selective stock-based compensation programs in parallel to the nondiscriminatory ESOP to assure that successor managers are sufficiently at the risk of the company.

The ESOP permits founding shareholders to realize the value of their investment in the company while they pass voting control on a separate, discretionary timetable to the next generation of managers or family members.

An Employee Stock Ownership Plan creates an ongoing, in-house market for the shares of a private company. Founding shareholders gain the ability to sell some or all of their stock at a pace which suits their needs. **Under certain conditions, sellers can even cash out tax-free.** Please consult the Menke & Associates, Inc. booklet *ESOP Pros & Cons* to learn more about the process of selling stock to an ESOP.

Laying the groundwork for succession in a company is one of the most challenging, yet rewarding tasks of a business owner. Justifiable pride results from establishing a corporate system which survives and flourishes beyond the immediate influence of the founders. Even younger entrepreneurs rest easier in the knowledge that the company will continue to function if fate should cut them short.

Corporate "employee participation" programs designed to enhance productivity without the nexus of stock ownership have shown disappointing results. The "Quality Circle" movement hailed so loudly in the early '80s has now nearly collapsed. The "Total Quality" movement of the '80s has been assailed as jargon. Initial success in these programs too often pales when employees realize that the real payoff for their extra efforts is going to someone else.

Fortunately, techniques for enhancing employee productivity through ownership have evolved rapidly. Stimulated by the 1984 law which encouraged founding shareholders to sell tax-free to Employee Stock Ownership Plans, experience with employee ownership has reached critical mass. Many pioneering managers have recorded their insights for others to follow. By selecting from a battery of tools already proven by other companies—and by avoiding their false starts—managers now have the power to engineer significant changes in the productivity rate with assurance, though not without a well-conceived long-term plan for effecting organizational change. Management's first commitment when crafting the plan must be to share some ownership with employees.

It is important that employees realize they are "at the risk" of the company's long-term success.

Stock ownership is therefore the logical compensation measure for productivity improvement. This is particularly obvious if the productivity enhancement program requires current sacrifice, such as a limitation on bonuses and raises, to permit reinvestment of capital in the business. An ESOP leaves these dollars invested in the company where they provide the capital foundation for productivity growth.

Executives often scoff that rank and file employees are unable to conceptualize the benefits of stock ownership. "All they want is cash" is a frequent opinion. Yet most of these same employers sponsor *voluntary* employee salary deferral plans (401(k) Plans) which at least satisfy minimum participation requirements by non-highly compensated employees. Experience proves that with proper leadership, even the least well-educated employees can gradually come to value the worth of the ESOP. It's surprising how much attention people pay when the topic is money.

No employee would turn down a cash productivity bonus, but if the company seeks long-term improvement in productivity, at least a part of the employee's compensation must match the long-term nature of the objective.

Both components, employee participation and employee ownership, are integral to an effective productivity enhancement plan.

Yet even a stock-based participation plan can backfire if the rewards are not understood to correspond with the extra effort required. In itself, adopting an Employee Stock Ownership Plan is not a productivity-enhancement panacea.

Problems in the implementation of employee ownership plans can almost always be traced to casual or incomplete communications regarding the plan.

> *"One can go through the motions, complete every step and totally miss the desired outcome of ownership mentality. We are changing people's behavior through this process. People need time to become comfortable with their new behavior before moving on to the next step. Most of us can only handle one crisis at a time."*[13]

It's an old saw, but a true one, that rumor expands to fill a vacuum of information. Employees are also quick to pick up on contradictory messages. For this reason, top management must determine what they wish to accomplish with the plan at the outset and short-circuit misunderstanding with clear, consistent and repeated communications.

Educating employees about the totality of their compensation program and the role that a company stock investment can play in their financial security is an essential ongoing task once the plan exists. This is the second minimum commitment of managers considering adoption of a plan. Any further disclosures—of the company's operational or financial results, for instance—should be tailored to support the level of autonomous decision-making required under the new productivity program.

These legitimate caveats all relate to choices within management's control. It's up to management to design and communicate a plan with real potential.

Obviously, deep-seated cultural change takes a while to set down roots. Yet despite pessimistic assessments like the one in the box above, many programs can be designed for rapid initial impact.

Shareholders can virtually guarantee a bold start by committing to sell—perhaps over a period of a few years—a block of stock equal to at least one-third of the payroll for the participants in the plan. This generates average individual stock account values of one-third of a year's pay—enough to make almost anyone sit up and take notice. Even if there is no immediate growth in the per-share value of the stock at all, the individual employee's investment will increase as stock is paid into the accounts.

Stock may be acquired from selling shareholders or represent newly-issued shares backed by new capital investment in the company. In the latter case, management has an especially interesting story to communicate. Employees will see the new investment project unfolding about them and realize the potential it holds for the company in which they now have an investment. In a very real sense, of course, what happens next to the value of that investment is up to them.

The Executive Decision

Establishing realistic goals for an ESOP is the responsibility and the prerogative of top management.

The initial planning phase of the **PRO**-Productivity System conventionally involves only the company president and perhaps one or two advisors.

It is pointless to invite creative contributions on plan design and implementation from second-level management until the existing shareholders are comfortable with a stock-based employee program.

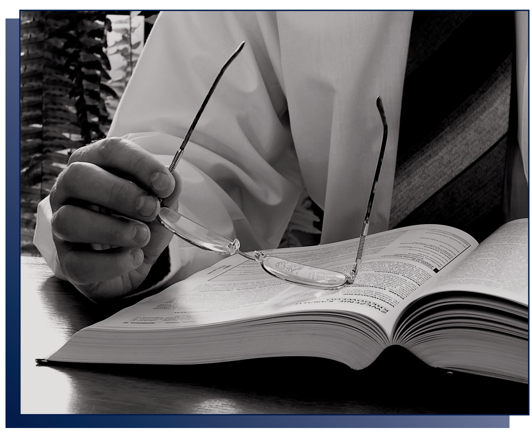
Owners and top management select from two broad options when instituting an Employee Stock Ownership Plan.

Option I: Keep Total Control

Almost all company founders and traditional managers mutually mistrust the idea of shared ownership because they fear it represents shared control.

Actually, voting control over ESOP stock is held by a board-appointed trustee under the terms of the Employee Stock Ownership Trust. An ESOP, like any trust arrangement, is a means for unbundling the attributes of ownership: it separates control over the stock from the financial benefit of ownership. Control is retained by the trustee directed by a committee of the board often a single individual, the founder or president of the company. The trustee and plan committee do, of course, have the fiduciary obligation to manage the trust for the exclusive benefit of plan participants.

ESOP is not about changing control unless and until current owners seek to transfer control.



At that point, and only then, successor trustees and plan committee members can be designated. This is true even if 100% of the stock is held in the ESOP.

The law requires virtually no disclosure to ESOP participants beyond the value of their individual personal accounts. At separation from service, the employees are entitled to the value of their accounts under the terms specified in the plan documents. Generally, they receive cash rather than stock in the company. Thus, only active employees participate in ownership. Even companies which encourage a high degree of employee autonomy and participative decision-making very seldom permit employees to vote the stock in their trust accounts. This does, however, constitute a design option that could be incorporated into a plan immediately or at some later date at the discretion of the Board of Directors. Experience shows that employees do not seek voting rights. Rather, they wish to have some input into the way their own jobs are executed.

Some owners prudently decide to use ESOP only for financial purposes.

For them, gaining the ability to cash out a shareholder tax-free and deduct the transaction is reason enough to create an ESOP. Other companies only seek the ability to acquire expansion capital on a pre-tax basis.

In such companies, employees should simply be educated about the structure of the employee ownership trust just as if it were any other sort of employee retirement plan. Employee communications should clearly recognize that no significant change is planned in corporate operations. An ESOP can be a very welcome and rewarding retirement program even if the company does not wish, at the present time, to undertake a participatory productivity enhancement campaign. **In our experience, hundreds of successful transactions have been accomplished without any change whatsoever in the client's management style or control systems.**

Option II: Encourage Participation

Other employers, determined to maximize productivity and corporate growth, launch a formal program to encourage Participation and Responsibility through Ownership: the **PRO**-Productivity System.

> ***"'Improved productivity' and other benefits assigned to the ESOP are in reality the results of a new corporate culture in which the ESOP is a cardinal ingredient. Without the associated change in corporate culture, the ESOP becomes only an employee benefit, albeit an excellent one. But why settle for this lesser goal when the corporate culture can be achieved at the same time?"***
>
> ***— Warren Braun***
> ***Comsonics***[14]

Even the rare managers who decide at the outset to target a high degree of employee involvement in the decision-making process should recognize that the program must be phased in at a pace which permits everyone involved to assimilate the new corporate culture.

Much more usually, managers do not know how far they wish to develop the program. Unless they have some prior experience with an employee ownership culture, they are obviously ill-advised to institute radical change overnight.

The **PRO**-Productivity System deliberately anticipates a measured pace of change. As each phase of the program is completed, the results are subject to careful assessment. Before promises of a more participatory environment are unveiled to the rank and file, reasonable comfort is established among middle managers. Experience shows that no program can succeed without a firm commitment from the supervisory and middle-management level.

If full implementation of the **PRO**-Productivity System seems premature, shareholders and top management can rein in change at no risk. The Employee Stock Ownership Plan still constitutes a valuable, controlled, in-house market for their stock and a reasonable retirement program for employees, pending more expansive use of its potential.

The Management Roundtable

The second planning phase of the **PRO**-Productivity System thus engages the management team alone in a workshop. The very process of determining how best to encourage greater employee involvement in concrete productivity enhancement projects is used to illustrate and practice participatory decision making. The product of the Roundtable is a kind of homework assignment for the management group which grows out of the issues identified in exercises on some or all of the following topics:

- Identify the company's current **Management Style.** Exercises based upon Likert's, MacGregor's & Ouchi's models from command and control to consensus decision-making. Where do the company's managers fit on the scale from Ghengis Khan to Mr. Rogers? How appropriate are the current habits of leadership? Are job functions, decision-making authority and responsibility clearly articulated? How do employees know they have succeeded? Design an ideal management style that fits the potential of the business and the talents and idiosyncrasies of its people.

- Focus on the **Cost Structure** of the business. Where do the profits really come from? How much potential does there appear to be for employees to increase productivity? Identify the current level of employee participation/autonomy/awareness of the cost structure. Do employees have enough information to modify their behavior in search of higher profits? Is there a need for employee education regarding basic financial principles and the cost structure of this particular business? Design an ideal relevant feedback system which would permit people to react quickly to significant profit opportunities or cost overruns.

- Focus on the **Organizational Structure** of the business: Does the current structure facilitate or impede information flow and decision-making? Does the company do strategic planning? Do employees work to a plan? Are there different functional departments or operating divisions which present distinct communication problems? How do they interact now? Is there too much insularity and not enough mutual support? Do most employees speak English? How will the productivity process deal with linguistic and cultural differences? Would strategic business unit organization and accounting principles enhance productivity? Design an ideal reporting and responsibility structure which would facilitate efficient operations at the lowest cost.

- Evaluate **Compensation Techniques:** Do current compensation structures match responsibility and risk? What should the balance be between short-term and long-term compensation, between base compensation and performance-based compensation. What is the realistic potential of the company's stock? Will the amount of stock targeted for ESOP ownership constitute an inadequate, appropriate, or excessive foundation for the productivity enhancement program? Should the existing cash bonus system, if any, be integrated with the ESOP such that some of the cash bonus is paid out to plan participants in the form of tax-deductible "dividends" allocated according to the number of shares in a participant's account? Design an ideal compensation scheme.

- Explore **Productivity Enhancement Techniques** used by existing successful ESOP companies as alternatives to consider: What level of employee involvement should be targeted initially? Should communication be limited to top-down education at first? What kind of bottom-up information channels exist now? Could autonomous decision-making be forced downward in the organization? Should it be? How should success be recognized and measured? Design an ideal employee communications program that is consistent with the goals of the plan.

A single day's workshop will not accomplish a change in corporate culture. The Management Roundtable does, however, help management to identify the company's current unconscious habits and explore alternatives which might enhance long-term productivity. The experience of the Menke facilitator leading the workshop provides perspective and serves as a catalyst to help the management team focus on issues they have long recognized, but perhaps failed to articulate. There is no magic in the system except that it provides a forum, a structure for the people actually working in the company to take stock of their situation in a systematic way. This kind of stock-taking is just as crucial to the **PRO**-Productivity System as the financial kind of stock. The goal of the Roundtable is to leave the management team with a pile of unfinished planning tasks and a format for working them out during several ensuing weeks.

During the workout phase of the program, then, managers themselves may consider whether any of their current habits contribute towards what Malcolm G. Putnam, President of Oregon Steel, calls "the We-They Syndrome between management and labor."[15] They can experiment in developing effective group dynamics among themselves, learn consensus-building skills and communication techniques, and perhaps modify the subtle hurdles which could sabotage from the start the message "We're all in this together."

The final objective of that long workout process is to establish the shape of the employee productivity enhancement program: What are its proximate and long-term goals? How should the company begin and how can it recognize success? Recognizing that you get what you measure and reward, how should the company's reporting and compensation systems be modified to encourage productivity growth?

As an equally important objective, the workout period also gives managers time to develop their own commitment to the employee participation process. On rare occasion, the decision is made at this point to postpone further employee involvement indefinitely. Unless and until managers are comfortable with the selected employee participation techniques, the plan will start out as someone else's pet project and probably finish as nobody's baby.

Involving All Employees

The third, open-ended phase of the **PRO**-Productivity System entails all the techniques which may be applied to communicate the nature of the Employee Stock Ownership Plan, or the financial and operational progress of the sponsoring company to the entire employee group. The decisions of the Management Roundtable phase find implementation here.

The Attitude and Information Survey

The first stage of interaction with the rank and file consists of an assessment of current attitudes and information levels. Communications time is valuable; it is best spent addressing issues that concern or puzzle the employees. (This can be particularly useful when a company with an established Employee Stock Ownership Plan is attempting to move from a nonparticipative "employee benefit" ESOP to a participative "productivity enhancing" ESOP.)

The employee assessment may take the form of questionnaires circulated among the employees or of live "focus group" meetings led by an outside facilitator who can serve as a neutral conduit of anonymous opinions to the management team. While the questionnaire method is suitable for testing information levels, it depends too thoroughly on predefined categories to elicit an accurate picture of the employees' real perceptions and concerns about their work. The focus group is a useful vehicle for uncovering rumors and recriminations, as well as enthusiastic energy and team spirit which never show up in a written survey. Either approach provides a benchmark for measuring the long-term success of the productivity project. Changes must be monitored in future years using the same or similar instruments in order to adjust and improve communications. Once the assessment is digested by management, the company moves on to active introduction of the new program.

Summary of Communication and Participation Techniques

There are four fundamental levels of employee involvement:

Level I—Top-Down Communications:

Symbolic Action:

- "An Employee Owned Company" on Business Cards and Stationary
- Business Cards for all "Associates"
- Parking Lot, Lunchroom, Restroom Egalitarianism
- Posters Advertising Employee Ownership
- Flyers and Pay Envelope Stuffers every Payday
- Flags, Logos, Signs on Company Buildings, Vehicles
- Hats, Clothing, Mugs, Pens, Pins
- Delegations to ESOP Conferences and Conventions
- Company Newsletter Stressing Employee Ownership

Education and Financial Disclosure:

- Booklet Explaining ESOP
- Kickoff Meeting Explaining ESOP
- Basic Financial Education:
  - How to Understand Financial Statements
  - How ESOP Meshes with Personal Financial Planning
- Periodic Disclosure of Selected Financial and Operating Information
- Verbal or On-Screen Disclosure, but no Distribution of Financial Statements
- Distribution of Formal Annual Report
- Video Communications Programs
- Annual Employee-Owners' Meeting

Level II— Bottom-Up Communications:

- Suggestion Boxes (Possibility for Anonymity)
- Ad Hoc Consultations (Walk-Around Management)
- Productivity Enhancement Contests (Public Acknowledgment)
- Identify Relevant Performance Measures (Individual or Group)
- ESOP Advisory Committee (No Fiduciary Liability)

Level III—Delegated Autonomy:

Personal/ Job Site Autonomy:

- Flex Time
- Authority to Spend within a Budget
- Pricing Authority
- "Stop the Line" Buttons

Chartered Task Forces:

- Employee Participation Groups
- Departmental Quality Circles
- Ad Hoc Problem-Solving Committees

Level IV—Voting Rights:

Elect a Nonvoting Representative to the Board
Elect a Voting Representative to the Board
One-Person One-Vote on All Shares in Trust
Each Participant Votes the Actual Number of Shares in his Account

At Levels I and II, employees receive or give information, but have no authority for particular actions. At Levels Ill and IV, employees take autonomous decisions. While an increasing number of companies are experimenting with some form of voting rights, few elect this level of involvement without experience at the lower echelons.

Top-Down Communication Techniques

Symbolic Action:

Virtually all ESOP companies eventually implement some of the Level I ideas. Symbols can have dramatic effect; they prepare the mind for more substantive change:

- "We've tried to eliminate all obvious signs of differences like time clocks, reserved parking, separate lunchrooms, anything that would say 'you fall into this class of citizens and these people fall into another class of citizens.' [...] Everything is designed to make people think of themselves as one team."

—Malcolm G. Putnam, Oregon Steel[16]

Since all the symbolic actions cast the employees in a passive role, they are only a first tentative step toward a participative productivity program. Many companies have used these techniques to good effect in the informal context of smaller companies where "Walk-Around Management" rather than formal participation programs elicits interaction among all levels of the organization.

Education and Financial Feedback:

Even the most rudimentary Employee Stock Ownership Plan is mandated to provide a summary of the plan in written form to employee participants. Some employers who have elected **Option I. Keep Total Control** distribute nothing more than this rather legalistic brochure. Most companies, however, at least sponsor a communications meeting to kick off the plan. After a slide or video presentation by a person who explains the legal structure of the plan, rules of eligibility, annual participation, vesting, and the timing of distributions, employees have the opportunity to ask questions and clarify their understanding of the program as a retirement plan.

The kick-off briefing also provides selling shareholders an opportunity to announce their intentions for integrating employee ownership into the culture of the company. If an employee survey is to be used, it can be distributed in this forum. A subsequent meeting to analyze the results of the survey effectively inaugurates the productivity enhancement program itself.

The survey will almost invariably reveal that another type of education is necessary if employees are to learn to make responsible decisions with a proper eye on the bottom line. It is remarkable how often managers and employees alike admit to basic business ignorance, even among otherwise skilled professionals:

- "Most people who work in companies don't understand business," says Jack Stack of Springfield Remanufacturing Corp. "They think profit is a dirty word. They think owners slip it into their bank accounts at night."[17]

- "It was genuine shock to find that the majority of the employees had no understanding of financial planning, investment, or profits—indeed no understanding of business—and that their primary concern was the next paycheck."—Warren L. Braun, ComSonics[18]

At ComSonics, Braun devoted 16 hours of instruction in 32 half-hour sessions (now provided to all new employees on video tape) to explain "what stock is, its purpose, and its functional relationship to the employee's future financial status."[19]

At SRC, Jack Stack tells new employees "70% of the job is disassembly—or whatever—and 30% of the job is learning." [...] "No one ever explains how one person's actions affect another's, how each department depends on the others, what impact they all have on the company as a whole. Most important, no one tells people how to make money and generate cash. Nine times out of ten, they don't even know the difference between the two."

A natural adjunct of basic financial education will be some discussion of the role of capital investment in personal financial planning. This topic, of course, affords the company a chance to reinforce the value of the ESOP stock investment. Until this sort of comprehensive financial education has been completed, however, it is generally counterproductive to disclose the company's formal accounting statements to employee-owners. Unless employees have sophisticated training, the array of GAAP accounting categories is likely to distract from the primary productivity message.

> ***"Employees will have a good understanding of financial constraints only when the financial data is reduced to relevant, current information that is exactly targeted to their operations."***
>
> ***— Warren Braun Comsonics[21]***

Because developing an appropriate curriculum and presenting it to the employees is a time-consuming task in itself, managers are usually best advised to distill benchmarks of performance from the company's normal records to provide employees with feedback which is relevant to their particular tasks and permits them to react to changing business conditions and alter their behavior in a timely manner. Such feedback should be available at least monthly in order to provide employees with some sense of control over the changing variable.

While the availability of appropriate numbers obviously influences the potential feedback, devising mutually agreed-upon measures is a crucial first step in the participatory process. Employees must understand and value the measurement system. In the jargon of organizational development, they must "own" the system. If the system is imposed from above, as in the time and motion measures promoted by scientific efficiency experts like Frederick Taylor in the last century, employees feel uninvolved at best and manipulated at worst.

The identification of **relevant feedback** is related to a less mathematical approach that functions better for some companies or positions. In the **responsibility analysis** exercise, employees who interact with each other clearly define their job tasks as they are actually performed, the objective is to unite decision-making authority with the actual responsibility for execution of tasks wherever appropriate. Even in companies with well-delineated job classifications and descriptions, actual practice frequently deviates far from the book. Investing the person who really accomplishes a task with adequate information and authority to make appropriate decisions can often generate major improvements in productivity, to say nothing of less friction in the workplace.

With experience, managers become more comfortable discussing comprehensive **financial results** with the employees. Some firms, concerned about revealing proprietary information in a competitive environment, take the precaution of displaying financial results only in non-permanent fashion during a talk or on-screen using overheads. Several other companies have developed special ESOP reporting formats which highlight the most important items and explain them in attached commentary. These **Annual Employee-Owners' Reports** maintain the clear understanding that participation and disclosure are not ends in themselves, but a means towards enhancing the financial condition of all the stakeholders in the company. Accounting statements are, after all, designed to reveal the overall financial condition of a company. Improving that condition is the ultimate goal of stockholders. In the last analysis, guiding employee owners to a reasonable understanding of the statements is an appropriate long-term goal for an ESOP company, though it is seldom a first priority. Without the strictures of formal GAAP accounting or SEC disclosure rules, the best Annual Reports make the company's financial information come alive to the employee-owners.

Bottom-Up Communications

Advocates of participatory management conventionally disparage the suggestion box mentality. It discourages real interaction, they contend. It elicits ideas only from the most aggressive employees and provides no automatic forum for participation. It allows some outlet for complainers and inventors, but promises no change in the company's overall culture.

Most of this is true, but **suggestion boxes** do have virtues. They permit anonymous comments which might not be expressed even in the most interactive venues. They allow managers pause to think through their responses and abbreviate time wasted on truly stupid ideas in meetings, where people must maintain some measure of polite respect for expressed opinions. Solid suggestion box systems require that prompt and reasoned responses be combined with an appropriate array of rewards. If you maintain a system like this, don't abandon it.

Gurus like Peter Drucker and Tom Peters have long popularized the idea of "**Walk-Around Management**" as the sine qua non of efficient communication among organizational levels. To be effective, this apparently informal technique requires just as much resolute and systematic observance as any other approach. Unless the managers consistently and often interact with a large number of employees, their occasional appearance on the shop floor or in the word processing room will take on Great-Event status. What's really going on is usually suppressed during Great Events. The formal participatory structures sketched in the **PRO**-Productivity System are more likely to produce a focused response from employees than casually deployed Walk-Around techniques.

On the cusp between autonomous decision-making and mere communication is the evolving custom of the **ESOP Advisory Committee**. As a legal entity, the Employee Stock Ownership Trust is overseen by a directed Trustee who takes his direction from an ESOP Plan Committee appointed by the Board of Directors. This Committee exercises the actual voting power of the ESOP-owned shares. The Trustee merely executes their instructions. Both the Trustee and the Plan Committee—often the same person or people—are legal fiduciaries. Because Plan Committee membership represents voting control, very few companies treat membership as a democratic function of the employee group.

The ESOP Advisory Committee, however, is another matter. Frequently constituted by election of the employees on a one-person, one-vote basis regardless stock of seniority or in their ESOP accounts, the Advisory Committee is not a fiduciary.

Its charter may cover any appropriate tasks, from publishing the Annual Employee Owner's Report to arranging for employee education to serving as a conduit for recommendations developed in departmental meetings. In some companies, a representative from the ESOP Advisory Committee is an ex officio nonvoting (or voting) member of the Board of Directors. As the company's experience with participation grows, this approach affords an appropriate outlet for some level of democratic participation in corporate governance.

Delegated Autonomy

The Delegated Autonomy category is the focal point of most fully developed productivity enhancement programs. While the techniques of Levels I and II enhance communications, they rely on executive initiative to effect real cost-saving changes. This is far from tapping into the responsible, informed decision-making capacities of the employee owners. Training employees to take informed, coordinated, yet autonomous decisions, however, calls upon the greatest skills of **the manager as coach**.

> ***"This employee participation kind of goes against the grain with me. I'm more the kind to tell people how to do things, delegate it all out. I have to work at this stuff."***
>
> ***— Cecil Ursprung***
> ***Reflexite Corp.***[22]

Everyone with experience agrees that participatory decision making ultimately yields better decisions and a more profitable company, but all concede that the process, especially in the beginning, is more time-consuming and frustrating than conventional command and control management:

> ***"But what is 'participation' in practical terms? Simply put, it is: involving people in the process of making decisions that affect them—about their company and their work. It does not mean making everyone a manager, giving up control, courting chaos, or instituting paralysis from endless disputation. It means inviting—even insisting—that everyone become involved."***
>
> ***— Peter B. Thompson Human Resource Management Systems[24]***

- "Since the heart of corporate ESOP/Participatory problem solving is to share in the risks and rewards of corporate life, each individual needs to participate in the progress of the firm by solving problems appropriate to his or her level of understanding of the problems the firm is experiencing. Under no circumstances should this become a 'democratic' or 'communal' decision making process. Great errors are made when this process is understood in terms of one-worker, one-vote 'democracy.' Hierarchical structures do exist, both of necessity and by good common business sense. The buck does stop at the CEO's desk. But the 'top dog' is no longer 'De Boss'; rather the boss becomes the 'coach,' involving the players in 'winning the game.' Worker input is sifted through a consensus-making process so that all can 'buy in' to the solution." —Warren Braun[23]

Great coaches lay groundwork so their players succeed first and build the habit of success. The company's playbook is consensus on the feedback benchmarks which guide the employee in his or her decisions. Too much information can be worse than too little, yet the feedback must convey enough information to permit corrective maneuvers and to reinforce success.

Monitoring the employee decision process, like tracking the skill development of a playing team, requires tact and a way to keep score. The feedback benchmarks are of equal importance to the manager-coach and the employee-players. Managers must encourage participation in increments that the employee group can handle; yet decisions must be meaningful to the employee and important to the bottom line. Otherwise the vaunted "participation" will be recognized as an empty phrase. You can't educate people to higher responsibility by giving them trivial tasks or completely foreclosing the right to fail.

> ***"We teach people the rules. We show them how to keep score and follow the action, and then we flood them with the information they need to do both. We also give them a big stake in the outcome—in the form of equity, profits, and opportunities to move ahead as far as they want to go."***
>
> ***— Jack Stack Springfield Remanufacturing[25]***

The easiest **autonomous decisions** are those directly involving the employee's own job performance. If it **is** feasible in a particular operation to organize work so that employees can have more discretion over the time and possibly even the site of their work, employees value the autonomy very highly and companies at least suffer no ill effects.

> ***"Sales people cut sharper deals because (as one marketer puts it) 'they're worried about return on investment, not just making the sale.' Shop-floor managers take the initiative to reorganize packaging, eliminating bottlenecks and freeing up packers for other work. [A] chemicals handler, on the job less than a year, figures out how the company can reuse solvent, thereby cutting the hazardous waste it must dispose of. He even works up a full cost-benefit analysis, mostly on his own time. Simple initiatives—which most companies never see."[26]***

Valid feedback benchmarks assure that work is accomplished and allow everyone to determine whether the greater autonomy is in fact enhancing productivity. Flex time and working at home where they are possible, are clear indices that the company expects the employee to function as a responsible professional.

Other examples of increased autonomy on the individual level include extending the authority for pricing or establishing service contracts, or for developing and maintaining client contacts. Each company, obviously, must extend employee responsibilities in ways appropriate to the particular business. The ultimate goal of the entire **PRO**-Productivity System is to instill a culture of ownership so thoroughly that bottom-line consciousness supplements short term self-interest, as in the examples from Reflexite in the box above.

Because they are the most formal participatory arrangements, the group problem solving task forces, called variously **Employee Participation Groups, Quality Circles,** or **Ad Hoc Problem Solving Committees** have received the greatest amount of written attention. Theoretical models for their structure and operation abound. Most of these models represent the consensus decision-making process as the essence of the participation group. Professional training in consensus building is a prerequisite for the productive operation of such groups.

Participation groups generally mandate input by all members so as to extract hidden truth from the timid and educate everyone to responsibility. At Chevrolet's successful gear manufacturing division in the early '80s, this mandate took the form of a required summation statement by every member of the 20-person production circle at the close of each morning's 20-minute meeting. Less incessant meetings are generally favored today.

Whether voluntary, mandatory, elective, appointive or ex officio, group participants must receive a clear charter and continuing meaningful assignments from management if they are to succeed. Without such guidance, they may be great group therapy, but not a particularly well-directed productivity tool. Generally, a representative from management sits in each group.

With guidance, employee problem-solving task forces can convey a spirit of shared responsibility to all employees, even those who do not attend in person. If the assigned tasks are appropriate, participation groups become the training ground for future supervisors and managers. Leadership qualities are tested under fire. Operational expertise is developed on well-defined issues. A broad perspective on operating or functional units evolves.

> *"When Americans feel that they are part of a team, and a player, they can outperform most of their opposite numbers in any other culture. But they must feel that they are a part of that team, and an active player, not just a 'bench warmer'."*
>
> *— Warren Braun*
> *ComSonics*[27]

Participants are coached in the proper format for reporting their recommendations to managers who make the ultimate decisions. Feedback flows downward to ensure that participants are able to place their recommendations in a company-wide context. As time goes on, responsibility for some decisions may be delegated to the participation group itself.

Great coaches have the capacity to inspire all the players to get involved, to help them develop their innate talent for the quick moves and decisive plays that bring victory out on the field, far from the playbook.

Voting Rights

Despite our proud democratic traditions, America offers few examples of democratically managed corporations. This remains true even in companies in which 100% of the stock is held by the employee group through an employee trust. It is certainly true that without the ESOP to insulate voting control from the employee-beneficiaries, hardly any private companies would consider initiating employee ownership programs.

> *"Since structures of political democracy have proven stronger over time than autocratic forms of government, why shouldn't a democratic business be stronger, more competitive, and more profitable than a traditionally run business?"*
>
> *— Buck & Heitfield*[29]

Yet there are some companies which are experimenting with the principle. Aside from the extremely limited statutory situations in which a direct vote pass-through is mandated (see *ESOP Pros and Cons),* a few companies permit the elected representative of the ESOP Advisory Committee to hold a voting seat on the Board. Mathematically, this does not convey actual control to the employee representative, no matter how much of the outstanding stock the trust holds. This approach does, however, confirm the openness of management and its commitment to a "no surprises" style which can alleviate the mistrust that almost inevitably follows when corporate decisions are made behind closed doors.

Yet it is important to recognize that even one of the most confirmed advocates of employee participation as the key to corporate success, Corey Rosen of the National Center for Employee Ownership, has reported that voting control is not a concern or a highly valued right of most employee-owners.[28]

To date, the experience of American companies in permitting employees to vote the shares in their accounts is so limited that it must be considered experimental. In time, as more companies develop a high percentage of employee ownership, it is to be expected that the vote will be passed through to participants more often. Certainly the theorists of more democratic forms can raise some thought-provoking issues.

In the meantime, employers considering the adoption of a stock-based productivity system should regard passing through voting rights as an unusual option.

THE NEXT STEP

There is great variety in the techniques used by ESOP companies to develop a culture of ownership, to enhance productivity, profitability, and shareholder value, but several principles are common in the most successful operations:

- **PARTICIPATION:** Institutionalized mechanisms that do not merely permit, but actively ensure employee participation.

- **RESPONSIBILITY:** Increasingly autonomous, yet coordinated employee responsibilities within a mutually acknowledged company strategy.

- **OWNERSHIP:** Precise reinforcement of desired results through well-balanced current compensation, long-term stock compensation and relevant feedback systems.
- **SYSTEM:** Consistent management involvement in all facets of the program from communications to coaching.

By implementing these principles, companies accomplish more at lower cost. This is the definition of productivity.

Menke & Associates Inc.'s **PRO**-Productivity System provides a step-by-step approach to controlled implementation of a productivity program rooted in the most fundamental economic truth: **People work best when they work for themselves.**

Since 1974, Menke & Associates, Inc. has been the most active firm in the nation in the design, installation, administration, communication and continuing operation of Employee Stock Ownership Plans. We are a full-service firm which conjoins under one roof all the elements required to create and run a successful ESOP.

For a **free preliminary analysis** of how the **PRO**-Productivity System could work for your company, please call **1-800-347-8357** and speak to one of our representatives.

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