

## **EQUITY: Why Employee Ownership is Good for Business**

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“In recent years a relative handful of companies, including some that we studied, have gone one step further. They rely on all the practices just mentioned, and they are just as dependent as any company on commitment from top management. But they have also learned how to incorporate the expectation that employees will think and act like owners *into the way they operate the company*. They teach employees the fundamental disciplines that drive the business, and then build employee involvement into everyday performance management. *Participation* in these companies means more than serving on a committee or helping to decide your work group’s schedule. It means taking joint responsibility with your co-workers for your part of the business – and for moving whatever needle gauges your unit’s performance. At these companies, a change in senior leadership won’t necessarily mean the end of the ownership culture.

Again, this is an easier notion to grasp when you can see it in practice. Our exemplar this time around is Community Provider of Enrichment Services (formerly Community Psychology & Education Services, but then and now CPES), in Arizona. We’ll describe CPES’s approach and then dissect this third part of our model to see how it works in a variety of contexts.

### **THE NEW ECONOMY’S OTHER SIDE**

CPES represents what might be called the other side of America’s new economy – not the glamorous, high-tech arena but the part in which (mostly) low-wage workers provide hands-on services to people who need them. Thus the fastest-growing markets these days include not just biotech and the Internet but mundane businesses such as home health care and personal services. CPES’s niche, so far, has been to provide care for people with severe developmental disabilities and mental illness – people who find it difficult to get and keep a job, to live independently, or in some cases even to feed and care for themselves. It’s a task that in the past would have been done exclusively by state agencies or by nonprofits, and in some states still is. But governments have been contracting out more of the service-providing chores they once did themselves, and more for-profit companies such as CPES are entering these markets. As the population ages, some of these providers are likely to expand into related but potentially much larger markets, such as the business of taking care of the elderly in their own homes. “There’s a big demand for those services,” says Tom Schramski, cofounder of CPES and until recently its CEO. “It’s going to go through the roof.”

Schramski, born in 1951, grew up in Mankato, Minnesota. As a child, he helped out at the two independent gas stations his father ran. But in 1973 – after “too many twenty-below station openings in the early morning” – he moved to Arizona, completed his BA at Prescott College, and went on to earn a PhD in psychology from the University of Arizona. Entrepreneurship came upon him sort of by accident. In February 1980, the State of Arizona settled a lawsuit brought by advocacy groups for people with developmental disabilities. The state agreed to

phase out the few large facilities in which it cared for these people. Instead, it would seek out organizations that could provide less restrictive community-based care. Schramski and a partner, David Harvey, decided to enter the business, and set up a company they called Counseling & Consulting Services. The market was wide open – “there were only a couple of provider organizations like ours” at the time, says Schramski – and the company grew. Harvey left in 1984 to pursue a consulting practice, taking the name with him. But Schramski stayed on to run the newly christened Community Psychology & Education Services.

The business did well. It grew steadily, if slowly, and it earned modest profits. But there were tensions, both external and internal. On the outside, the State of Arizona, which issued CPES’s contracts, seemed ambivalent about for-profit companies. “In 1992 the state put provider organizations under a microscope,” Schramski remembers.

I was in the paper. Everybody was in the paper. They said things like, “CPES spent \$27.37 on flowers!” Maybe we gave flowers to somebody’s family after somebody died....All this stuff. Even though our rates were the same as every other organization’s. They were trying to drive a wedge between for-profit and not-for-profit.

Advocacy groups and clients families could sometimes be distrustful as well. Are you going to make money off taking care of our daughter? Is it right that you should profit from providing services to these needy people? Internally, Schramski was learning the difficulties of running a service business in which reimbursement rates – hence the company’s revenue – were determined by a penurious government agency. The company could pay its frontline workers only a dollar an hour more than the minimum wage. The work was difficult and demanding, both physically and emotionally. Clients often needed help with the most basic of functions. Some could be obstreperous, sullen, or otherwise “cognitively challenged.” So employee turnover was high. Schramski and his managers were perpetually scrambling to make sure that client care didn’t suffer from the revolving door on the front lines.

At some point in the early 1990s, not long after the state’s investigation, Schramski had an epiphany. Or rather a pair of epiphanies. He read an article about employee ownership and invited one of us (Corey Rosen) to make a presentation on the subject to the company. He read *The Great Game of Business*, in which SRC’s Jack Stack (with Bo Burlingham) explains the system of open-book management he had developed at his company. Employee ownership, Schramski came to realize, would cut right through the for-profit/not-for-profit dichotomy. CPES could continue to operate as a for-profit enterprise, but it would be benefiting the people who actually did the work – hard for either the state or clients’ families to object to. Moreover, sharing the wealth, opening the books, and getting employees involved in the business in the manner described by Stack might cut down on turnover and make for amore stable, more productive organization. Selling stock to an ESOP, not incidentally, would provide Schramski with liquidity and an exit strategy, should he ever decide to move on to something else.

In 1995 Schramski signed the papers to set up an ESOP, selling 50.1 percent of his stock to the plan. Later he sold it the rest, making CPES a company wholly owned by its employees.

That was the simple part, as it turned out. The hard part was helping people on the staff learn to think and act like owners. Employees at CPES were even more uncertain about ownership than employees in more conventional industries. They were particularly leery of anything that smelled of finance. “A lot of us come from a social-work kind of background,” says Bob Bennetti, CPES’s regional director for southern Arizona, “and talking about the bottom line, revenue, margins, and that stuff is – not that it’s hard but it’s almost distasteful, because what people think is that it compromises your decisions in terms of the quality of care. And so I think that was the resistance initially.” Some people left. Others dragged their heels. As at a lot of companies, enthusiasm for the new ideas waxed and waned depending on how hard Schramski and other leaders pushed them. “In the first couple of years, we got people interested in it,” Schramski recalled in late 2003. “Then we had a trough for a couple of years in there, where we didn’t stay at it. And then the last couple or three years, we brought it back.”

Today, CPES could be a poster child for employee ownership in this kind of service business. It has continued to grow steadily: its payroll now numbers more than seven hundred, while its revenues total roughly \$22 million. It has offices in both Tucson – company headquarters – and Phoenix, and it operates close to one hundred group homes and other facilities. Its profits are still modest – caring for this clientele is not exactly a high-margin endeavor – but they are steady, and its stock value has increased. Turnover dropped from 100 percent per year to (at last report) below 60 percent, a huge cost savings and an obvious benefit to CPES’s clientele. A few senior employees already have six-figure balances in their ESOP accounts. When families interview CPES as part of the process of choosing a provider, company representatives let them know that CPES is owned by its employees, and are glad to share the company’s financials with them. “The reaction to the employee ownership has been very, very positive” from families, says Schramski.

But what’s most remarkable about the company is its system of management, which is modeled on the approach taken by Stack at SRC. To get a feel for it, sit in on one of the company’s regional meetings, known as huddles.

## **THE HUDDLE**

This particular huddle – October 23, 2003 – takes place in a big meeting room at the Rodeway Inn, just off the interstate in Tucson. Maybe sixty people are gathered around the tables, which are set up party-style with paper tablecloths. Most are laughing and joking noisily, which to a visitor seems incongruous because the meeting’s ostensible purpose is to review the southern Arizona region’s financial performance for the previous quarter. Equally incongruous, though in keeping with the jovial mood, are the noisemakers, confetti, and cans of Silly String that cover the tables. The group includes Schramski, then still the CEO; Bennetti, the regional director; the other managers and supervisors for the southern Arizona region; a couple of dozen front-line employees, and at least one consumer, which is the word CPES folks use to refer to the people they serve.

It soon becomes plain that this is no ordinary review meeting. The financials projected on a screen up front are simplified: they include eight lines of dollar figures, from revenue to net

operating margin, and a couple of ratios, such as salaries as a percent of revenue. They are broken down by team. (A team is responsible for several care facilities.) Each team's leader walks the whole group through its numbers. The energy level is higher than most companies would see at a meeting to announce bonuses. Good results bring whoops, hollers, rounds of applause. Not-so-good numbers earn the speaker catcalls and shots of Silly String. Every member is compared with the company's plan. Here, for example, is Linki Peddy, associate director for the Tucson area:

OK, these are our numbers for our day service sites here in the Tucson area. We actually did better than we had anticipated, although we're still striving to do better. We thought that we would have an income of \$137,000; we actually brought in \$138,000, even more than that, which put us to the good by \$1,200. Year to date, we're tracking about \$9,700 over what we anticipated.....

For salaries we anticipated that we would be spending about \$98,000; we actually only spent \$88,000....Year to date we're tracking about \$25,000 under what we had anticipated [for salaries]. Salaries as a percent of revenue, we are tracking well below what we had anticipated, which was 71 percent, and we're at 64 percent. [Applause, shrieks.] Buildings and grounds maintenance and repair, we're doing well; we're under what we had anticipated year to date. In fact, the only thing we're running over on is building and grounds maintenance for September. [Noise; someone in the front row shoots Silly String.]

Program support costs [PSC], we're doing better than anticipated: \$2,600 last month, year to date we're tracking almost \$8,000 under what we had anticipated. PSC as a percent of revenue, also tracking below what we had anticipated. Net operating income, we anticipated \$15,000 for the month; we actually made just under \$27,000, and \$37,000 for year to date. So the bottom line is, we anticipated 11.2 percent [and] we actually did 19.5 before administrative expenses; year to date we're tracking about 20 percent. So overall we are doing much better than anticipated, and it's getting better and better. [Whoops, cheers, etc.]

We quote this at length just to underscore a couple of points. Peddy is not a member of CPES's financial staff. Her audience includes most of the managers and supervisors in the region, plus plenty of line employees – people with little or no formal training in finance. Yet all seem to be following the simplified financials that are projected on the screen, and several will themselves take a turn leading the group through the numbers that they are responsible for. Near the end, regional director Bennetti will take people through the region's consolidated financials, again at the same level of detail: performance for the quarter, compared with plan; performance year to date, compared with plan.

After the financials come numbers related to the quality of CPES's services. Licensing violations, if any. (In this business there are always one or two.) Unusual-incident reports, required by the state for incidents such as a client hitting somebody. Staff turnover. Workers' compensation. But then after these numbers comes something quite different: stories of individual consumers and how they are progressing. Harold S. had to leave the family that was supporting him, but is now safely ensconced in a small CPES group home. David P. had been "chased out of his community" because of a couple of incidents; he, too, is now safely in a CPES home. A young woman, a CPES consumer, is brought to a high school football game, where she meets up with her friends, the CPES staff member is able to leave and come back later to pick her up, a sign of her growing ability to function independently. Each story brings applause, laced with hollers of approval. The accounts are heartwarming and poignant, and obviously serve to remind the group of why they're in this business at all.

Finally come a dozen or so awards for employees who have gone beyond the call of duty over the past quarter. Again, different people take turns announcing the awards – but each one calls out, "Drum roll, please", before the announcement, and the assembled men and women beat energetically on the tables with their hands. Marcie Brown, a supervisor at the site known as Coral, gets an award for coming in at midnight one night when the pipes broke, and again when the roof collapsed after a torrential downpour. The "job developers" on Peddy's team – people who help find gainful employment for consumers who are able to work – get an award. So do the three people on the community resource committee – Shannon, Shana, and Jeff – for everything they have done on their own time at the company's community resource center. A picture of a dance at the center goes up on the screen. All told, more than a dozen awards are handed out.

The whole thing lasts a little over an hour. People then help themselves to pizza and soft drinks, provided by the company.

## **KEY ELEMENTS**

That's essentially what's going on at CPES. Scrutinize each element of the approach and you will see how.

## **Establishing Metrics**

Business is a game of numbers, so it is said, and learning to be a partner in the business means learning which numbers matter and what each one means. Typically, equity companies focus on one or a few critical numbers – the numbers that will mean the difference between success and failure – and then help frontline managers and employees understand them. For the ramp and ground-operations employees at Southwest, turnaround time is one such number. For the shop-floor workers at Stone, it's labor variance. For those at Nypro, it's profit per machine and the other numbers that are on the daily report described by CEO Brian Jones (chapter 5). SAIC, which lives and dies with proposals and contracts, has traditionally watched three key operational variables (number of proposals submitted, number of contracts awarded, and time utilization of professional personnel) and three financial ones (revenues, revenue growth, and

profits). “We have a discipline all the way from the division level up” monitoring those figures, says executive vice president Joe Walkush. “We try to keep it simple, just the important numbers.” At one point not long ago, the company realized that its receivables were stretching out too long, so it added one last metric – imputed interest on receivables – to its “watch” list.

CPES looks at those key quality indicators, such as license violations, and a simplified income statement that includes the following line items and ratios:

Revenue

Total sales / ERE (employment-related expenses)

Salaries overtime

Salaries as a percent of revenue

Vehicle maintenance and repair

Buildings/grounds maintenance and repair

Program support cost (PSC)

PSC as a percent of revenue

Net operating income (dollars)

Net operating margin (percent)

Note two things about this selection. One, it focuses on the numbers that matter. There is a *line of sight* between hitting the targets on these numbers and succeeding as a company. In a human services business, these line items, particularly salaries and other personnel expenses, are the key costs, and the difference between making money and not making money lies in controlling those costs. CPES employees know that overtime in particular can be a killer. “People are more willing to help each other out” because they know the numbers, says Steve Ross, a service coordinator. “If somebody’s short staffed and somebody else has extra staff, they’ll help out instead of putting someone in for OT. Program support cost – which Bob Bennetti likes to call an “index of bureaucracy” – is another. So long as the company can control its personnel costs and keep PSC where it belongs, it has a good chance of winding up in the black.

Two, the list focuses on items that employees and supervisors can control or influence without harming quality. Food expenses aren’t on it because the company doesn’t want its staff trying to cut corners with consumers’ diets. But maintenance and repair of facilities and vehicles are numbers that can be watched closely, and are. “It has certainly made a difference in terms of people’s attention – things that you wouldn’t pay attention to ordinarily,” says Bennetti. “Vehicle

maintenance is an example.” At a conventional company, a vehicle in the shop for repairs is a good excuse to rent a nice car – “and what do I care what I’m paying for it, I’ll keep it an extra two, three days. But if I’m seeing the budget every month, I’m more likely to go, ‘I’m going to go bug the mechanic; I got to get that vehicle today.’”

## **Understanding and Communicating the Numbers**

To reach the point where CPES and other open-book companies are today, most companies find that they have to do a good deal of focused financial-literacy training, of the sort discussed in chapter 5. CPES itself began with a modest brochure titled “The Wild and Wacky World of Financial Literacy.” But classes and training programs rarely have any lasting effect unless people get a chance to deepen their knowledge and put it to work – to get some on-the-job training. One of the main businesses of Jack Stack’s company, SRC, is remanufacturing heavy-duty engines for use in trucks and farm machinery. Workers take old, worn-out engines, salvage what they can use, throw out what they can’t, and rebuild the engine using a combination of original parts and replacement parts. In other words, they have to make hundreds of decisions a day about whether it is worth trying to salvage a particular part, or whether it makes more sense to chuck it and put in a replacement. Stack helped them learn the economics of these decisions to compare the price of a replacement part with the labor time (including overhead) involved in salvaging one.

At CPES, frontline supervisors help construct the budgets for their individual services. “We put the budget together from the ground up,” says Schramski. “So that could be a supervisor, GED level, that’s managing a \$150,000 program. And they know their budget backwards and forwards. They’re building in expectations about certain costs – for example, next year they may know their lease is going to go up by \$200 a month. They fill all that stuff in.” For Amy Rubinson, who describes herself as ‘not a big number cruncher,’ the process was an eye-opening. “Having to deal with budgets as a supervisor.... now that everything is open, we can really see the company as a whole and see where the impact is. It has given us a better picture of [what’s going on]. Because you have to fit your needs for your consumers, the ones that you are directly responsible for 24/7, into that whole picture.”

Another way of learning something, of course, is to teach it – and CPES, like most such companies, makes a point of asking many different people to walk their peers through a review of key results. That’s why all the team leaders took a turn at the front of the room, risking the Silly String and catcalls, instead of having a more professional presentation from someone on the finance staff.

## **Managing the Numbers**

The financials, of course, reflect the results of the past quarter or year. Running the business purely on the basis of the financials has been compared to driving by looking in the rearview mirror. So equity companies that use some form of open-book management find ways to track and monitor business performance as it’s happening. They create scoreboards – physical or virtual – to track key operational numbers, such as the week’s shipments or hours billed for

professional personnel. They review financial results as frequently as possible. Cisco Systems is able to close its books on a daily basis. SRC produces an income statement every two weeks. Foldcraft, an employee-owned Minnesota-based manufacturer of restaurant seating and other products (mostly under the name “Plymold”) publishes a month-to-date income statement every week. ECCO, an employee-owned Idaho company that makes backup alarms for trucks and “light bars” for police cars and other emergency vehicles, prepares a simplified income statement every week. CPES holds monthly meetings at which team members review their performance so that they can make adjustments as necessary well before the end of a quarter.

Employees at these companies also learn to look forward – to forecast the key numbers. “When they get the financials [at the end of a month],” says Schramski of CPES employees, “they already know what’s going to be in them....The whole idea is looking forward.” Stack’s open-book system creates, in effect, an ongoing three-part comparison, each part involving employees in managing the numbers from the ground up. One: a participatory budgeting process lays out the plan for the year. (At CPES the annual plan is known as the “stake in the ground.”) Two: weekly, biweekly, or monthly financials show performance to date, compared with plan. Three: a weekly, biweekly, or monthly forecast shows how people think the coming period is shaping up – and thus allows them to make adjustments as necessary before something happens, rather than after.

The adjustments themselves, of course, are the nuts and bolts of frontline management. People figure out ways to bring in a little extra revenue or save a little more money this week. They plan for additional staffing because the next month is likely to be particularly busy. At King Arthur Flour’s retail store, as we saw earlier, it’s a matter of juggling daily sales dollars against daily labor hours. At Stone Construction Equipment, it’s ensuring that labor time is allocated to the products that need to be built that day. At CPES, it’s watching controllable expenses such as overtime hours and maintenance costs, week in and week out, and making decisions about how to manage those costs without compromising care.

This kind of responsibility transforms the meaning of “participative management” in an organization: now employees are participating directly in running their part of the company. Participation is no longer an “extra,” it is an intrinsic part of the way the company operates. The meaning of accountability also undergoes a change. Like any employee, employee owners remain accountable for doing their individual jobs properly. But like any owner, they are now accountable for the company’s business results as well. To be sure, the scope of accountability rises as you go up the hierarchy: only the CEO is accountable to the board for the entire organization’s performance. But now it’s not just executive vice presidents and division managers who are responsible for the performance of subunits; everyone in those subunits is accountable for whatever elements they can control. Thus team members at CPES are accountable for compiling their budget, for tracking their performance against budget, and for managing whatever they need to manage to hit (or better) the budgeted target. That is day-to-day business management

in a nutshell, and the employee owners at equity companies learn to think and act like business-people – like partners in their enterprise.

## REINFORCING THE MESSAGE

The open-book approach not only gets employee owners involved in running the day-to-day business, it also offers a way of cutting through some of the thorny problems that companies of all sorts regularly bump up against. Solving those problems in open-book fashion, moreover, reinforces the notion of employees as business partners. Consider just two examples.

One such problem is *incentive compensation*. “Incentive comp” is one of those carrots we mentioned earlier, and surely generates as much controversy (and uncertainty!) among employees and managers as any other facet of employment. Should we pay bonuses? How much, and to whom? How should the bonuses be determined? What will the bonus be this year? (And of course, “I wonder how much her bonus was compared with mine.”) Open-book management may not end such controversies entirely, but it can eliminate the mystery and murk that surround most incentive-comp programs. Typically, open-book companies tie bonuses to achievement of specific business results over the course of a quarter or a year. They pay bonuses to everyone, usually as an equal percentage of salary or wages, because they operate on the assumption that everyone contributed to the results. Because people can see month in and month out how they are doing on those key performance measures, they can see whether they are likely to earn a bonus.

A bonus adds to whatever compensation may accrue to the employee owners – profit sharing, dividends, increased stock value – by virtue of their ownership. And of course, it is immediate, paid out in cash, which raises its visibility and impact. At CPES, for instance, the institution of a quarterly bonus tied to profit had a dramatic effect. “Suddenly a direct-care person earning \$8 an hour was getting a check for \$150 or \$175,” remembers Schramski. “Do you know what that was like to them? That was employee ownership! It just got people going....It really caught hold.” Amy Rubinson, the supervisor, agrees that the bonus helped transform people’s outlook:

....The quarterly bonus system, I think people are really liking that. And everybody knows it’s based on profit, so even if this home does great, it’s the whole company [that counts]. And they’re seeing, hey, we are getting this money, where the bonus system before, you were nominating people and it was really just not objective enough....everybody’s really getting a piece of the pie this way. And my employees are definitely liking to get those envelopes every quarter. And [they] feel like the company is really coming back down to the line staff and saying, “You’re making this money for us. You’re in there every day, in the housing, and we’re going to recognize you for that.”

In conventional companies, a bonus is in some sense artificial: it is an inducement for employees to behave in a certain way so that shareholders will benefit. In equity companies, it is simply a graphic reminder that everybody is in this together and that everybody benefits when the business succeeds.

A second problem: *initiatives*. Companies have launched so many initiatives in recent years that some have dozens going simultaneously, each with its task teams and rounds of meetings. By now the very word is likely to elicit Dilbert-style eye-rolling. But the idea behind an initiative is simplicity itself: sometimes an organization needs to focus attention on a particular issue to achieve a definable result in a short time frame. It needs to cut costs or boost quality in a given area. It needs to learn a new skill. Troubles arise when initiatives are simply announced from on high and when they bear no obvious relationship to the business disciplines that drive financial performance. Equity companies practicing open-book management try not to make either mistake. They get people involved from the beginning in designing their own initiatives. They link the initiatives clearly to business results.

CPES, following Stack's vocabulary, refers to its initiatives as "minigames." (The "big game," so to speak, is the game of business itself.) In the huddle described earlier in the chapter, Bob Bennetti reserved some time to report the results of the quarter's minigames. Seven facilities won the vehicle-maintenance minigame – that is, keeping the quarter's expenses below a certain level. Each staff member at a winning facility got a coupon for a shopping trip. Stone Construction Equipment doesn't use the same vocabulary, but it does use the same idea. When a particular work cell beats its labor-variance goal for the month, as we mentioned in chapter 2, the managers cook the frontline employees a fancy meal.

We can't leave this topic without going back to those noisemakers and Silly String. How many companies would decide that a financial-review meeting is, well, an occasion for a good time? The mood at CPES's huddle was particularly festive: employees got a free lunch, a chance to let off some steam, and a chance to chat with people from around the company – all while carrying out the serious responsibility of reviewing their organization's performance. We talked about employee groups having fun in the previous chapter, but by and large it was off-site fun, at picnics and the like. CPES shows that work itself can be fun – even when the business at hand is serious."

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