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**Shareholder Value Orientation and HRM in Germany:**  
**Will the German Production Model Prevail?**

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## **ABSTRACT**

Within the context of debates over “varieties” of capitalism, especially the complementarities of corporate governance systems and national production regimes, this paper addresses the consequences of increased shareholder value orientation in Germany on investment in human capital, an underlying pillar of the German production model. Private sector corporations are the focus of this investigation. The discussion focuses on the operational dimension of shareholder value orientation by analysing the effect of shareholder value orientated management control and incentive systems on investment in human capital. For these theoretical connections two explanations are presented. Firstly, as reflections of corporate governance systems, the influence of accounting standards and ownership structures on company’s management control is outlined. Secondly, the relationship between shareholder value orientated incentive structures, investment in long-term and qualitative assets is illustrated. In this view it is argued that changing behaviour in human capital investment on an operative level threatens the prevailing success of shareholder value orientated German companies in producing high quality goods based on incremental innovations.

## 1 Voc

According to the Varieties-of-Capitalism (VOC) approach<sup>1</sup> a worldwide variety of capitalist systems exist, despite increased internationalisation of capital markets.<sup>2</sup> Models of capitalism are seen as nationally specific systems of economic and political institutions with strong interlocking complementarities that influence the behaviour of companies.<sup>3</sup> The idea of complementarities is crucial to the approach.<sup>4</sup> They focus upon five spheres, the spheres of an institutional framework, the system of training and education, industrial relations, corporate governance, and inter-company interaction and argue that these are hardly exchangeable without the whole system collapsing. In a market orientated approach to company strategy, a company strategy is seen to be conditioned by the institutional structure it operates in.<sup>5</sup>

They categorize the different institutional frameworks into coordinated market economies (CMEs) and liberal market economies (LMEs).<sup>6</sup> In LMEs, economic activities are primarily co-ordinated through competitive markets, and are characterized by arms-length relations and formal contracting. More specifically, LMEs typically rely on short-term company financing, monitoring through the capital market, decentralized wage bargaining, lack of codetermination and industry-based apprenticeship systems, strong anti-collision policies, and market-based standard setting.<sup>7</sup> The co-ordinated market economies (CME) depend on strategic interaction and rely on the institutional support available for the formation of credible commitments.<sup>8</sup> Typically, CMEs are associated with, centralized wage bargaining systems, co-operative industrial relations at the micro level, co-operation of firms in education/training and standardization, and an important role of business associations.

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1 The varieties-of-capitalism approach exists in several variants see Jackson 2001. Soskice, 1990, 1999, has developed the most influential approach on different variations of capitalism to date. Aoki 2001, Boyer 2000, Black, Coffee 2000, Hall, Soskice 2001, Jackson 2001; Lane 2000, 1999, Streeck 1995, 1997; Vitols 2001; Whitely 1999.

2 Vitols, 2001, p. 338. Hall, Soskice, 2001, p. 9, 15.

3 Höpner 2001, p. 6. Vitols, 2001, p. 338. Boyer, 2000.

4 Previous research findings of Milgrom and Roberts 1990, 1995, had shown complementarities among particular marketing strategies and forms of production. Hall and Soskice transfer this idea to political economy and see institutions as complementary if the presence of one raises the returns available from the other. Soskice 1996, pp. 40, Hall, Soskice 2001, p. 16–18; Streeck 1992, Hall, Gingerich, 2001, p. 1.

5 Hall, Soskice 2001, p. 15., Zugehör, 2003, p. 20, Hassel, Beyer, 2001, p. 7, Boyer, 2000.

6 Hall, Soskice, 2001, p. 112.

7 See Hall, Soskice, 2001; Hall, Gingerich, 2001.

8 Because instances of market and strategic coordination occur in all capitalist economies Hall, Gingerich 2001 propose to see LMEs and CMEs as two ends of a spectrum rather than contradictions.

## 2 DQP as the dominant company strategy in Germany

Germany is a typical example of co-ordinated market economy.<sup>9</sup> The “German model” refers to the post-war form of capitalism in Germany, which was characterised by regulated capital and product markets, co-operative relations between companies, owners and employees, centralised wage finding and dual system of education.<sup>10</sup>

Within this framework private sector firms had access to long-term, patient capital through a dense network of cross-shareholdings that not only depend on share value but also was expensively monitored through internally.<sup>11</sup> Personnel interlocking enabled the exchange private or “insider” information and tax and accounting regulations made retained earnings to an important source of investment.<sup>12</sup> Thus, managers were less sensitive to current profitability and had higher leeway to invest in project generating long-term returns. With lower pressures to undertake higher-profitability, higher-risk strategies were weaker,<sup>13</sup> and skilled workforce could be retained throughout economic downturns and thereby create trustful work relations.<sup>14</sup>

The high degree of job protection, the right to co-determine company decisions on social and personal issues, secure wages through centralised wage setting on industry level and high degree of responsibility on lower hierarchy levels, encouraged employees to invest in company-specific skills and to engage in extra role behaviour.<sup>15</sup>

While the institutional framework<sup>16</sup> provided companies with long-term patient capital, skilled labour and a high degree of employee commitment, firms also faced with high socially subscribed labour costs and institutional framework, inhibiting radical change.<sup>17</sup> Thus, many German companies competed on a non-price basis resulting in the adoption of quality focused

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9 Hall, Soskice, 2001, p. 4.

10 Zugehör 2003 p. 12; Culpepper 1999.

11 Hall, Soskice, 2001, p. 22

12 Hall, Soskice, 2001, p. 23.

13 Vitols, 2001, p. 352.

14 Aoki (1994) has argued that long-term employment is more feasible if financial systems provide capital on terms that are not sensitive to current profitability. Fluid labour markets may be more effective at sustaining employment in financial markets where resources are readily transferred among endeavours and thereby maintain a demand for labour.

15 Hall, Gingerich 2001, p. 10; Höpner 2001, p. 7.

16 Soskice 1999, p. 109, believes that incentives and constraints are set by a range of market related institutions within which companies are embedded and are summarized as institutional frameworks.

17 See Streeck 1992, pp. 29, 1997.

strategies and incremental innovations. This production of relatively complex high quality products is often referred to as **diversified quality production**.<sup>18</sup>

Competitive advantages through diversified quality production are based on **skilled worker** with industry technology and company-specific product knowledge skills, **work processes** which allow internal flexibility and are **monitored** based on inside often qualitative information, **consensus-orientated decision making**, which is relatively slower, as results have to be negotiated with the relevant stakeholders, but also easier and faster to implement as the negotiation process increased the decision legitimacy and stakeholders are already informed and high levels of **employee commitment**, that is secured by offering long employment tenures, industry-based wages, and protective works councils.<sup>19</sup> Based on the Michigan approach to personnel management, it is assumed that company strategy in turn conditions personnel management. The interrelatedness of the institutional framework, company strategy and personnel management will be exemplified by shortly outlining the importance of training for German firms. Training understood as the learning of work-related skills and knowledge is an important factor for the success of DQP. It is part of a form of personnel management, which recognised the central position of employees' skills and knowledge for business success and see employees as a 'potential, which has to be systematically planned, maintained and developed'.<sup>20</sup> With the adoption of DQP and their need for skilled employees German companies had to offer more training to their employees than companies who prefer mass production.<sup>21</sup> The stakeholder environments offered support for employers to provide employees with general, 'transferable' skills, which are useful to many different employers and 'firm-specific', 'non-transferable', skills, partly, through the apprenticeship training system. This is a dual system, which combines formal vocational education (off-the-job) which is the theoretical education underlying the tasks and on-the-job training, to expose trainees to a range of work situations and problem-solving tasks.<sup>22</sup> Collective agreements on industry-wide wages restrict the possibility to poach generally skilled labour through higher wages and thus provide an institutional infrastructure to avoid market failure of general skills.<sup>23</sup> Chambers lower the training costs for the employers by providing external

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18 Tüselmann, Heise, 2000, p.1.

19 Marshall, 1999.

20 Muller 1999, p. 474; Staehle 1988, p. 576.

21 Ryan 2000, p. 6.

22 Mason et al. 1996, p. 185, O'Sullivan 1998, p. 9.

23 Pepper 1995, p. 1.

advice and monitoring.<sup>24</sup> Employers associations can organise training on an inter-firm basis, which again helps to inhibit poaching and makes investment in general skills profitable for employers.<sup>25</sup> Finally, as the German apprenticeship model only yields returns in the long run, it requires a long-term view on capital.<sup>26</sup>

### 3 Corporate governance

After the short outline of the institutional framework as a basis for a high-skill, high quality strategy, now the role of the corporate governance system in specific will be analysed. Corporate governance is given special consideration because it influences strategic and operative economic activities by determining the availability of finance for long term projects and the criteria of investment evaluation.<sup>27</sup>

Within the numerous definitions of corporate governance, in this essay corporate governance is seen as a part of nationally specific institutional configurations that determine the allocation of resources and returns in corporations.<sup>28</sup> Corporate governance systems are seen to reflect the power relations and political settlements between shareholders, creditors, management, and labour as they are embodied in a particular institutional history, including corporate law, accounting rules, capital markets, financial regulation, and industrial relations.<sup>29</sup>

The relevant literature distinguishes between two main models of corporate governance, the shareholder and the stakeholder model.<sup>30</sup> These differ regarding, **the parties they empower**; the way they offer firms **access to capital**, and the **form of monitoring management**.<sup>31</sup> While the question whose interest should count in deciding how to run the firm, are answered by the different cultural attitudes and theories underlying the concept of the firm, the terms on which firms have access to capital, strongly depend on the monitoring capacities in the economy.<sup>32</sup>

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24 Crouch 1995, p. 297.

25 Thelen 1998, pp. 4.

26 Culpepper 1999, p. 44.

27 Gerum 1992, pp.253, Hall Soskice p. 15.

28 Lazonick, O'Sullivan, 2000b, p. 14.

29 Streeck, Yamamura 2001, Cyert, March 1963; Aoki 1984, Jackson, et al. 2004, p. 4; Deakan, Hughes 1997, O'Sullivan 2000b.

30 Kester, 1996, p. 109, Deakan, Hughes, 1997; Keasy et al., 1997. Schaede, 1995, p. 94.

31 Gospel, Pendleton, 2003 p. 558; Roberts, van den Steen, 2000, p. 3.

32 Hall, Soskice 2001.

### 3.1 Shareholder model

In the shareholder model the firm is viewed as a property of owners, who are the sole risk bearers and only “residual claimants”. Therefore the maximisation of shareholder value is the primary goal of the firm.<sup>33</sup> Based on agency theoretical assumption, the maximisation of shareholder value is facing the following problems: 1) The separation of ownership and control, induced through growing corporation and their need for professional managers and outside capital,<sup>34</sup> 2) the fundamental conflicts in interest between managers and shareholders - shareholders primarily have a financial interest in maximising the value of their shares in the firm, whereas management may be more interested in private consumption or the status enjoyed with creating a large, highly visible company, 3) the infeasibility of complete contracts, which makes it impossible for capital providers to ensure that management behaves in their interest contract-based.<sup>35</sup> To ensure that managers run the firm according to shareholders interest, the **focus** of shareholder oriented corporate governance has been on finding agency costs<sup>36</sup> minimising corporate governance mechanisms.<sup>37</sup>

Because the managerial revolution led to a dispersion of corporate ownership and growing liquidity of the market for corporate shares,<sup>38</sup> this resulted in an absence of shareholders with large stakes, which would have an interest to control management.<sup>39</sup> Therefore, several indirect mechanisms of investment control evolved in the US.

1. Shareholder protection through market-oriented disclosure rules and minority rights.<sup>40</sup>
2. **Markets for corporate control**, discipline managers by threatening to takeover the company, if shareholder value is not maximised. Takeovers mostly target poorly performing firms, and remove the incumbent managers once the takeover succeeds. To avoid the impression of being a non-value maximising firm, and their own jobs, managers are believed to improve returns to capital and de-investment in “underperforming” assets.<sup>41</sup>

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33 Lazonick, O’Sullivan, 2000a, p. 24; Kay, Silberston, 1995, p. 86.

34 Chandler 1980, Lazonick O’Sullivan 2000a, pp. 22, O’Sullivan 2000a, pp. 75-80 documents a rapid increase in ownership dispersion since 1910 and Berle and Means 1932, pp.47 show the huge growth in the average number of individuals holding stock in a public companies.

35 Prowse 1994, p. 11. Vishny, Shleifer 1997, p. 744.

36 According to Jensen, Meckling, 1976, p. 310, agency cost consist of monitoring cost, bonding cost - the cost the agent is willing to incur, either as a guarantee for his interest-conform behaviour or as a compensation for opportunistic activities and residual loss – the divergence between the agent’s decisions making in the interest of the principal and the welfare maximising decisions for the principal.

37 Kester 1996, p. 108.

38 Lazonick O’Sullivan 2000a, pp. 22, O’Sullivan 2000a, pp. 75-80.

39 Prowse 1994, p. 15.

40 Shleifer, Vishny 1997, p. 750; Jackson 2002, p. 127.

41 Franks, Mayer 1990. Jensen 1993. Shleifer, Vishny, 1989; Vitols 2000, p. 2.

3. **Markets for managers** or managerial talent exist in the US as top-managers are mostly recruited externally. If their company is taken over, their reputation is damaged and the prospects for a new job limited.
4. **Incentive systems** that link management compensation to company performance are aimed at creating a direct incentive for managers to maximise shareholder value.<sup>42</sup> By granting stock options or share ownership to top management they are rewarded for increases in net earnings or share price.<sup>43</sup>

### 3.2 Stakeholder model

This model of corporate governance involves a wider constituency of stakeholders, and is designed to maximise the joint welfare of the involved stakeholders.<sup>44</sup> The underlying belief of the stakeholder model is that besides shareholders employees can also be residual claimants. Because employees invest in their own "human capital", part of which is firm specific, they also bear some of the risk associated with the enterprise and should therefore be treated as a valuable resource.<sup>45</sup> Thus, corporate governance practices are characterized by structures that limit the influence of shareholders and distribute power among involved stakeholders, namely managers, employees and investors.

Deep linkages between financial and industrial companies provide a mechanism to regulations that promote dispersion of power between the stakeholders and protect the company network against invasion from the outside.<sup>46</sup> Investors seem to pursue "strategic goals" related to organizational strategy and long-term relational incentives rather than shareholder value maximisation goals.<sup>47</sup> This strategy fosters the building of stable, long-term relationships, in which capital providers have the incentive to intensively monitor and the power to control management. The monitoring is based on 'inside' information about the operation of the company and takes place in the supervisory board.<sup>48</sup> The supervisory board is part of the two-tier board structure of quoted German companies and its legally prescribed composition allows employees' to co-determination.<sup>49</sup>

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42 Murphy 1985; Jensen and Murphy 1990, Jensen and Meckling 1976, Fama 1980, Shleifer, Vishny 1989; Jensen 1989; Lazonick, O'Sullivan, 2000b. Frank et al. 2001.

43 Rappaport, 1999, p. 4.

44 Jackson 1997, p. 9.

45 Blair 1995, p. 15, p. 238.

46 Höpner, Beyer, 2003, p. 179.

47 Höpner, Jackson, 2001, p. 6.

48 Kester 1996, p. 108, Stiglitz 1985, Blair et al. 2004, p. 3.

49 Soskice et al. 1997, p. 11; Tuschke, Sanders, 2003, p. 633, Goergen et al. 2004, p., 13. Depending on the size of the company 50% of the supervisory board members must be employee representatives.

This form of monitoring gives management the leeway to focus on generating long-term returns, especially on creating human capital, which has commonly been identified as one of the key areas influencing the company's long-term success.<sup>50</sup> Thus, the stakeholder model can be seen as a key factor for the success of the DQP, as it provides patient capital for long term projects and allows investment evaluation based on inside information. These are necessary conditions in which employers can make a long term commitment to security, and therewith enable sunken human capital investments and consensus orientated decision making, both central pillars of DQP.<sup>51</sup>

### **3.3 Accounting as reflections of corporate governance models**

To provide share- and stakeholders with the information necessary to enact either form of control is a task, which falls into accounting's area of responsibility. It does so by translating physical economic processes into financial figures. Thereby, accounting provides the basis of communication and information through which company-internal and –external interaction takes place. Accounting can be differentiated into financial reporting and management accounting. Financial reporting addresses the information needs of “outsiders”. It protects providers of capital by decreasing their informational asymmetry.<sup>52</sup>

Management accounting provides financial information within the organization to enable better decision-making.<sup>53</sup> Management accounting encompasses techniques, which are calculative practices to document economic operations and management control systems and which draw upon management accounting information to control divisions, teams or employees' performances.<sup>54</sup> Management control systems can be understood as a broad set of control mechanisms designed to ensure that work activities and subunits fulfil the company goals by providing the information about performance and systems enabling managers to correct deviations from established plans.<sup>55</sup> Budgeting usually is the integral part of systems of accountability. The budget is one of the most important communication devices within an organization and is intimately related to the process of organisational control.<sup>56</sup> The way the

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50 Ferner, Varul 1999, p. 2; Pfeffer 1996, pp. 600; Huselid 1995, pp. 635.

51 Hall, Soskice, 2001, p.25.

52 Lewis, Pendrill 2000, p. 4.

53 Bradley 1997, p. xx.

54 Groot, Lukka 2000, p. 1.

55 Otley, Broadbent and Berry, 1995, p. 532, Whitley, 1999, p. 511.

56 Wilson and Chua 1988, pp. 235.

budgeting process is carried out, the importance of keeping the bottom-line, the restrictiveness of budgets and its linkage with reward systems influences management behaviour.<sup>57</sup>

### **3.3.1 Financial reporting and management control systems**

Roberts and Scapens argue that accounting is a central intermediary variable between a firm and society. They see financial reporting rules to embody societal approaches to time and space, which are transmitted into the organization by being reproduced in the internal control systems.<sup>58</sup> According to this **the time-horizon with which investors** judge top-management's performance as well as **the importance of accounting information** in this process of control becomes constitutive for the internal system of accountability. If accounting information serves as the main instrument to control management activities, accounting measures rather than the production process will be perceived as reality of the organization and behaviour will adapt accordingly.<sup>59</sup>

### **3.3.2 Accounting in Germany**

According to the central feature of the stakeholder, financial reporting reflects the responsibility of a company to consider a broad range of stakeholder groups.<sup>60</sup> The outlined ownership structure explains the low demand for publicly accessible information. Thus, accounting standards give greater discretion to managers in deciding when economic gains and losses are incorporated in accounting income.<sup>61</sup>

The politically prescribed dominant objectives of German financial reporting are to determine a distributable income for owners without harming the position of other stakeholders, to safeguard creditors' interest, and to preserve nominal capital. This has been prioritised over the transparency of the real economic situation, and the provision of relevant, timely and unbiased information.<sup>62</sup> These objectives concretise themselves in the central principle of conservatism, which creates a tendency to undervalue assets and overvalue liabilities and thus understate the company value and create hidden reserves.<sup>63</sup>

Management control is characterised by the central importance of technical competence, consensus based decision making and control systems aimed at groups, wide control spans,

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<sup>57</sup> Collins 1982, p. 113.

<sup>58</sup> Roberts, Scapens, 1985, p. 443-456; Ferner, Varul 1999, p. 5.

<sup>59</sup> Ahrens 1999, p. 106; Joseph et al. 1996, p. 73; Kaplan 1984, p. 409.

<sup>60</sup> Brotte 1997, p. 25.

<sup>61</sup> Ball et al. 2000, p. 3.

<sup>62</sup> Haller, Walton 1998, p. 5.

<sup>63</sup> Haller 1998, p. 98.

and low supervision.<sup>64</sup> This implies that financial figures computed on the basis of accounting information play a much less important role in monitoring employees than in American firms. In his study Ahrens found that German management accountants emphasise the integrity of the operational process and express their indifference towards accounting information, which does not mirror the underlying operational economics of the organization.<sup>65</sup> In the German literature the task of accountants is described as that of a neutral expert with technical expertise but no pretension to judge business decisions.<sup>66</sup> A comparative study by Strange concludes that German management accounting is more modest in its goals, more restricted in its use, and accounting concepts mirrored operational processes more accurately, while British management accounting overemphasizes the single-minded pursuit of profit.<sup>67</sup>

The lesser dominance of accounting in German accountability can be explained by the closeness of supervisor and supervisee. The salient feature of accountability in circumstances with frequent face-to-face contact is that accounting information is interpreted and understood within the shared context of mutual knowledge. Supervisees can anticipate the significance the supervisor will attach to the result. Information is not one-dimensional and has the room to explain their actions and the potential for misunderstanding is limited.<sup>68</sup>

### **3.3.3 Accounting in the US**

Due to the dominating position of shareholders in the US and the strong tradition of gaining capital through the public market American financial reporting is investor-orientated.<sup>69</sup> The corporate report serves as the basis upon which investors monitor management and compare investment opportunities meaningfully.<sup>70</sup> Therefore, financial reporting rules are very detailed, allowing management little room for discretion.<sup>71</sup> Financial reporting is expected to provide timely, reliable and relevant information about the firm's financial performance during a period. To ensure timeliness of information and account for the relatively shorter time horizon of investors, companies are to disclose quarterly reports. Information about enterprise earnings is based on the accrual accounting as this provides a better indication of the company's present and continuing ability to generate favourable cash flows.<sup>72</sup> Considering

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64 Soskice et al. 1997, p. 14. Sorge 1995, p. 250; Lane 1992, p. 41. Marsden 1999, p. 12.

65 Ahrens 1999, p. 102.

66 Wimmer, Neuberger 1998, p. 465.

67 Strange, 1991.

68 Roberts, Scapens 1985, p. 452

69 Heintges 1997, p. 167

70 Meek, 1998a, p. 175. FASB, 1978, No. 1. Nobes, 1998 pp. 63, Haller, Walton, 1998, p. 3.

71 Heintges 1997, p. 33.

72 Nobes, 1996, pp. 106.

the central position the corporate report plays in the monitoring of management by investors, it can be expected that the outlined characteristics of the external accounting system be reproduced in the company-internal control system.<sup>73</sup>

Ferner and Varul argue that these quarterly time horizons and utmost importance of financial figures cascades down into the internal organization of firms and that this becomes most evident in the role that management accounting plays in American companies.<sup>74</sup> In his study Ahrens found that in Anglo-American firms, accountants take part in management decisions, creating pressures on managers to consider the bottom-line implication of their actions. He also gained evidence that the perceived substantiality of accounting is relatively higher than to what is perceived as operational and economic concerns.<sup>75</sup> Investment appraisals prepared by management accountants, for example, are perceived as spurious by non-management accounting, especially engineers.<sup>76</sup>

Even though the limits of accounting as a mirror of productive reality are widely known, in the US this has simply lead to an overemphasis on financial figures. This has given rise to a control system based in financial measures referred to as “management by numbers”.<sup>77</sup> In this form of accountability calculated accounting information becomes the principal bearer of knowledge. Due to the one dimensionality of the information the potential for misunderstandings between employee and employer rises.<sup>78</sup>

### **3.4 Incentive systems**

Compensation practices have been identified as an important economic device of firms to align interest of employees with the firm.<sup>79</sup> Employees can be rewarded input based through time-based pay systems, in which they receive a fixed income, or output based through performance related pay.<sup>80</sup> All wage components which depend on individual achievements, ranging from traditional piecework to different systems of reward linked to appraisal and income-relevant forms of management by objective, on the firm’s or its subdivisions’ performance, such as profit-sharing, annual bonuses or employee ownership plans, or on

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73 Coates et al., 1996, p. 14.

74 Ferner, Varul, 1999, p. 5.

75 Ahrens 1997, pp. 103, 139.

76 Currie 1995, p. 344.

77 Ezzamel et al. 1990, p. 153.

78 Roberts, Scapens 1985, p. 452.

79 Goergen et al. 2004, p. 15., Prendergast, 1999, p. 7.

80 Graßhoff, et al., 2000

discretionary subjective measure of performance, are classified as performance-related pay.<sup>81</sup> These diverse means of compensation provide different incentives for employees to exert effort and to allocate their time.<sup>82</sup>

### **3.4.1 Incentives in Germany**

Reflecting the institutional framework German firms operate in, the traditional German incentives system was characterised by low dispersion of wages between individuals, industries, and firm size and a low degree of individualized wage components or remuneration schemes depending on company success or individual achievement.<sup>83</sup>

Management compensation reflected the long-term strategic interest of capital providers. The concern about linking compensation to economic performance was low, compensation parts contingent on the financial success of the company small and managers usually provided with long-term employment contracts.<sup>84</sup>

For non-management compensation collective bargaining played and still plays an important role in German remuneration practice. Regional industry-level collective agreements between unions and employers' associations determine wage levels. Collectively bargained wages usually account for at least 90 percent of actual pay. Also, principles of remuneration including the introduction and application of new remuneration methods are subject to the co-determination rights of the works councils. Works councils often oppose performance-related pay because of its flexibility over time, and worker's risk of losing compensation in economic downturns.<sup>85</sup>

### **3.4.2 Incentives in the US**

In the shareholder model, stock-based incentives are used as a governance substitute for the lacking monitoring efforts by large and powerful owners. The stock-based incentive pay is generally added on top of salary and bonus pay.<sup>86</sup> The trend towards variable pay seems to be unbroken and increasing and American CEOs are among the highest paid.<sup>87</sup> Especially, stock options are prevalent for chief executives in the US and have grown steadily since the 1990s.

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81 Kurdelbusch, 2002, p. 326.

82 Prendergast, 1999, p. 8.

83 See Hall, Soskice 2001, p. 24

84 Shonfield, 1992, p. 169.; Basic compensation accounted of German managers accounted for 47% of the total pay package, while American managers only have 28% fixed in a study by Kraft, Niederprüm 1999, p. 24.

85 Kurdelbusch, 2002, pp. 325-29,

86 Tuschke, Sanders, 2003, p. 634.

87 Lebow et al., 1999.

By 1999, 94 per cent of the Standard and Poor 500 companies granted options to their top executives, and the value of these awards accounted for nearly 50 per cent of total CEO remuneration in these firms.<sup>88</sup> Previous empirical evidence also found that, compared to German firms', compensation was strongly linked to individual performance; performance appraisals were more frequent and emphasize individual achievement.<sup>89</sup> There is a high wage inequality between senior executives and shop floor workers. Non-managerial wage setting takes place on the firm or plant level with low unionisation in the private sector.

## **4 Increased shareholder value orientation of German companies**

Until the beginning of the 1990s the German model was remarkably stable. With increasing internationalisation of companies and markets in the 1990s, however, changes in the institutional framework as well as in company behaviour towards more market orientation have occurred.<sup>90</sup>

### **4.1 Indicators of increased shareholder value orientation**

In recent studies on corporate governance in Germany first empirical evidence has been found that there is a trend towards more shareholder value orientation in Germany.<sup>91</sup> Companies have increased listings in foreign stock exchanges, have set up investor relations departments aiming at international investors, and have introduced international accounting methods and quarterly reporting, stock option schemes for management and employees, and profit targets.<sup>92</sup> In the following it will be outlined, what evidence these empirical studies have found so far. The adoption of international accounting rules, and the introduction of profit targets, value based management systems and variable managerial compensation are seen as key indicators for the adoption of shareholder value orientation.<sup>93</sup>

#### **4.1.1 Accounting rules**

To present themselves for international capital and to satisfy the informational needs of the rising institutional investors in the German capital market, transparency of financial results and earnings prospects has become a paramount imperative for shareholder value orientated German companies.<sup>94</sup> Therefore several German companies have chosen to disclose their annual report according to US GAAP or IAS instead of the tax-dominated, insider- and

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88 Gospel, Pendelton, 2003, p. 559.

89 Ferner, Varul 1999, p. 5; Wever, 1995, p. 614.

90 Jackson 2001; Jürgens et al. 2000; Perlitz et al. 1997; Vitols 2000; Streeck 2001.

91 Höpner 2001 Lane 2000, Jackson 2001; Jürgens et al. 2000; Vitols 2000.

92 Jürgens 2000 p. 16., Deutschmann, 2000, p. 2, Jürgens 2000, p. 16.

93 Höpner 2001, p. 11. 2003, pp. 36-67. Jürgens et al. 2000; Lane 2000; Vitols 2000.

94 Deutschmann 2002, p. 3.

creditors-oriented German accounting.<sup>95</sup> These accounting principles allow a more accurate attribution of costs and profits to the appropriate reporting period, and give investors a quarterly picture of the firm's performance.

#### **4.1.2 Management control and profitability goals**

The introduction of value based management systems and profit targets symbolises to the operational dimension of shareholder value.<sup>96</sup> To ensure, that shareholder value is created the impact of business decisions is assessed on future, discounted cash flows. German shareholder value orientated companies have started to introduce such systems. These value based management systems include the "initial" Discounted Cash Flow (DCF) approach by Rappaport; the Cash Flow Return on Investment (CFRoI) method, the Return on Invested Capital (RoIC) method; and the Economic Value Added (EVA) approach, which seems to be the most frequently used.<sup>97</sup>

In addition to introducing value based management concepts often profitability goals, i.e. "hurdle rates" companies must fulfil to satisfy the shareholders' demands for business segments or the whole company, have also been implemented in shareholder value oriented German companies.<sup>98</sup> Almost all of the DAX 30 companies publish financial targets, many of which are specified in terms of return on capital or assets often accompanied by declarations to sell under-performing company units in the future.<sup>99</sup>

#### **4.1.3 Management reward**

With increasing shareholder value orientation the late 1990's, sharp rises in the remuneration of German senior managers have been documented. In some companies the average rise for board members from 1996–1999 was more than 100 per cent.<sup>100</sup> Variable salary component with long-term incentive effects such stock options, share-related bonuses or employee share-ownership plans, account for these rises.<sup>101</sup> They are key characteristics of a shareholder value-orientation,<sup>102</sup> and have become more popular in German management compensation practice.<sup>103</sup> Top management compensation is linked to the capital market value of the firm, operative profitability indicators or partly substituted by shares, to create an incentive for

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95 Hassel et al., 2003, p. 712.

96 Rappaport 1999, p. 192.

97 Höpner 2001, p. 11.

98 Glaum 1998, p. 56–58;

99 Jürgens, Rupp 2001, p. 34.

100 Almond et al. 2003, p. 439.

101 Jürgens, Rupp 2001, p. 37.

102 Rappaport, 1999, pp. 133–158.

103 Lane, 2000, p. 220; Glaum 1998, pp. 58; Pellens et al. 2000, p. 46.

management to maximise shareholder value.<sup>104</sup> Empirical evidence has been found that especially firms with dispersed ownership are the most likely to implement stock-based incentives.<sup>105</sup>

The increase in variable pay of managers seems to “trickle down” to all company employees. Several German companies have re-designed the remuneration system for all employees by introducing flexible wage components or rearranging company-specific payments to employee shares, stock options or company wide bonus systems.<sup>106</sup> In company wide bonus systems, for example, every employee receives payments if the company achieves the specified business goals. While employees covered by collective agreements often receive these payments on top, management remuneration often substitutes parts of fixed wage for performance-related payments.<sup>107</sup>

## **4.2 Determinants of increased shareholder value**

In the literature two main factors can be seen as the cause of increased shareholder value orientation. Vitols and Lane have interpreted shareholder value strategies as responses to product market changes,<sup>108</sup> while the literature on Anglo-American funds describes changes in financial patterns as driving forces behind the changes taking place in Germany.<sup>109</sup> Streeck has presented descriptions and empirical evidence that developments in Germany such as the exhaustion of the German model, and shock of unification as well as the internationalisation of production and financial patterns are seen as potential destabilisers.<sup>110</sup> Höpner identifies management action and the internationalisation of production and finance as the main drivers for increased shareholder value orientation in Germany.<sup>111</sup>

### **4.2.1 Capital market induced shareholder value orientation**

Caused by the increased competition in the financial sector and international competition via the globalisation of capital markets, German banks have started to become more active as shareholders since the late 1990s.<sup>112</sup> Facing narrowing margins in their conventional business German banks have decreased their ties with industrial companies and increasingly focused on more short-term profit oriented investment bank strategies, which avoid the risk to bail out

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104 Graßhoff, et al., 2000, Deutschmann 2002, p. 3.

105 Tuschke, Sanders, 2003, p. 636.

106 See Kurdelbusch, 2002, p. 332 for a list of companies that have introduced variable pay since the mid 90s.

107 Kurdelbusch, 2002, p. 332.

108 Vitols 2000, Lane 2000.

109 Nölting 2000.

110 Streeck 1997, 2001.

111 Höpner 2003.

112 O’Sullivan, 2002c p. 281; Gospel, Pendleton, 2003, p. 572.

failing firms.<sup>113</sup> Due to the higher concern about the yield on assets they hold, rather than about relationship-cementing value of their equity holdings the watershed in German banking system begins. As close ties with industrial companies, i.e. the protection of domestic industrial companies as a business objective, are not compatible with the acquisition of orders in international investment banking a major sell-off of equity holdings by banks has taken place.<sup>114</sup> This trend was favourably influenced by changes in the German income tax law, which grants tax-favoured treatment for gains realised upon the disposition of shares. Also, large banks started to reduce their supervision of industrial companies by abolishing interlocking directorates by retreating from non-financial supervisory board chairs. A similar development can be seen in the large insurance companies.<sup>115</sup>

These developments have led to a changed approach from German banks to control their investments. Traditionally, the equity stakes and the loans granted to the corporation were safeguarded by having access to critical information about the company, mostly through representatives who are key members of the supervisory board.<sup>116</sup> With the decrease of debt and equity held by banks and reduced intercompany-shareholdings this close and intensive form of monitoring becomes inefficient.

Simultaneously, national and international institutional investors continue to rapidly grow in Germany.<sup>117</sup> The shares held by these institutions rose from only 12% of shares traded in Germany in 1990, to 22% in 1997 and in 1999.<sup>118</sup> Also German individuals themselves are increasingly investing in shares. The averaged equity holding has risen from 10% of disposable income to 22%.<sup>119</sup> Without underestimating the complexity of investment strategies among institutional investors, in practice,<sup>120</sup> these actors prioritise shareholder value

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113 Jürgens 2000, Deutschmann, 2001, p. 2.

114 Höpner, Krempel 2003, Dore, 2000, p. 178; Beyer and Höpner 2003; Dziobek and Garrett 1998.

115 Beyer, 2002.

116 Finegold, Soskice, 1988, p. 29.

117 Höpner, M. 2001, p. 13.

118 Soskice et al. 1997, p. 9, Krahen, Schmidt, 2004, p. 35.

119 Dore, 2000, p. 178.

120 Unit trusts and mutual funds are market-oriented as they directly compete for domestic savings on the basis of performance. Pension funds can also be classified as market-oriented as their contracts are awarded on the basis of investment performance. While, directly managed pension funds tend to favour voice to gain directly from monitoring and Insurances, use voice as well as exit in governance, as their claims are fairly predictable and long-term. See Black, Coffee 1994, pp. 2057–8. And while a significant secular increase in large-block shareholding with sharp percentage increases in holdings by mutual funds, partnerships, investment advisors, and employee benefit plans could be documented by Blair et al., most institutional investors, when they purchase large blocks, sell the blocks relatively quickly—too quickly to be considered relational investors. See Blair et al., 2004, p. 27.

and liquidity.<sup>121</sup> They normally take a portfolio approach to risk dispersion by spreading their investments among a large number of companies and pressure firms for quarterly improvement in earnings.<sup>122</sup>

In an investigation on the shareholder value orientation of German companies Höpner supports these arguments by empirical evidence. He finds that, especially the degree of share dispersion and the percentage of shares held by institutional investors have a strong impact on shareholder value orientation.<sup>123</sup>

#### **4.2.2 International product market competition**

The increasingly international competition on product markets since the 1990s is seen as another determining factors for shareholder value orientation.<sup>124</sup> Recent changes in the global economic and technological environment and a sharp recession in the first half of the 1990s have induced many German firms to expand their foreign investment and co-operations, to change their internationalisation strategies,<sup>125</sup> and to profound organisational restructuring, with a view to improve global expansion and responsiveness by segmenting their operations in business units or decentralized parts of the company to profit centres.<sup>126</sup>

According to these findings shareholder value orientation is also a reaction to external competitive pressures. In highly competitive markets managers can only secure their jobs through high profitability orientation.<sup>127</sup> To realise this profitability orientation many German companies have chosen the introduction of financial indicators, which symbolises the operational dimension of shareholder value orientation.<sup>128</sup>

Based on the evidence gained from Höpner's study it can be concluded that both development, increased pressures from international product markets competition as well as capital market pressures from institutional investors on selected German companies can explain their increased shareholder value orientation. He finds that 66% of the variance of

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121 Gospel, Pendleton, 2003, p. 572; Thomson, Pedersen., 2000, p. 689.

122 Soskice et al. 1997, p. 9, Deakin et al., 2001, p. 4.

123 Höpner, 2003, pp. 97- 102. creates an index for shareholder value orientation, based on the information quality of the annual report which is strongly influenced by the application of international accounting standards, the existence of an investor relations department, the introduction of profit targets and variable compensation systems.

124 Vitols, 2000, p. 1; Höpner 2001, p. 8; Lane, 2000, p. 210.

125 Lane, 2000, p. 214.

126 Jürgens, Rupp 2001, p. 34.

127 Januszewski et al. 1999.

128 Höpner 2003 p. 92, Rappaport 1999.

shareholder value orientation can be explained by the percentage of shares held by institutional investors and their affiliation to the export sector.<sup>129</sup>

#### **4.2.3 Management as a driver of shareholder value orientation**

So far the shareholder value has been presented as an externally induced concept used to discipline managers and to ensure their focus on shareholder value.<sup>130</sup> Concluding that managers oppose the shareholder value concept as it potentially limits their leeway to act, management has been readily accepted the externally initiated concept. Shareholder value orientation can be seen as a management concept that has gained great popularity among German managers in the late 1990s.<sup>131</sup> Through case study research it was found that the introduction of shareholder value orientated practices and processes were initiated to a great extent by company management.<sup>132</sup>

The reasons for this seem to lie in the following developments. First, an increase in business graduates as CEOs has taken place, so it is easier for management concepts based on financial indicators to gain acceptance. The formerly science or technically oriented managers had preferred concepts, which emphasised technical and growth oriented success rather than financial figures.<sup>133</sup> At the same time the importance of an external labour market for CEOs has increased in the 90s and the average time of employment has decreased and the competitiveness among top-managers has increased. Financial indicators make performance of different sectors comparable.<sup>134</sup> In addition, the decreased internal monitoring by banks entailed a retreat from seats on supervisory boards. The voids have readily been filled by former top-managers of the concerned companies. This trend has led to a change in monitoring, namely to decrease internal and increase external monitoring. Thus, shareholder value orientation does not decrease management's leeway to act but holds certain attractiveness for them.<sup>135</sup> In previous empirical studies it was found that the lack of a main block-holder increases managers base salary and shareholder value strategies increase the variable compensation parts, as variable compensation mostly takes the form of an on-top payment rather than substituting fixed pay.<sup>136</sup>

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129 Höpner 2003 pp. 102.

130 Jensen, Meckling, 1976, 328-330, Jensen 1993, pp. 850, Shleifer, Vishny 1996.

131 Wiwo 1.6.2000, S. 96ff.

132 Jürgens, Rupp 2001, p. 34.

133 Bleicher, 1983, p. 135. Sorge 1999, p. 143.

134 Hassel et al., 2003, p. 707; Höpner 2003 p. 131

135 Handelsblatt 17.4.2000, 53

136 Kraft, Niederprüm 1999, p. 24, Schmid, 1997, p. 77.

Contrary to the assumption that shareholder value limits managers' leeway to act by emphasising their focus on profitability and maximisation of shareholder value, it serves management's interest from a compensation point of view. Through international competition and the changes in the capital market management leeway has been limited in the way that they have to consider the development of the market capitalisation of their company, i.e. the shareholder profit when making investment decisions. The idea that management therefore opposes the shareholder value concept doesn't seem to be entirely true as compensation increases.<sup>137</sup>

#### **4.3 Increased shareholder value orientation of German companies: consequences on human capital as a central pillar of DQP**

During the 1990s the shareholder value concept, which stresses financial mobility, has become prominent with German managers, bankers and academics, who regarded provision of the "patient" capital based on the close relations of bank and industry as the critical strength of the German system in comparison to the US. The argument was based on the belief that the dominant German production strategy was based on **skilled human capital, consensus-orientated decision making and co-operative employee relations**, all three of which required a long-term perspective and investment criteria not solely based on publicly available information.<sup>138</sup>

Critics of the shareholder value concept fear that increased shareholder orientation will lead managers of publicly-quoted corporations to maximise the net present value of the assets under their control or distribute profits to shareholders, rather than retain profits for reinvestment, and thereby sacrifice beneficial long-term projects and investments.<sup>139</sup> Hutton, for example, argues that the greater the shareholders' and the stock market's influence on the formation of the companies' objectives,<sup>140</sup> the more managers can be expected to focus upon the periodic maximisation of shareholder-oriented performance measures, making long-term strategic undertakings and investments in human capital, i.e. in training, extremely difficult.<sup>141</sup>

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137 Höpner 2003 p. 139.

138 O'Sullivan 2002c, p. 257; Lane, 1989, 1995; Sorge, Warner 1986; Stewart et al. 1994; Soskice 1990, Finegold 1991, p. 9. Finegold 1996, p. 236.

139 Useem, 1993, The proportion of disturbed profits from American firms rose from an average of just under 50 per cent in the 1960s and 1970s to around 70 per cent in the 1980s and 1990s O'Sullivan, 2000a. Almond et al. 2003, p. 432.

140 Hutton, 1995, p. 156.

141 Finegold, Soskice 1988, p. 29.

The notion of a decreasing time horizon has been referred to as short-termism and can be defined “as representing decisions and outcomes that pursue a course of action that is best for the short term but suboptimal over the long term”<sup>142</sup> or simply as “giving more weight to the near term than is justified by the cost of capital”<sup>143,144</sup>. The existence of short-termism has been examined by testing the efficiency of the capital and the test implies that in general capital markets are inefficient, meaning that share prices do not correctly reflect both the short- and long-term prospect of a company.<sup>145</sup> When criticising varying time horizons, one has to be careful not to generalise, claiming that ‘short-term’ is generally imprudent and bad and long-term horizons are wise and good. In this essay it is argued that in the interrelated relationships of the institutional framework, the wide adoption of DQP and a high commitment approach to personnel management, changing time horizons of investors, may cause a misfit between these elements.<sup>146</sup>

Despite worries about changing time horizons, the consequences of shifting investment evaluation criteria are also discussed.

Based on the above-mentioned theoretical insights it was concluded that the way on which top management is monitored is transported into the company through controlling and incentives systems. These systems define middle management’s discretion and incentives to engage in long-term not directly financial performance boosting activities.<sup>147</sup>

In the following, hypothesis on possible effects of increased shareholder value orientation, namely the adoption of international accounting practices, and the introduction of profit goals and performance related wage components on investment in human capital, specifically in-house further training are generated.

#### **4.3.1 Impact of ownership structure and financial reporting**

Various authors have started to consider the impact of corporate governance on personnel management, in the last years. O’Sullivan, Lazonick were one of the first authors to investigate a causal connection between ownership structure and personnel management. In

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142 K.J. Laverly, 1996, p. 826.

143 Marsh, 1992, p. 447

144 For causes and consequences of short-termism also see Marsh, 1992, Jacobs, 1991, Porter, 1992, p.16.

145 Marsh, 1992. Fama, 1970, 1991. Segelod 2000, p. 2.

146 This approach is based on Hall, Soskice’s, 2001, pp. 12 that the individual spheres of an institutional framework are not exchangeable without the whole system being endangered of collapsing.

147 Ferner, Varul 1999, p. 5.

their study of structural changes in the American capital market from 1920 to today, they found that long-term HR policies in American firms only started to disappear with the erosion of corporate bonds which provided a source of long-term finance to US firms and the rise of institutional investors, who tend to rearrange their portfolios in search of higher yields, and thus pressure companies to maximise their short-term returns.<sup>148</sup> Bolton and Scharfstein also found that relational financing provides more security for the firm, with the result that managers have been less prone to cut investment in training when there are cash-flow shortfalls.<sup>149</sup> The changes in German capital market and the possible effect of changing investment evaluation criteria are furthered by the adoption of international accounting standards. The more accurate attribution of cost and benefit to its appropriate time period as well as the quarterly disclosure information of the company's performance further limits management's ability to take a long-term perspective on investments. Many HR activities, especially training and commitment require a long-term approach, however, as a time-lag exists between the input "the qualification", for example, and the output as the benefit the companies can draw from better educated more committed employees.<sup>150</sup>

#### **4.3.2 Impact of new controlling systems**

The potential influence of shareholder value orientation controlling systems on long term human resources practices derives from the explanation that the pressure from the stock market are transmitted into to the company, through the use of the discounting cash flow technique (DCF), hurdle rates and short-term horizons leading to a prioritisation of cost reduction over long term investments.<sup>151</sup> The DCF technique is believed to make managers focus on measurable effects, evaluate individual projects without their contribution to the long-term development of the firm.<sup>152</sup> Baldwin and Clark found that the decentralised type of capital budgeting used by U.S. firms, specifically the screening of investment requests through systems of classification and levels of authorization tends to promote investments in assets which are easy to measure and classify, and exclude investments and in intangibles, and capabilities such as flexibility, knowledge and innovation.<sup>153</sup> This formal budget setting and review processes results in a tight control of labour costs in American firms.<sup>154</sup> Because these firms typically do not rely on the initiative and commitment of their workforce, and

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148 O'Sullivan, Lazonick, 1996, 2000a.

149 Bolton and Scharfstein, 1998, p. 106.

150 Bröckelschen 1998, p. 150.

151 Dearden, 1969, 124, Thomkins, 1973.

152 Hayes, Garvin, 1982. Skeddle, 1973, Gold 1976, Hill, 1989.

153 Baldwin and Clark 1994. Segelod 2000.

154 Armstrong et al., 1996; Marginson et al., 1993.

employees have a relatively short tenure. For German firms, who strongly depend on employees' skills and long-term contribution, however, this type of management control seems likely to cause a misfit.<sup>155</sup>

In addition to a tighter, more formalised budgeting process, a changing focus on the object of control, from production-orientated goals to financial indicators, can also be observed.<sup>156</sup> The increased importance of accounting information in monitoring top and middle management influences HRM as most HR information is qualitative, i.e. their returns are difficult to measure.

It has been shown that in American firms' managers are mainly controlled and assessed based on a set of financial indicators and that has led to a "management by numbers" as the dominant form of monitoring. A result of the dominance of financial figures in assessing and rewarding top and middle level managers based on financial figures, they may perceive the accounting information to correctly reflect the economic reality. Line or division managers usually are not involved in the production process and performance is measured across distance. Mutual knowledge about how the accounting information is interpreted and understood is relatively absent. For divisional managers the received accounting information may be the only source of knowledge they have about those activities. Therefore, they cannot look "outside" the result but only increase their understanding by looking into them. Thus, accounting information becomes the principal bearer of knowledge. This one-dimensionality of information may become a considerable source of anxiety for managers and employees. The employee cannot anticipate the significance the manager will attach to the result. The manager can only rely on the available, principally the accounting information. The potential for misinformation or misinterpretation rises. The employees at the lower levels of the organization, whose daily jobs are tied to the production process, will interpret accounting information in terms of its significance for production.<sup>157</sup> Profitability is regarded as a condition to continue production. Managers who are charged with protecting the interest of the shareholders will have an instrumental interest in production. For managers the "results" recorded in the accounts are the product, the underlying physical and social processes are seen merely as means to realise the product.<sup>158</sup> This can lead to companies to neglect qualitative

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155 Whitley 1999, p. 512.

156 Ferner, Varul 1999, pp. 6.; Shonfield, 1992, p. 169;

157 Gospel, Pendelton, 2003, p. 566.

158 Roberts, Scapens 1985, p. 452.

investments such as investments in HR, because the costs of investing in training appear immediately in the profit&loss statement, while the benefits are deferred and difficult to quantify.<sup>159</sup> The importance of key financial indicators in the process of controlling management can be furthered by also linking reward to key financial figures.<sup>160</sup>

### **4.3.3 Impact of performance oriented compensation**

The increase of performance related pay might cause dysfunctional behavioural responses. Assuming contracts cannot completely specify all relevant aspects of employee behaviour, employees tend to emphasize only those aspects of performance that are rewarded. Based on the assumption that employees carry out multiple tasks, a reallocation of time and effort towards those activities that are directly compensated for and away from uncompensated activities may take place. This is referred to as multi-tasking.<sup>161</sup> Milgrom and Holmstrom propose that in a setting in which the cost of effort for two different activities is equal to an employee, and he therefore is indifferent to the effort allocation between the tasks, all his effort will be allocated to the task, which has a higher return on his reward. This behaviour is thought to take place, despite the possible interest of the firm that employee effort is equally allocated to both tasks.<sup>162</sup> Even if equal returns are offered for both tasks, a higher measurement error in the evaluation of one activity can lead to a neglect of the other.<sup>163</sup> This can lead to biasing performance away from qualitative to quantitative aspects of performance and a concentration of effort on the rewarded dimensions.<sup>164</sup>

Due to the difficulty to measure the benefits of training, expenses for training are often not accounted for in budgets. Because decisions to provide training are mostly taken by middle managers, who are pressured to fulfil their budgets, and often their performance related is tied to this fulfilment, they often face a dilemma. Depending on their view on the importance of training they have three basic alternatives. First, they can concentrate their efforts on those activities that are effective to fulfil their targets and cut investments in training. Second, management will not cut training expenses but increase their discretion by creating budgetary slack and direct their energies towards manipulating the appearance of the accounts rather than changing the underlying processes.<sup>165</sup> Third, managers will not cut training expenses but

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159 Crouch et al. 1999, p. 210.

160 Collins 1982, p. 113.

161 Holmstrom, Milgrom, 1991, Baker 1992.

162 Holmstrom, Milgrom 1991, 1994.

163 Prendergast, 1999, p. 23.

164 Marsden 1999, p. 150., Holmstrom, Milgrom 1991, pp. 24, Milgrom, Roberts, 1992, 194, pp. 154.

165 Roberts, Scapens 1985, p. 453

try to conceal them, for example, by loaning apprentice labour to projects in return of a percentage of the project's success. Like that lengthy financial justification with senior management can be avoided, direct training expenses are kept low and the overhead cost of the project rises.<sup>166</sup>

## **5 Methodology of empirical investigation**

The aim of the study is to explore the effect of increased shareholder value orientation of German companies, and in particular to ask whether the implementation of shareholder value principles influences these companies' style of HR management, specifically long term policies like training and trust building.

It has been outlined that it is the company's management control system, which transports the environmental changes into the company. Therefore it seems necessary to investigate if the use of accounting information in the company has changed as a consequence of different accounting rules and shareholder pressure.

It has been shown that training is a constitutive part of the German production model, which is very likely to be affected by an increased consciousness for short-term financial performance because it requires a long-term perspective and its returns are not directly mirrored in financial figures.

An experimental approach is taken for the field research, because the nature of the relations is thought to be causal. To account for the variety of factors that could distort empirical findings of field research, a control group design is applied. The case studies follow a *ceteris paribus* variation, meaning that the studied companies are as homogenous as possible with the exception of the independent variables: 1) the use of international accounting practices, and 2) ownership structure of the firm as well 3) listing on the stock market. Four companies have been studied. The small number of studied companies causes one of the key problems of the investigation, the selection bias. Selection bias usually occurs if a non-random selection of cases results in inferences that are not statistically representative. To limit the selection bias an intra section analyses is conducted. It is hoped that this will help to control for: 1) the wider economic developments taking place in Germany, specifically the recession that started

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166 Warner, Campbell 1991, p. 156

in the late nineties, which affects industry sectors with different strength and 2) varying degrees of importance of long term HR policies across sectors.

The case study companies operate in the pharmaceutical sector. The pharmaceutical sector has been chosen because German companies have a long history of success in this industry, an important explanation for the success of pharmaceutical companies seems to be rooted in the German educational system, and these companies put a strong emphasis on training as their success strongly depends on the know-how of their employees and the sector has been relatively unaffected by the recession.<sup>167</sup>

The research was carried out between 2002 and 2004. The primary research tool was in-depth semi-structured interview as they offer the potential for a deeper examination of the processes involved in the relationship of human resources management and accounting practices.<sup>168</sup> In the majority of cases, interviews were tape-recorded and fully transcribed. If less formal conversations take place, these will be written as soon as the circumstances allow and treated as notes of observations. In total 28 interviews were conducted. Of the respondents, one quarter (7) was senior personnel managers; the remainder were finance managers and controllers (8), accountants (7), general managers (3), and works councils (3). Interviews in the case study companies were conducted in the headquarters as well as in German production subsidiaries.

Apart from this oral information written company internal documentation such as the report on personnel related issues (Personal- und Sozialbericht) was drawn upon in 2 cases. To substantiate the first indications, further information is drawn from the Max Planck Database of the 100 biggest German companies.

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<sup>167</sup> O'Sullivan 1998, p. 14.

<sup>168</sup> Langfeld-Smith, 1997, p. 221; Joseph et al. 1996, p. 92.

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