White Paper

What to Do When People Are Your Most Important Asset

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Introduction

The relentless force of globalization has left only one sustainable path to profitability for firms operating in high-wage, developed nations—to compete based on superior human capital capabilities and strategies. Any benefits that were historically associated with superior technology and access to capital (both physical and financial) are now far too short-lived to provide a sustainable advantage.

This paper tackles one of the central challenges of using strategic human capital management as a source of competitive advantage: although human capital is an "asset" in knowledge-intensive firms, it is accounted for and reported as a cost under current accounting standards and regulations. Moreover, it is treated as the worst kind of cost – a hidden one buried inside a large general category of expenditures ("selling, general, and administrative expenses," or SGA).

In essence, our accounting and reporting systems, which may have worked satisfactorily during the industrial era, are now impeding the emergence of knowledge era opportunities. Overcoming this will require creative new measurement systems that help organizations manage people as assets, moving away from the far easier task of managing them merely as costs. Creating these new systems of measurement is particularly important for publicly traded firms, since they are the organizations most negatively affected by our current accounting and reporting requirements.

The remainder of this paper discusses the current situation in additional detail, outlines a research-based measurement methodology for addressing these challenges, and provides evidence from three organizations that are already using "human capital measurement" as an integral part of their human capital strategy.

The Measurement Imperative

Have you ever wondered why – when "people" are an organization's self-proclaimed "most important asset" – those people appear as costs on the balance sheet? What are the implications of this accounting relic for today's knowledge-era organizations? And what can be done to address any unsatisfactory implications?

Here's what we've learned about how the situation affects organizations in today's knowledge-driven economy. The evidence clearly suggests that, under our current system of accounting and reporting, there is a systematic under-investment in the management and development of people, relative to all other assets inside an organization.

Although many of the incentives to under-invest in people affect all employers, particular incentives disproportionately affect publicly-traded firms due to analysts' focus on measures (such as quarterly earnings) that reflect a firm's "costs" without any accompanying reflection of their offsetting future benefits. The stock market's myopic focus on this quarter's earnings thus penalizes those firms that are currently investing heavily in their people, relative to others. The toll can be particularly severe when compensation packages align executives' incentives too closely with the market's focus on the short-run. This confluence of forces results in a "perfect storm" that is not only harmful to the people inside the organizations that under-invest in them, but also harms the organization itself, its shareholders, and society at large.

To elaborate on this point, consider the following thought experiment. Two organizations are identical in all but one respect: Company A makes substantial investments in developing its people, and Company B does not make such investments. What will be evident to any analyst or investor reviewing and comparing the companies' income statements is that Company A has higher overhead (SGA) expenses (and correspondingly lower earnings) than Company B. What will not be evident to analysts, however, is that some of Company A's higher "expenses" should be expected to generate future productivity gains and financial benefit (i.e., those expenses are actually investments). Consequently, Company A's stock prices will be lower—at least in the short-run—than Company B's. The decision of Company A to invest in learning and development thus occurs *despite* pressures from financial markets.

This all makes perfect sense, you may be thinking, but where's the hard evidence? For starters, we analyzed the effect of spending on employee education and training—one of the people-related "costs" that is buried in SGA—on the stock prices of 600 publicly traded firms. From 1997-2001, hypothetical portfolios made up of those firms that made the largest investments in employee development had an annualized return of 16.3 percent in the following year, compared with an annualized return of 10.7 percent for the S&P 500 for the same period. (These results should, of course, be treated with some caution, as there are limitations inherent in hypothetical, back-tested models.)

Nevertheless, the inexorable conclusion from this finding is that the firms that were making large investments in employee development were under-priced at the time they made their investment, and they were under-priced precisely because they are making these investments.

In sum, it is a big strategic mistake to do what the market rewards in the short run—treating people as costs—because the market will penalize you for it in the long run anyway.

As an aside, we believe so strongly in these findings that we've put this research into action, and have moved from tracking hypothetical portfolios to managing real assets of clients in portfolios of firms that make significant investments in their people. As this article was going to press, the strategy was performing well, with our portfolios beating their benchmarks (up-to-date information can be found at www.bassi-investments.com).

Next Generation Human Capital Measurement

The "holy grail" evidence outlined above, important as it is, falls short of providing specific tools that organizations can use to begin measuring and managing (and ultimately reporting) people as assets. To make progress on this front, we have been working with a diverse group of organizations interested in making headway on these issues.

Together with them, we have developed research-based "human capital" measurement tools that are based on a rigorous framework that enables measures of people development and management to be linked to the organizations' future business outcomes. This linkage then generates actionable insights that help organizations identify what they should be doing — and where they should be doing it.

This is a significant advance over previously existing measures, such as (1) the weak "people" measures used in many balanced scorecard projects that fail to yield predictive, actionable insights, (2) employee satisfaction surveys that are not linked conceptually and empirically to any underlying performance improvement framework, and (3) traditional ROI measures that are backward-looking (and more often applied for self-justification purposes than for actual continuous improvement).

Our work identified five human capital indices, summarized in Table 1, that represent leading indicators of business results. While there may be additional indicators that differ across industries or market segments, these five represent a core set of indicators that can be applied across all types of organizations.

Full information on each of these five human capital indices is captured from a given organization through the Human Capital Capability Scorecard (HCCS), a robust research-based framework developed by McBassi & Company. Versions of the HCCS have been applied in many organizations across a wide range of industries and sectors.

Table 1. Definitions and Interpretation of Human Capital Indicators

	Definition	Strategic Importance of Monitoring
Leadership/ Managerial Practices	Managers' and leaders' communication, performance feedback, supervisory skills, demonstration of key organizational values, efforts and ability to instill confidence.	Leadership and managerial practices are the foundation for ensuring that human capital is developed, sustained, and deployed successfully. These practices thus lay the foundation for the achievement of all organizational goals. Many researchers have concluded that this factor is the most important driver of an organization's ability to retain its top performing people.
Workforce Optimization	The organization's success in optimizing the performance of its workforce by establishing essential processes for getting work done, providing good working conditions, establishing accountability, and making good hiring choices.	Since human capital represents a major portion of most organizations' total operating cost, the quality of the practices, systems, and processes for ensuring that employees are effective is a foundational determinant of business results.
Learning Capacity	The organization's overall ability to learn, innovate, and continually improve.	An organization's ability to respond effectively to constant (and inevitable) changes in its environment hinges on its ability to learn. Hence, training, development and innovation must be valued and supported in order for an organization to have the capacity to respond to changing conditions and consistently achieve strategic goals.
Knowledge Accessibility	The extent of the organization's "collaborativeness" and it capacity for making knowledge and ideas widely available to employees.	Organizations that capture, apply, and re-use knowledge and best practices among departments and divisions, and that have successful, collaborative team structures are best able to leverage their knowledge and talent for business results.
Talent Engagement	The organization's capacity to engage, retain, and optimize the value of its employees hinges on how well jobs are designed, how employees' time is used, and the commitment that is shown to employees.	The most successful organizations are those that proactively manage talent retention by creating desirable work environments, including designing jobs purposefully, ensuring that employees' time is well used, recognizing and valuing employees and their work, and providing opportunities for employee advancement.

Three brief case studies below describe an extremely diverse group of organizations, each of which has worked with us to identify the links between their human capital indices and their key business outcomes.[a] The summary-level results of those analyses are the primary focus of the case studies.

[a] We have also analyzed the relationship between human capital indices and other organizational outcomes, such as plant safety and intermediate financial measures. Those findings, gathered from some of the organizations described below as well as others, are generally quite similar to the results described below. This article, however, focuses its attention only on the analysis of organizations' key business outcomes.

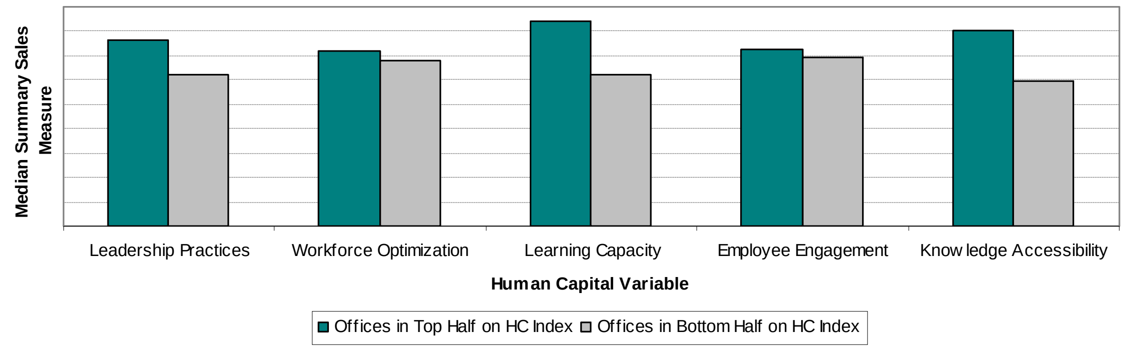
Case #1: A Global Manufacturing Firm

American Standard – an established global manufacturer in the areas of air conditioning systems, bath and kitchen products, and vehicle control systems – has tracked the five human capital indices within the organization over the past three years, and has used them to manage its talent across and within its major business units. The indices have become an integral component of American Standard's strategic management process, feeding into and improving its balanced scorecard measures and its performance management system.

We worked with American Standard to examine the relationship between the human capital indices and an internal American Standard measure that was designed to summarize the financial results and growth trends of the U.S. sales offices within one of its major business units. The analysis found a clear relationship between the indices and the summary sales measure.

For each of the five indices, the sales offices that were in the top 50 percent of all offices in their score on the given index also had a higher median summary sales score. Depending on the specific index, the median sales scores were between 6 and 35 percent higher for offices in the top half of the human capital distribution (see Figure 1 below)[b]. The largest differences were seen between the top half and the bottom half in their scores on Learning Capacity and Knowledge Accessibility.

Figure 1. Median Summary Sales Office Measure, American Standard, by Top Half/Bottom Half on Human Capital Variables



The combination of summary findings like those included in Figure 1 with more detailed information (not shown here) on individual sales offices' scores on each index (and on the specific items that comprise each index) provides American Standard with a clear method to identify

[b] The specific levels of the summary sales data are not available for publication and are therefore not included on the y-axis of Figure 1.

specific human capital initiatives that would be expected to bring about in the greatest improvements in sales productivity.

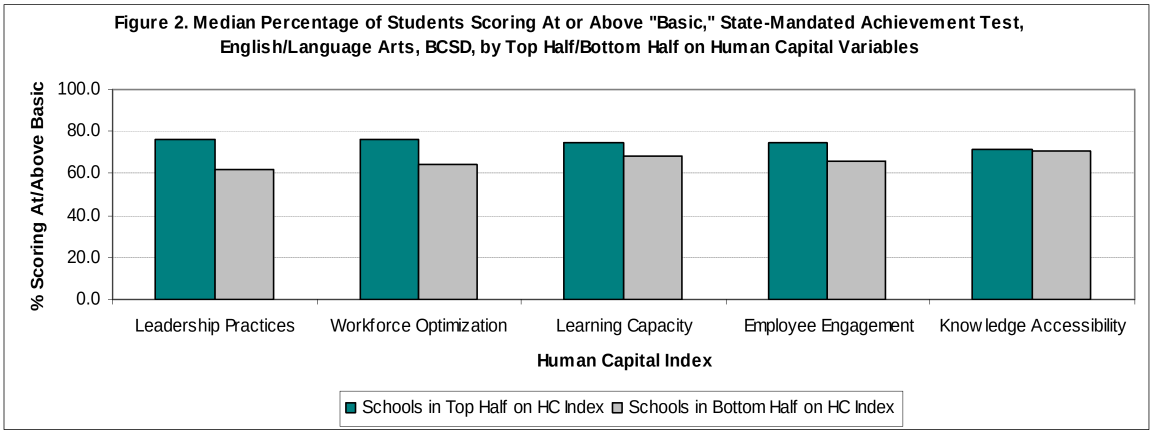
The Senior Vice President for Human Resources at American Standard, Lawrence Costello, describes the impact of these findings in this way: "For the past three years, American Standard has been creating a much more strategic process for investing in the development and management of our people. The missing piece for us was a way to link our investments to bottom line results. Our human capital measurement methodologies created that link, helping us to develop a clear road map for improving business results. Equally important is our improved capacity to persuade managers to make the necessary investments by providing them with compelling evidence on the bottom line impact that results from improved development and management of their people."

Case #2: A Growing Public School District

The very same human capital metrics that predicted the success of sales offices in a large manufacturing firm can also be used to predict key "business outcomes" in an extremely different organizational environment: a public school district. In this case, the business outcome of primary interest is student achievement.

The Beaufort County (South Carolina) School District (BCSD) is a rapidly-growing district with over 17,000 students distributed across more than 25 schools. In recognition of the importance of the work and learning environment for its faculty, staff, and administrators, BCSD has been using the HCCS to track its human capital indices among those groups since 2002. Like American Standard, BCSD was anxious to determine the relationship between its human capital factors and its key outcomes.

Figure 2 shows the relationship between the five human capital indices and a key measure of student achievement across the 20 elementary and middle schools in the district: the percentage of students in a given school scoring at or above the "basic" level on the state-required standardized test in English/Language Arts.



Again, among the schools that scored in the top 50 percent on a given human capital index, the median percentage of students scoring above the basic level is higher than in the schools in the bottom 50 percent. Differences range from 2 percent to 24 percent, with the largest difference seen in the Leadership Practices index. (Similar patterns are also observed in four of the five indices for the other major category on the state exam – Mathematics.)

Further analysis finds that these human capital indicators are twice as powerful in explaining student achievement as is the socioeconomic status of the children within the schools. This is very good news for educators, since human capital factors are within the scope of influence of schools system, while socioeconomic status is not.

As a result, BCSD is now using the human capital indicators in a wide variety of ways to improve student achievement within the district. The superintendent uses the school-specific results as a part of the biannual performance review for each of the principals within the district. The principals, in turn, use the results to guide resource allocation decisions within their schools and to develop action plans with their teachers. And the district's organizational development department uses the results to monitor improvements and to guide their strategic planning and budget decisions.

Case #3: A Large Consortium of U.S. Banks

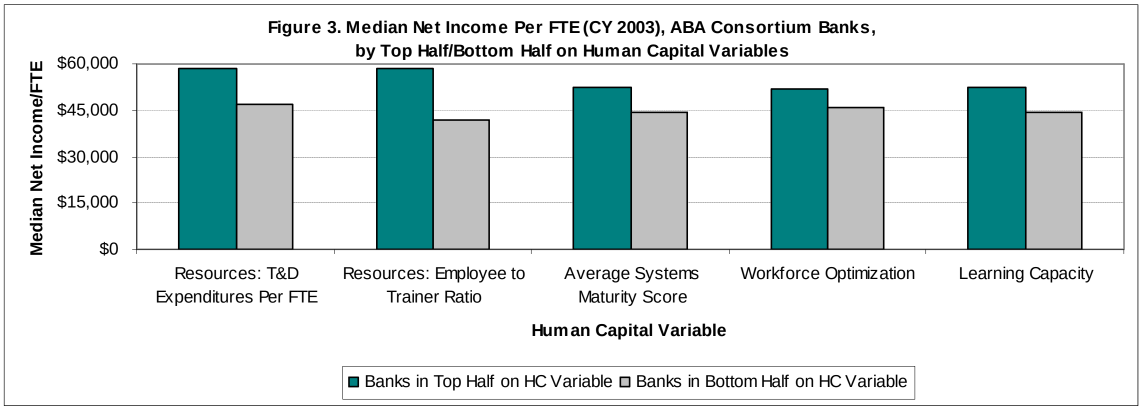
In 2004, the American Bankers Association convened its inaugural Chief Learning Officer Summit. The summit involved CLOs from some of the nation's leading banks, and was intended to provide a forum for the CLOs to learn from each other about current best practices and to explore the relationship between each organization's human capital investment and its overall business performance.

A central element of the summit was a benchmarking study that used a modified version of the HCCS as its foundation for gathering benchmarkable data on an array of human capital indicators for each of the 17 banks included in the consortium. Because of the design of the study, comprehensive data on all items included in the five human capital indices were not able to be fully captured. Information was gathered, however, on a variety of summary statistics that are incorporated in measuring an organization's human capital maturity. These data allowed us to calculate two modified versions of the standard human capital indices (Workforce Optimization and Learning Capacity), as well as to examine directly the effects of three other human capital items (overall maturity of human capital systems, training and development expenditures, and level of human capital staff available).

The analysis found clear evidence of a positive relationship between banks' financial performance (measured using five different outcome measures)[c] and the investments they make in professional development and other human capital best practices. Those banks in the top half of a given human capital variable had stronger financial performance for 19 of the 25 comparisons that were examined (five human capital variables times five financial outcomes).

The strongest evidence supporting this relationship was observed for outcome variable that measured net income per employee FTE (see Figure 3). This variable saw a positive relationship for each of the five different financial performance outcomes that were examined in the study.

[c] The five summary financial outcomes variables analyzed were return on assets, return on equity, net income per employee FTE, total assets per employee FTE, and stock price performance.



The study concluded that "those institutions that demonstrate the greatest commitment to human capital enjoy the greatest financial rewards."

Conclusion

When people are *your* organization's most important asset, it is imperative that they be measured and managed in a way that recognizes their centrality to your success. This also serves to inoculate your organization from the pervasive myopia that results from the current system that continues to account for people only as costs.

In order to be successful in this venture, however, you must seek a high standard by finding and deploying a set of human capital metrics that actually predict future business results. This means moving beyond the traditional measures used in "HR Scorecards" and the descriptive (but non-predictive) measures used by most organizations that rely on the balanced scorecard. The preceding examples demonstrate that predictive "next generation" metrics do exist and are being used by leading organizations today.

About the Authors

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