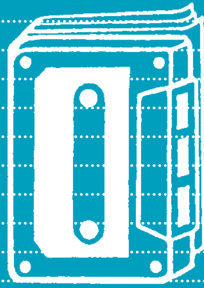

Audio-Tech Business Book Summaries

In this issue:

- ***Grasp...*** the reasons why your people truly are your company's most important asset today, and what you can do to maximize their performance.
- ***Exploit...*** your employees' full potential by devising a human capital strategy to create a competitive advantage that other companies cannot copy.
- ***Improve...*** your business results by using systems thinking to foresee how your human resources policies will affect many other parts of your business.
- ***Gain...*** the information you need to make the right decisions about employees, rather than being misled by survey results or benchmarking.
- ***Increase...*** the returns on your HR investments by mastering the powerful tools of Internal Labor Market Analysis and Business Impact Modeling.

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Play to Your Strengths

Managing Your Internal Labor Markets for Lasting Competitive Advantage

by **Haig R. Nalbantian, Richard A. Guzzo, Dave Kieffer, and Jay Doherty**

A summary of the original text.

The average cost of a company's workforce is 36 percent of revenue. It is by far the largest investment any company makes, and yet it is the asset that executives manage most haphazardly. While extolling the virtues of human capital, companies routinely make decisions that harm the productivity and motivation of their workforce — through layoffs, misplaced incentives, or simply through misaligned strategies that encourage the wrong kind of performance.

Moreover, most companies fall into four essential traps that keep them from maximizing their workforce:

- ***First, they view their employees simply as an operating expense,*** a cost to be minimized, not as a great source of value creation.
- ***Second, companies have no one who is really in charge of accounting for human capital,*** not even the human resources department.
- ***Third, practices and policies are decided on piecemeal*** without regard for their system-wide effects on people and their performance.
- ***Fourth, there are no good ways to measure the effects of decisions,*** and so most get made on instinct, hunch, or bad information.

Human resources are more important than ever because the power of tangible assets as sources of competitive advantage has faded. *Technologies* can be copied. *Capital* flows easily, even during economic downturns. And *economies of scale and scope* are less critical, as small competitors are easily taking on big ones.

The last source of competitive advantage, then, is *human capital and the system each*

company uses to manage it. Human capital is the company's stock of knowledge, technical skills, creativity, and experience, and it is becoming increasingly vital. But the workforce alone is not the source of advantage. If it were, today's richest companies would simply pay the highest wages for the best people and enjoy a permanent advantage.

The reason that this approach wouldn't work is that the real competitive advantage comes not merely from people, but from how firms manage them. The set of management tactics, polices, and practices for doing so are the company's human capital strategy. That strategy is the last asset which companies can gain enduring advantages.

Human capital strategy is the sum of all actions used to manage people throughout an organization. It consists of six factors that affect business results:

1. ***People*** — the nature and quality of the individuals in the workforce.

2. ***Work processes*** — such as whether the company uses an assembly line or small work groups to build jet engines.

3. ***The managerial structure*** — including whether managers exert high control or low control over employees' work.

4. The flow of ***information and knowledge*** — both within the company, and to and from customers and suppliers.

5. ***Decision making*** — including decisions that affect major areas of strategy, operations, finance, marketing, and sales.

6. ***Rewards*** — including the motivators that influence employees to work hard, to innovate, and to develop.

All companies use a human capital strategy made up of these six elements. The factors come together in unique combinations to fit the individual companies, because different patterns work best for different enterprises.

A firm's human capital strategy creates a competitive advantage in two ways:

- ***First, it provides longevity*** because the sum of a company's human capital practices typically lasts longer than the impact of technology and financial capital.

- ***Second, it provides inimitability*** because a successful company's strategy for managing human capital is very hard for competitors to copy.

To achieve these advantages, you will need to enact three core ***principles of human capital management:***

1. Insist on systems thinking.

2. Get the right facts.

3. Focus on value.

We'll examine these principles in the next three segments of this summary. We'll then go on to define the *tools* of assessing your human assets. And in the last segments, we'll consider the *implications* for your company.

INSIST ON SYSTEMS THINKING

The first principle we'll discuss is ***systems thinking.***

There are two essential types of human capital in your company. One is *generalized.* The other form of human capital is *specific to your firm.* Human capital — a measure of the value of your employees — is the sum of both types.

- Generalized human capital is what an employee brings when he or she is hired. An advanced degree or a professional talent can be of use to you, but it can also be of use to another employer as well.

- Firm-specific human capital involves those employee attributes or skills that are valuable only to your company and are nontransferable. That type of human capital is gained through training, longevity, and advancement on the job.

Each firm requires a different mix of general and specific human capital, and even within a given company, different levels of the general and specific may be required depending on the job to be done.

Knowing exactly the mix that's needed — and how to

get it — is a key to successfully managing your human capital. For example, in one company, the possibility for pay increases within a particular job were low, while the big rewards came from changing positions in the company, even laterally. As a consequence, not surprisingly, people didn't stay in one job for more than two years.

Unfortunately, this had two negative effects. As people bounced around the company, they were trained as generalists without much firm-specific knowledge. Secondly, since the company's product cycle was three to five years, people rarely saw a project through to completion and so were not accountable for the results.

Although the company's policies about reward and advancement appeared to be logical when considered individually, their almost invisible net effect was to produce a workforce that was deficient in specialized knowledge, unaccountable for results, and unable to support goals of product quality and rapid time to market.

The problem resulted from the fact that the company wasn't thinking of itself as a whole *system* of organizational units, people, processes, incentives, and behaviors. It had evolved a strategy for managing human capital without thinking it through, and the results were less than optimal. Delivery time, product quality, and customer satisfaction were all in free fall. It was costing hundreds of millions. And the problem had an all but invisible cause.

The problem was that the company's leaders lacked systems thinking. Like any other complex system, businesses are made up of interrelated and interdependent parts. In any system, a change in one place causes changes in many other areas. Without careful consideration of those resulting changes, there may be unintentional effects, such as a sharp drop in profitability due to people changing jobs so frequently.

Without thinking of decisions — especially about people — in the context of the entire system, there is no way to predict the outcome of any change you decide to make. The problem with that notion is that, up until now, there has been no way to understand all the interactions that might take place in a system as complex as a corporation. There were simply too many possibilities.

One of the concepts used extensively by the authors is that of the Internal Labor Market. This is a method of learning the rates of movement of people through jobs, the rates of promotions, the financial gains that employees experience through lateral moves and promotions, the number of outsiders hired into leadership positions, and the job performance of those outsiders.

This technique involves the gathering of both soft and hard data. The soft data consists of what people say is going on. The hard data measures what is actually going on. The two are used in a statistical model to create causal relationships that tell which factors contribute to various outcomes, both good and bad.

In many cases, the analysis will show that without knowing it, a company may have erected barriers to advancement, leading to high turnover rates, which are costly and decrease firm-specific human capital. In other cases, a company may find that it is rewarding the wrong thing, leading to poor performance.

For example, giving incentive pay for performance to employees in a hierarchical structure where they have little flexibility simply produces frustration. In another case, a company that offered large rewards for promotions discovered that it could improve its profitability by strengthening the rewards for people who stay in the same jobs. This change discouraged the tendency of managers to move around the company, instead of developing the specialized expertise in a single area that the company desperately needed.

Once you start to think of your organization as a complex and tightly-interconnected system in which all parts and all decisions influence all others, you can begin looking for the right information with which to analyze and model your own business. This leads to the second principle of effective human resource management.

Get the Right Facts

If systems thinking is the first principle, ***getting the right information*** about the system is the second. It seems bizarre that executives who would thoroughly analyze any

sort of capital expenditure would fail to do the same when it comes to investing in people. It's not so bizarre, however, when you consider the lack of good tools for making such decisions. In the absence of such tools, managers have fallen back on hunches; on unreliable facts, such as survey results; and on often irrelevant facts, such as benchmarks.

One of the most common mistakes companies make in trying to get the facts is relying on survey results. They invest millions of dollars every year trying to understand what employees want, what they think, what will keep them on the job, and what makes them leave. Oddly, few companies actually look at what employees do. And when they bother to look, they find that what employees say and what they do are often worlds apart.

A newer approach to the problem of gathering facts about employees comes from the way some companies are looking at their customers. For example, instead of using surveys, Benetton is monitoring customers' actual behavior at the point of purchase. Data captured about the color of the clothes that are being bought is sent directly to the factory floor. Within a few days, the shelves are stocked with the most popular colors — the colors that customers might not have *said* they liked, but the colors they actually *bought.*

Toyota recently learned a lesson about the gap between what its employees say and what they want. Toyota management believed that pay and promotions were closely tied to employee performance. It also offered extensive training and career management services to advance workers. But a major survey Toyota conducted suggested the opposite. Employees said they discounted those things as motivators. So Toyota was about to change its policies.

But before doing so, the managers investigated the hard data — what employees actually did, not what they said. It proved to be the exact opposite. In fact, pay and promotions were tied to high performance, and those who participated in company programs for advancement did, in fact, advance.

Making such matters even more complicated to tease apart is the fact that companies, not just individuals, say and do different things. One company the authors studied said it rewarded performance. But when they looked more closely, they saw that the company rewarded *business units* that performed well, not individuals. So a high-performing employee in a new unit, for example, might be getting less reward than a low-performing employee in an older, more profitable unit.

The results on morale should be obvious. In addition, the company was shelling out $13 million annually to the employees who had ranked at the bottom of the performance curve for five years running. Without knowing it, the company was not rewarding individual performance. It was actually rewarding longevity on the job and business unit performance. In the end, investors turned on the company with a vengeance and its stock lost 50 percent of its value. This was all the result of not having the right facts.

Once the right facts are in hand, they must be viewed as a process over time, not just a snapshot. This will reveal the pace of employee advancement, pay improvement, and the actual causes of employee behavior. Only then will you be in a position to estimate the value of your human capital and its impact.

Focus on Value

The third principle of human capital management involves ***value.*** Like any asset, human capital is an investment with a stream of economic returns. When the benefits of those investments exceed their cost, value is produced.

Unfortunately, most companies look at employees as simply a cost, rather than a source of creating more wealth. That results in the view that the investment should be minimized, not maximized. When Gordon Bethune tried to pull Continental Airlines out of its death spiral in the mid-1990s, he realized that the company had so aggressively cut the cost of human capital that it had little to offer to its customers.

Companies can't afford to think about people as a variable cost. With knowledge-based enterprises, customer relationships, and innovation at the core of so much of today's

business, human capital is far too important to treat that way. People are the prime source of differentiation, unlike buildings, computers, furniture, and other physical assets.

One company the authors analyzed wanted to cut workforce costs, so it substituted a large number of part-time workers for full-time employees. It was therefore able to reduce the number of managers. It also engaged in obsessive benchmarking. In addition, it cut overtime to the bone.

By the time it got around to assessing the impact of such decisions, a great deal of damage had been done. The company destroyed revenue worth five times the savings it realized from the ill-considered cost-cutting measures.

To avoid such costly blunders, the authors have developed a technique called Business Impact Modeling, which uses computer modeling techniques to make simulated decisions and see the outcomes in various metrics, such as productivity. The problem that companies face is that the outcomes are never simple and are rarely intuitive.

For example, cutting overtime *seems* a logical way to save money. But in the analysis, one company found that it could increase productivity 3.3 percent for every 1 percent increase in the ratio of overtime hours to regular hours.

Another lesson is that benchmarking can be dangerous. There is no evidence that mimicking the practices of another company can help you. Each company is unique, so you should use benchmarking data to stimulate thinking, not to make strategic decisions.

Also, decisions about human capital have to be made on the basis of real and systematic analysis of data, not on hunches and intuition or even what seems most logical at the time.

And finally, measuring cost alone gives you no indication of what value is being created. The logic seems solid: Full-time employees cost more, so reducing their numbers saves money. But in many cases, such employees cost more because they produce more value than part-timers produce for the same investment.

Only by finding the drivers of competitive advantage and aligning the people policies and practices with them can a company get the most out of this valuable asset. The big question is: How do you do that?

The answer is: Develop a genuine, well-researched, strategy for managing human capital. That is the topic of the next part of our discussion.

Defining Human Capital Strategy

Up to this point, we've focused on the principles on which an effective human capital strategy must be based: systems thinking, relevant facts, and a focus on value. The next step is to integrate those principles in the form of practical tools that you can use to understand your workforce and determine the type of human capital you need.

Unlike most assets, human capital changes and evolves over time. People learn, change jobs, leave, get hired, and can be motivated or demoralized. Unlike a building or a piece of furniture, they can turn against you if you mistreat them. They make choices and can choose to help or hinder you. And yet they can be managed.

That's why every company needs a human capital strategy. This is a blueprint that specifies all workforce requirements and the management practices needed to optimize business performance. This blueprint has three key workforce characteristics to consider:

1. *Workforce capabilities.* These are the mix of knowledge, skills, competencies, and experience that determine what the workforce *can* do.

2. *Workforce behaviors.* These are the specific actions of the workforce as reflected in work intensity, diligence, cooperation, teamwork, and adaptation to change, among other things. These behaviors are what the workforce *does* do, as opposed to what it *can* do.

3. *Workforce attitudes.* These are the attitudes concerning risk taking, initiative, commitment, teamwork, flexibility, and so on. These are what the workforce *believes and values.*

Just because a company has human resources policies and practices doesn't mean it has a strategy. If they are not consistent and mutually reinforcing, they can degrade those characteristics. The real management practices that will define a strategy for human capital are:

- How people are selected and developed.
- How their work is organized.
- How they are supervised or directed.
- How information is developed and shared.
- How critical decisions are made.
- How people are motivated and rewarded.

Although most organizations don't realize it, they do already have a strategy for human capital, usually evolved by default. And predictably, the results are not always positive. Although many parts of the organization are involved in building and managing human capital, their activities are rarely coordinated, or even discussed.

Every company today needs a coherent, well-planned, and explicit human capital strategy that produces the right workforce for the business. This means asking six tough questions:

1. Does your company have an explicit human capital strategy?
2. If so, is it producing the workforce you need to be successful?
3. Are its components aligned with each other, or do they work at cross-purposes?
4. Is the strategy really understood and accepted by key stakeholders?
5. Is the strategy adaptable to changes in the business environment?
6. Is it backed up by measurement so that management can track how well it is being executed and be accountable for the results?

Asking such questions will allow you to compare your current workforce capabilities with what they ought to be if you are to achieve optimal performance in the future. To find the answers, you can use two tools developed by the authors: Internal Labor Market Analysis℠ and Business Impact Modeling℠. Let's take a look at the analysis first.

UNDERSTANDING YOUR INTERNAL LABOR MARKET

Every workforce evolves constantly as new people enter, others leave, and employees acquire new skills. At any moment in time, the workforce is the outcome of three labor "flows." They are:

1. ***Attraction.*** How successful is the organization at attracting the kinds of people it needs to achieve its goals?
2. ***Development.*** How successful is it at growing and nurturing the kinds of human capital it needs to execute its business strategy?
3. ***Retention.*** How successful is it at retaining people who have the right capabilities and produce the highest value?

One of the key ways a company can answer those questions involves its system of rewards, whether through compensation, benefits, or opportunities for career advancement. Regardless of what a company says it values, by looking at what it rewards you can see what it truly values.

The Internal Labor Market Analysis is based on that idea. It examines the flow of people into, through, and out of an organization and answers fundamental questions about the workforce, such as:

- Who gets hired?
- Who stays?
- Who advances?
- Who performs well?
- What actually gets rewarded?
- How are the rewards distributed?
- How is talent developed?

The ILM Analysis takes three to five years of HR data to produce a highly detailed description of the way a company's internal labor market is running. It also shows the

attributes of that human capital, including such measures as experience, selected skill sets, and productivity.

It can identify such barriers to progress as career bottlenecks or choke points, where people advance to a certain point and stall, unable to move up, resulting in high turnover at that level. It can show such things as when a firm should be hiring from inside or outside to fill certain job levels. And it uses statistical core models to get at the drivers of turnover, promotion, lateral movement, compensation, and individual performance.

The computer model relies on three categories of independent variables and statistical controls:

1. ***Employee attributes.*** These include such things as race, gender, education, job, industry, labor market experience, and performance history.

2. ***Organizational attributes.*** These include such measures as the size and heterogeneity of a department or work group, the turnover rate within the group, the manager's span of control, and the workload, among others.

3. ***External influences.*** This includes the market environment, such as unemployment rates, product or service market share, and location.

With such a model, it's possible to examine in detail such decisions as those concerning workforce diversity. Should a company hire a diverse workforce at a high level, or hire at a lower level and prepare those employees for advancement? Ordinarily, such a decision would have to be made on intuition, and then management would simply await the outcome. With the computer model, the consequences of the decision can be seen in advance, and often hidden or unintended effects teased out and avoided.

Once the internal labor market is thoroughly understood, it's time to start building a strategy for managing it effectively.

Building Your Strategy

Building a strategy for managing human capital involves asking three key questions:

1. ***Where are you now?*** What is your workforce now, what are the internal labor market dynamics that drive it, and what are the most influential management practices?

2. ***Where do you want to go?*** What does your business strategy tell you about your ultimate goals? What is the vision? And what are the implications of that vision for human capital?

3. ***What creates value?*** What workforce attributes, and what human capital practices, drive business success?

Building a human capital strategy is about closing the gap between where the company is now and where it needs to be. From the ILM Analysis, your company will understand trends in the workforce as well as the future state it should assume over time. It also shows the causes and consequences of workforce dynamics. With those models, then, it can show how changes will affect those dynamics.

For example, suppose the analysis shows that education and early job experiences influence the rate at which people advance into management positions. That can be used to predict how many new recruits will advance to management positions within five years if you increase new hires by 25 percent. You can also calculate how much the company's retention rates and compensation costs will change as a result of that new policy.

The second approach to seeing into a company's future comes from the Business Impact Modeling tool. This is a quantitative analysis of business performance that identifies workforce characteristics and management practices that are the strongest drivers of a company's most desired and most important business outcomes, namely, profitability, quality, and customer retention.

The difference is that while the ILM Analysis focuses on workforce outcomes, Business Impact Modeling focuses on business outcomes. For example, to what extent will customer retention be hurt if you accelerate the rate at which your employees rotate through customer-facing jobs?

Like ILM Analysis, Business Impact Modeling uses human

resource information and payroll data. But it takes in a much broader range of data as well, including that kept by finance, quality control, marketing, and operations. The information captured by the ILM Analysis is fed into the Business Impact Model to predict specific business outcomes.

For example, at one hospital system the authors analyzed, they found that more than 60 percent of the differences in workforce productivity could be explained by factors relating to human capital, mostly the mix of full and part-time employees.

In another case, turnover was studied to see if it's always bad for a business. In fact, turnover can be good when it creates an escape hatch for poor performers and a way to create a vacancy for outstanding employees.

Getting such answers is only possible through computer modeling or costly real-life experience. With that sort of information and a new view of your organization's real functioning, you can begin to assemble the best human capital strategy. Start by taking the following six steps:

1. ***Know where you are.*** The ILM Analysis will give you the facts about your current workforce and workforce management practices. It will spell out capabilities and tell you whether you are building them or buying them. It will show strengths and weaknesses and most importantly, what you are really rewarding.

2. ***Project the future.*** Through interviews, surveys, focus groups, and structured planning meetings, decide where you are going to go next. Consider how the business will be different, what new technology or process will affect you, and who your customers will be. Then consider the human capital implications for that scenario.

3. ***Find the value.*** Business Impact Modeling can help identify the human capital attributes that will create the greatest value. This is a chance to test the qualitative data gathered from executives and managers.

4. ***Close the gaps.*** Test alternative solutions, including new workforce attributes or new combinations of practices, to find ways to close the gap between where you are now and where you should be.

5. ***Design the interventions.*** Plan the specific changes you will make in the workforce and the way you'll manage it. The ILM Analysis models can then simulate the what-if scenarios you create. The Business Impact Model can estimate the return on investment of your interventions.

6. ***Implement with accountability.*** Use metrics to focus implementation efforts. Metrics will show when course corrections are needed and allow continuing assessment of success.

In this way, you can move quickly to start developing and implementing an effective human capital strategy. Resistance will be lowered because the strategy will be based on facts specific to the business. Realistic targets can be set. Trust in management will grow because the facts behind the strategic decisions can be explained. And line managers and employees will be energized by seeing the real impact of human capital practices on business results.

The People Side of Strategic Shifts

It is widely known now that most change initiatives fail. Some say 60 percent, such as Michael Beer and Nitin Nohria of Harvard Business School. Some say more. The problem, well known now, is that management changes its strategy but the people on the ground don't implement it. The failure is usually laid at the feet of employees who are reluctant to change, and then all sorts of motivational programs are dreamed up to get them moving. But the root cause for that lack of change isn't addressed.

In most cases, management practices remain the same, still aligned with the old model and at odds with the new. The employees are responding rationally to a system of incentives and institutionalized practices that push them in the old direction rather than the new one. It is in this crucial area of

implementation that most companies make their biggest mistakes.

Take the example of United Airlines trying to compete against Southwest in the lucrative California market of the 1990s. Along with other carriers, United decided to cash in on the low-cost, frequent-departure, short-haul, point-to-point strategy that had been making Southwest rich. So United set a new strategy, modeling it on Southwest's. But they made no adjustments to their people practices and policies.

United was saddled with hostile flight attendants, battling unions, and other labor problems at the time. The airline's management did nothing to fix those problems. Sadly, United was unable to see that Southwest had a completely different culture and a completely different way of hiring and managing people. United failed miserably in that market because it didn't recognize that its business was a system and that the most important part of it was the human capital.

One lesson United might have learned could have been easily gleaned from a thorough analysis of its human capital *before* making the decision to go head-to-head with Southwest. It might have found that Southwest's success depended so much on its unique workforce that United didn't stand a chance without major changes in its own human capital capabilities.

Once a company begins to consider all strategic decisions in light of its human capital, it not only makes more rational decisions, but it positions itself to adapt to changes in the competitive environment. When companies merge or acquire others, their understanding of human capital is put to the ultimate test.

If most strategic changes fail, acquisitions have an even worse track record. Up to 80 percent of them are doomed, depending on what data you consult. Often the only ones making money are the investment banks. The reason for those failures can be summed up in one word: people.

And the reason behind that is simple: Executives fail to consider that when they're buying a company or merging with one, they are acquiring a huge store of human capital. A survey of CFOs showed that almost half of them viewed human capital as only moderately important in acquisition pricing. This is the reason that integrating two companies can become such a nightmare.

Companies must take a careful look at the human capital *before* they decide to make a decision to integrate. Another important point to consider is how much integration is right for the particular marriage of cultures. There are three kinds of integration:

1. Complete
2. Partial
3. Portfolio

Complete integration takes place when one company swallows up another and forces it to adopt its culture, infrastructure, identity, brands, and so on. *Partial integration* occurs when some, but not all, of the acquiring firm's systems, practices, and policies are merged into the acquired firm. And *portfolio integration* refers to a company being turned into a subsidiary and being otherwise left untouched.

To make the decision about how much integration is appropriate, consider three elements:

1. Know yourself, know your target, and know the differences between them.
2. Estimate the potential scope of the integration.
3. Recognize the pace at which integration should take place.

The forces that push for integration are low when an acquisition meets the need for a product, patent, or location, but not a need for the employees. Those forces are high when an acquisition requires collaboration on projects or creates opportunities to leverage capabilities or join forces, such as in sales or research and development.

There are also significant barriers to integration at times. The barriers are high when the acquired company has a very different demographic profile or differs culturally. The barriers in different human capital management styles can also be deal-breakers for integration.

In the end, rational decisions about acquisitions — or anything else — can only be made after carefully looking at the

people in the company and how they are managed. This can be done by using the three core principles already mentioned:

1. ***Use systems thinking.*** The human capital of the acquired company and the buyer are parts of a larger system that is going to have to execute a known strategy. Viewing all the people through this strategic thinking and assessing how well they will do under various schemes for integration is essential in the ultimate success of the purchase.

2. ***Get the right facts.*** Many acquisitions are based on intuition, hunches, or a superficial understanding of the facts. A company can avoid disappointment by taking the time to dig out the facts about the workforces that will be integrated.

3. ***Focus on value.*** Instead of looking for savings in costs, companies should consider whether the target firm will add value.

The Investor's Perspective

If human capital is so important to a company's bottom line, why is it often overlooked by investors? Investments in tangible assets such as land, buildings, and inventory have always been used to value firms. One reason for ignoring human capital is that it has been difficult to measure, despite decades of attempts to link shareholder value to it. Yet everyone knows that human capital contributes hugely to a company's value.

To date, there is no clear tool for measuring how well a company can create shareholder value out of human capital. One effort in that direction was conducted by Douglas D. Dwyer, linking productivity and shareholder value. What he found was substantial and persistent differences in the productivity of manufacturing plants in the U.S. Moreover — and not surprisingly — investors place a high value on the more productive firms. A 10 percent gain in productivity translates into a 5 percent gain in share price.

In other words, productivity itself is an intangible asset that can be measured. And there is credible evidence that the differences in plant productivity are tied to the management of human capital. So that is one possible way of viewing how well a company is creating value out of its workforce.

One of the most likely sources of real information on this subject may be the silver lining on the cloud of scandal that has rocked so many corporations of late. Everyone from investors to Congress is pushing for more transparency in corporate governance, and that is likely to lead to earlier and fuller disclosure, which will inevitably shed some light on human capital practices.

For example, National City Corporation is one of the largest banks in the United States, with over $100 billion in assets. In its 2001 annual report, CEO David Daberko detailed National City's efforts to change its value proposition to customers and cited the human capital practices that were being revised to support that effort. He admitted that those investments, which are costly, will hurt short-term earnings but were essential to long-term success.

Another bank, First Tennessee National Corporation, believes its people practices are a source of competitive advantage. As a result, it briefs financial analysts about human capital issues, including the linkage between its business results and the retention of high-performing employees.

Shareholders are showing an increased interest in human capital issues, and some third-party vendors are starting to produce that kind of data where it's available. As that type of information becomes more widely available, expect to see analysts factoring it into investment decisions and stock valuations.

New Roles for CEOs and Other Leaders

In this summary, we've laid out the bedrock principles of human capital strategy. Companies can derive substantial benefits when those principles are implemented properly. When that happens, executives have the facts they need to make good decisions about the people side of the business. In many cases, the impact of decisions about human

capital on both performance and financial results can be predicted with a high degree of certainty. Businesses can finally make the most of a critical asset: their people.

This new approach to human capital management offers great potential for improving business results. That potential, however, may not be fully realized under old organizational arrangements.

Human capital is a strategic issue that straddles functional boundaries. The data needed to find the human capital drivers of value, for instance, are not solely under the control of human resources, finance, marketing, or any other single function. It is essential to cut across functional boundaries to get the right facts, to analyze them, and to act on them.

To do this, it's necessary to get the leaders of all parts of the company involved. It also requires that the CEO take a new approach to human capital. That means putting an end to viewing employees as an expense and starting to look at them as a key investment, one with a great deal of upside.

Ask yourself these key questions:

1. ***What is the actual size of our investment in human capital?*** This includes not only wages and benefits, but the cost of leadership development tactics. Knowing what you're spending is the first step in optimizing the return on that investment.

2. ***How is human capital managed as an asset in your company?*** How do you acquire, develop, motivate, retain, and deploy your people? Through the analyses described in this summary, the answers will become clear.

3. ***Which attributes of your people and which of your people practices have an impact on business results?*** What is that impact? The facts that emerge from the computer modeling will pinpoint those results.

4. ***Are the returns from your investment in human capital satisfactory?*** How can you redirect your investments to achieve better returns?

By having solid answers to those questions, CEOs can position themselves to differentiate the company on the basis of intangibles, such as human capital. Those are the leaders that security analysts and institutional investors are going to reward as they become more and more keenly interested in how companies are creating value from clever and effective management of the workforce.

Those leaders use metrics that track human capital performance. They follow a strategy for managing human capital. They depend on a system of rewards, training, career development, and targeted recruiting to continually strengthen that asset. They align their people strategy with their business strategy. And they allocate their human resource assets to their most productive uses.

Unfortunately, to date, most leaders aren't doing that. Despite their propensity for measuring everything, most financial officers do not know how to measure human capital and show no interest in it. Only 16 percent say they have an even modest understanding of returns from the company's single largest investment, according to CFO Research Services. A stunning 14 percent said they knew nothing at all about it.

What this leads to, aside from the obvious lack of information to pass on to investors, is a lack of discipline in the way that important investment is handled. Obviously, you can't tell if your investment is paying off if you have no idea of the return you're getting.

This leads to self-destructive decisions to lay off employees when times get tough. Lost in the decision-making process is the fact that long-term assets, such as knowledge and experience, are lost, usually forever. Once an employee is gone, it's often impossible to get him back, especially if he has valuable experience. And it may be your competitor who hires him.

Fortunately, this situation is changing. More and more financial executives are understanding that it is their role to manage this key investment, especially with so much attention being paid to corporations and their governance today. They are seeking larger roles in decision making about human capital. And as a result, they are seeking hard financial data that can

quantify the cost and benefit of their human capital.

Meanwhile, in response, human resources departments are changing and moving toward increased responsibility for strategic objectives. That new role requires a fact-based understanding of the way the overall corporate strategy is served by the workforce and the company's strategy for it.
All of these changes will pay off. Every company that gets its system of people management "right" enjoys an extraordinary competitive advantage over its rivals. It can obtain better performance from its greatest asset, and it does not have to worry about other firms copying the key to its success. In doing this, the company is truly playing to its strengths.

ABOUT THE AUTHORS

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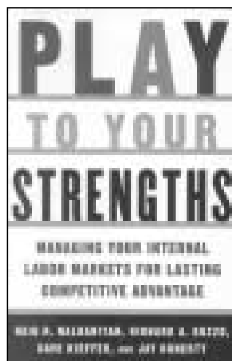

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