White Paper

Human Capital and Organizational Performance: Next Generation Metrics as a Catalyst for Change

by Laurie Bassi and Daniel McMurrer

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McBASSI & company

Introduction

Over the past decade we have been working with colleagues from around the globe and from a variety of disciplines to quantify human capital management and use the resultant measures to predict future organizational performance and outcomes, both financial and non-financial.

The resulting human capital metrics can serve as a catalyst for change, providing a critical missing link for creating and sustaining competitive advantage for organizations operating in an increasingly knowledge-intensive, global economy.

Although employees are always both an asset and a cost for their employers, most organizations have proven to be much more capable at measuring the cost side of the human capital equation than the asset side. At a minimum, this imbalance results in inefficiencies in human capital management. And our analysis shows that, in many cases, the imbalance creates a chronic under-investment in human capital relative to other forms of investment.[1] The result is sub-optimal performance on the part of most organizations, often accompanied by a sacrifice of long-term productivity and profitability in exchange for short-lived gains.

Improving the quality and relevance of human capital measurement – enabling organizations to better understand their overall “people-related” strengths and weaknesses and identifying areas for improvement – is, in our view, essential to correcting this situation. It requires moving beyond the traditional “HR metrics” currently in use by most organizations.

In the discussion that follows, we summarize the progress that we have made and its implications for organizations seeking to improve their organizational performance through improved human capital management. The discoveries that have emerged from our work fall into three categories: empirical findings; insights into the barriers that keep organizations from more effectively managing human capital; and the benefits that accrue to organizations when they shift from HR to human capital metrics.

Empirical Findings

The framework we use for identifying the key drivers of organizational performance (both within and across organizations) rests on a decade of research.[2] A critical finding that has emerged from this research is that with few exceptions, traditional HR metrics (e.g., employee turnover rates, average time to fill open positions, total hours of training provided) are not predictive.[3] In other words, the easily-quantified measures typically used by HR professionals fail to capture the drivers of organizational performance.

Finding a next generation of human capital measures – those that *do* predict organizational performance – requires methods for objectively quantifying "soft" but critical aspects of the quality of the management and development of employees. The best way that we have found for doing so is to use thoughtfully designed employee surveys. The survey questions are designed to measure the extent to which specific people-related best practices, identified generally in the research literature as being important determinants of organizational success, do or do not occur within their work setting.[4] Collectively, these survey questions enable us to measure overall "Human Capital Management" (HCM) within an organization.[5]

Our empirical research has focused particularly on the relationship between HCM metrics (either individually or as a group) and *subsequent* organizational performance. Those measures that are associated with organizational success in a following year are the ones that are truly predictive (and the ones whose improvement should be a high priority for an organization).

Our major empirical findings in this area are summarized briefly below.

1. There is a core set of "human capital drivers" that predict organizational performance across a broad array of organizations.

HCM can be broken into five major categories, each of which can be measured separately, and each of which helps to drive organizational performance:[6]

- Leadership Practices
- Employee Engagement
- Knowledge Accessibility
- Workforce Optimization
- Learning Capacity

(Each of these categories of human capital drivers can be divided into additional subcategories, each of which contains a number of individual "best practices" items.) Typically, any organization can be assigned an overall HCM score as well as a score in each of these five categories of human capital drivers.

2. These drivers can be used both to predict variations in financial performance both *within* an organization and *across* different organizations.

Figure 1, for example, shows the relationship between HCM scores (overall and for the five summary categories) and overall financial performance for the top and bottom half of branches within a large financial services firm. [7] We have also observed similar patterns of results for sales offices and other distinct subunits of other organizations.

Firms with higher HCM scores also do better in the stock market in the following year. Figure 2 shows the relationship between HCM and subsequent stock market appreciation across a group of publicly-traded firms in the same industry (financial services). [8]

Figure 1

Financial Outcomes in Financial Services Firm: Subsequent Financial Performance as % of Target, by Branches in Top/Bottom Half on Human Capital Indices

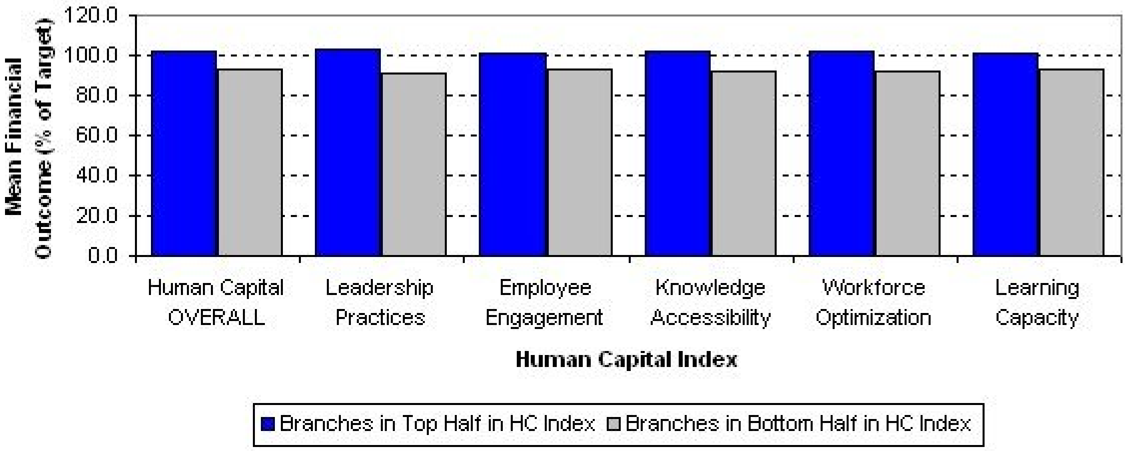
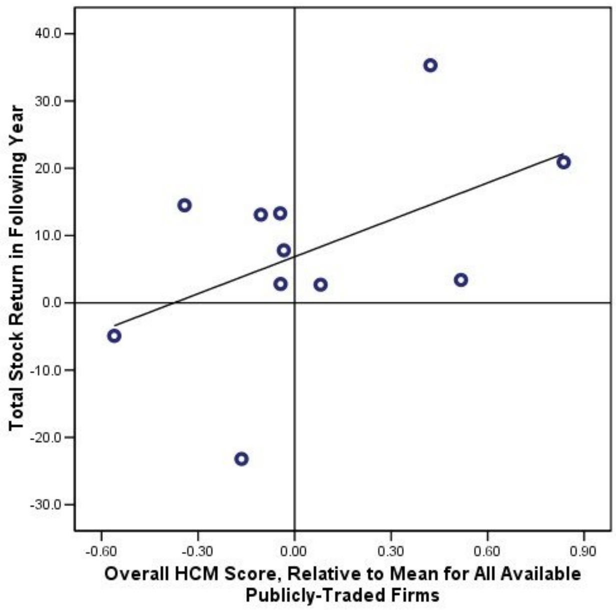


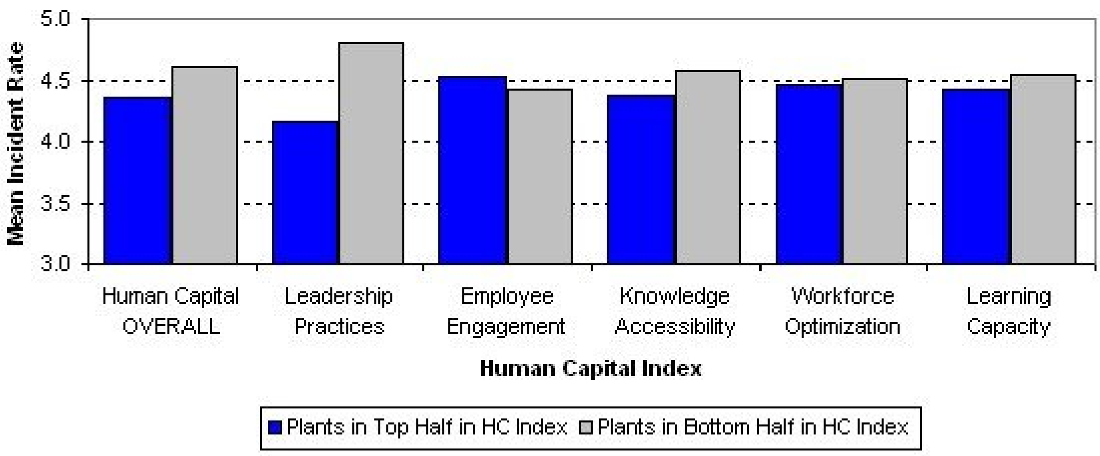
Figure 2
Relative Human Capital Maturity and Total Stock Market Return in Following Year, Financial Services Firms



3. These same drivers can also be used to predict a broad array of non-financial outcomes. Key non-financial outcomes can range from variations in safety rates in manufacturing plants to gains in student achievement across schools.

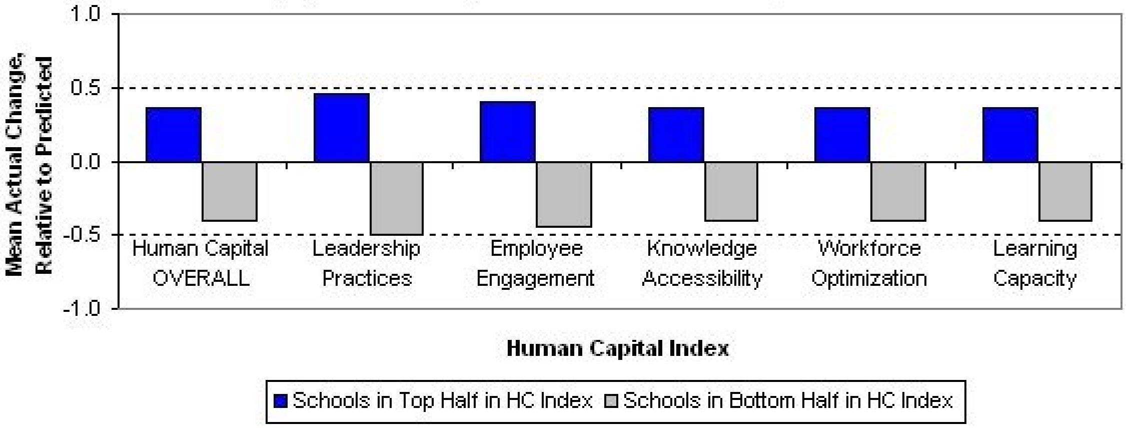
Figures 3, for example, depicts the relationship with safety rates (recall that a *lower* incident rate is the desired outcome).[9]

Figure 3
Safety Rates in Manufacturing Firm: Subsequent Year Mean Incident Rate, by Plants in Top/Bottom Half on Human Capital Indices



Similarly, Figure 4 shows the relationship within a public school district between HCM and subsequent gains in student performance – *after* controlling for socioeconomic status of each school's student body.[10]

Figure 4
Student Outcomes in Public School District: Subsequent Mean Change in Performance on Standardized Test, Actual Versus Predicted by Socioeconomic Status, by Schools in Top/Bottom Half on Human Capital Indices



4. Although there is a core set of human drivers that explain organizational performance across a broad array of organizations, **these drivers are not all equally important across organizations, or even within a single organization over time.**

Claims made by consulting firms that profess to have found a (typically small) set of "one size fits all" questions that are equally important predictors of performance across all organizations should be viewed with caution. For example, there is typically little overlap across organizations in which individual human capital items are most closely associated with their key outcomes.

Using relatively straightforward statistical tools (comparable to those used in six-sigma analysis) it is possible to drill down into the human capital drivers to identify the specific factors that are the most important drivers of organizational performance. [11]

This drill-down capacity is what an organization needs to make prioritized, data-driven decision for improving organizational performance through more effective human capital management.

It is possible to quantify the quality of leadership (and management) and identify its impact on organizational performance. Leadership typically is one of the most important human capital factors driving performance.

The specific factors associated with the driver "Leadership Practices" routinely emerge as the most important determinants of organizational performance (financial and non-financial) across a broad range of organizations. For example, in the figures above, leadership practices shows the largest difference between the bottom and top groups in three of the four outcomes displayed.

The determinants of employee satisfaction and productivity/ profitability may be very different.

By focusing excessively on employee satisfaction, with too little attention placed productivity and profitability (or other key outcomes), HR departments risk pointing their organization in the wrong direction. For example, Table 1 delineates separate lists of the top five individual human capital items (out of about 70 possible items) that drive financial performance and that drive employee engagement within a large retail bank. It is notable that only one items appears in both "most important items" lists.

Table 1
Drivers of Financial Performance and Employee Engagement

Most Significant Drivers of Financial Performance	Most Significant Individual Drivers of Employee Engagement
1. Employee receives feedback that helps improve work quality.	***1. Managers eliminate barriers to effective work.***
2. Employee has confidence that managers can lead unit to success.	2. Job is interesting and meaningful to employee.
3. Managers eliminate barriers to effective work.	3. Employees have opportunities for advancement.
4. Training received supports business goals.	4. Employee has opportunities to gain or extend skills.
5. Teamwork is encouraged and enabled.	5. Organisation values and supports learning and development.

Barriers to More Effective Management of Human Capital

In working to measure HCM across a variety of different types of organizations, we've also frequently encountered a series of similar barriers that make it difficult for organizations to move toward measuring those elements of human capital that truly affect their key outcomes:

The search for a silver bullet. As noted above, it is not realistic to expect that a small number of questions can reliably predict organizational performance uniformly across different organizations. The truth is that each organization needs to do the hard (but not impossible) work of determining which human capital drivers are most important to its performance.[12]

Employee satisfaction/engagement surveys that miss the mark. It is quite possible for an organization to use information from well-researched employee surveys, in combination with straight forward "six-sigma-type" statistical techniques, to quantitatively identify the human drivers of organizational performance. Unfortunately, employee surveys are rarely used for this purpose. Indeed, it is safe to say that each time an organization chooses to deploy a major employee survey *without* following through by using the results to identify performance drivers, an important opportunity is missed.

An excessive focus on individual, rather than organizational capability. Individual skills, however necessary, are themselves insufficient for the creation of highly effective organizations**.** When evaluating the strengths and weaknesses of an organization's people, the scope *must* be expanded beyond individual employees and should include rigorous, valid systems that enable the assessment of capability at the broader, organizational level. Organizations that fail to include this perspective are perpetually at risk of focusing on employees as "the problem" to be solved, when it may well be capability at the organizational level that is the true issue.

An excessive focus on HR metrics (a.k.a. the "head in the sand" strategy). HR departments tend to focus on "HR metrics," relatively easy to come by, but non-predictive, measures of the *efficiency of the HR function itself*. While no doubt interesting to HR professionals, those measures are not what is needed to improve the performance of the organization as a whole. That requires a much broader perspective on factors, such as the effectiveness with which employees are managed and developed, that drive organizational outcomes. By focusing on largely irrelevant HR measures, it is possible to avoid confronting problems but also means that the organization is not doing the hard work of identifying and implementing real solutions to improve its outcomes.

Too much focus on organizational strengths, not enough on areas for improvement. While it may be possible, and even sometimes productive, for individuals to focus on their strengths (and avoid developing their weaknesses), the same logic does not translate for organizations as a whole. The many organizations that focus on becoming ever-better at the aspects of human capital management at which they are already quite good almost certainly are experiencing diminishing marginal returns. Improvement efforts should be redirected toward areas of organizational weakness; real gains are typically found in getting better at their weakest human capital driver. The trick, of course, is in knowing how to find the weakest and most important link.

The belief that intuition and vision are enough. The operations and finance sides of the business are not run by intuition. Similarly, the human side of the business, which is typically both the biggest cost and asset of an organization, cannot be run (effectively) without rigorous measurements systems. HR professionals who focus only on "vision" and shrink from the accountability that meaningful human capital metrics creates will never be taken seriously within their organizations as real business partners and solution providers, nor will the HR function itself be provided with the resources and responsibilities necessary to make a meaningful difference.

Benefits to Organizations that Deploy Human Capital Metrics

While we are the first to admit that “silver bullets” are non-existent, our work over the past decade has demonstrated that human capital metrics can serve as an important catalyst for change. In particular, the following represent some of the benefits that we have observed within those organizations that have shifted their focus from traditional HR metrics to measures of the true human drivers of organizational performance:

Defeating short-termism. Developing the capacity to rigorously identify the human capital drivers of an organization’s performance gets the attention (and respect) of senior executives. It helps to undermine a chronic tendency to under-invest in human capital (saving a few dollars in the short term) by compellingly documenting the financial and non-financial consequences of doing so.

Providing meaningful input for an organization’s balanced scorecard. The learning and development measures included in most organization’s balanced scorecards are woefully inadequate. Meaningful human capital metrics correct this situation.

Leveling the playing field. By focusing on predictive human capital metrics, rather than non-predictive HR metrics, the “human side of the business” benefits from the same types of tools, evidence, and rigor as do the operations and finance sides of the business.

Better leadership: Human capital metrics and methodologies (such as those described above) reveal and quantify the impact that leadership and managerial capabilities (and development) have on business results. This provides a degree of rigor that has heretofore been missing (and much needed).

Launching a quiet revolution: Although the shift from HR to human capital metrics may, to some, seem to be to rather innocuous, it has the potential to launch a quiet revolution in an organization. It is the elixir that helps to identify and eliminate stubbornly-resistant, industrial-era mindsets, processes, and mangers – and sets the stage for replacing them with their knowledge-era counterparts. This is what is needed to prosper in and benefit from an increasingly knowledge-intensive, global economy.

About the Authors

Laurie Bassi is the CEO of McBassi & Company and the Chairwoman of the Board of Bassi Investments (an investment company that invests in companies that invest in their employees). Her primary research interests are in the economics of human capital. Email: lbassi@mcbassi.com

Daniel McMurrer is the Vice President for Research at McBassi & Company and the Chief Research Officer at Bassi Investments. His principal research interests are in identifying empirical linkages between firms' human capital investments and practices and their subsequent business results. Email: dmcmurrer@mcbassi.com

About McBassi & Company

McBassi & Company is a research-based consulting firm that has the expertise and tools to help organizations use measurement as a catalyst for improving their return on people. For more information about McBassi & Company or its services, call 413.233.6558, email info@mcbassi.com, or visit the company website at www.mcbassi.com.

Endnotes

[1] The theory and evidence in support of this point can be found in "Developing Measurement Systems for Managing in the Knowledge Era," Bassi and McMurrer, *Organizational Dynamics*, Volume 34, Number 2, 2005. Version available at: http://www.mcbassi.com/pdfs/BassiMcMurrer-OrgDynamics-WhitePaper.pdf.

[2] A summary of the process by which we developed this framework and identify and test the human capital drivers of organizational performance can be found in Section III of *Employers' Perspectives on Human Capital Development and Management* written for the Organization for Economic Cooperation and Development, Feb. 2006, Bassi and McMurrer (http://www.mcbassi.com/pdfs/BassiMcMurrer-OECD-Feb2006.pdf)

[3] One important exception is training expenditure per employee. See "How's Your Return on People?" Bassi and McMurrer, *Harvard Business Review*, March 2004.

[4] While the data collection methodologies used are comparable to those used for measuring "culture" or employee satisfaction/engagement, and there may be some overlap in the content of the questions, the intended outcome is different. Essentially, the approach described here holds itself to a higher (and more difficult to achieve) standard—which is finding the determinants of future performance.

[5] Our concept of the "management of employees" is a very broad one that incorporates our 5 key human capital drivers described later in the paper. Hence, it extends beyond (and incorporates) a more traditional HR concept of management of employees which tends to be limited to formal performance management processes.

[6] A document describing the full definitions of the five major categories of human capital drivers, as well as the twenty subfactors that constitute them, is available for download at http://www.mcbassi.com/pdfs/HCCScorecardOverview.pdf.

[7] A document describing the full definitions of the five major categories of human capital drivers, as well as the twenty subfactors that constitute them, is available for download at http://www.mcbassi.com/pdfs/HCCScorecardOverview.pdf.

[8] A document describing the full definitions of the five major categories of human capital drivers, as well as the twenty subfactors that constitute them, is available for download at http://www.mcbassi.com/pdfs/HCCScorecardOverview.pdf.

[9] Figure 3 displays the relationship in a large manufacturing firm between plant-level HCM and safety results the following year.

[10] Figure 4 provides the relationship between HCM (measured during the 2004/05 school year) and a measure of student improvement from Fall to Spring of that same school year on a national standardized test. The student improvement measure is the difference between the actual level of student improvement and the level that would have been predicted using each school's grade level and the socioeconomic background of its students (as measured by percentage of students eligible for free or reduced lunch).

[11] See *A guide to Using Measurement Systems to Improve Business Results*, Bassi and McMurrer, http://mcbassi.com/pdfs/Guide-UsingHumanCapitalInformation.pdf.

[12] *Ibid*.

