

CHAPTER 1: A Great Gap to be Filled

*Though your balance-sheet's a model of what a balance-sheet should be,
Typed and ruled with great precision in a type that all can see;
Though the grouping of the assets is commendable and clear,
And the details which are given more than usually appear;
Though investments have been valued at the sale price of the day,
And the auditor's certificate shows everything O.K.;
One asset is omitted - and its worth I want to know,
The asset is the value of the men who run the show.*

(Archibald Bowman, "Reporting on the Corporate Investment"
Journal of Accountancy, May 1938 p. 399.)

In 1960 Douglas McGregor published his book "The Human Side of Enterprise". He suggested there were two basic approaches to management. "Theory X" assumed people were instruments of labour - human *resources* - and that management was about efficient task fulfillment, with a carrot and stick approach to performance. Or, he suggested, you could take the view that what people are actually looking for is challenge and interest, and that the task of management is to maximise commitment and liberate their ideas and abilities. This he called Theory "Y". Most organisations today would say their thinking embraces more of "Y" than "X". However, forty years later, in a numbers-driven business culture, while we are good at measuring people as costs and *resources*, we still have no accepted way to value people as *assets*.

The gap Archibald Bowman identified in his piece of doggerel remains today. Developing new business models for today's world is one of the greatest challenges we face. This book takes up the challenge.

1.1 "Our people are our most important asset"

Most chief executives would readily nod assent to this frequently heard statement. Yet the people within an organisation do not always experience decisions and policies reflecting this in everyday life. They are much more likely to see it being driven by efficiency and minimising costs. Asking audiences how they perceive this reality in the UK, I have found that less than 20% feel that the decisions made by top management match their espoused belief in the real value of people. The accountant who once described people to me (admittedly with a smile) as "costs walking about on legs" is often closer to reality.

The problem is that people do not fit the strict financial definition of an "asset". They cannot be transacted at will; their contribution is individual and variable (and subject to motivation and environment), and they cannot be valued according to traditional financial principles. And yet organisations today are as much concerned about the "war for talent" as any other business issue. Why so? It is very simple. The *valuation* of companies has progressively changed since about 1990, putting a much higher value on the "intangible assets" like knowledge, competence, brands and systems. These assets are also known as the "intellectual capital" of the organisation. And it is people, and people alone, - the "human capital" - who build the value.

Jack Welch, one of the most well known American CEO's, is famous for saying that "there are three key measures in business – customer satisfaction, employee satisfaction and cashflow in that order". More recently, he said he had the first two round the wrong way, and that employees should come first. What he recognised was that, at the end of the day, everything depended on people – their capability, motivation, creativity, organisation and leadership. People manage the tangible assets, and they also maintain and grow the intangible.

We cannot track intangible assets in the same way as financial and physical assets. We have to learn new ways, but these must have the same level of credibility as well established systems of accounting. We must do it - in the era where knowledge and talent are at a premium there is no doubt at all about which are our most important assets. Organisations that continue to think of their people as mere resources and costs have not crossed the millennium divide.

There is a growing volume of research aimed at recognising and *proving* the relationship between "good people management practices" and "the bottom line". Today, that bottom line is seen as both profitability and long term shareholder value. The major consultancies are devising their own systems for the 'metrics' of people management. William Mercer, for example, have developed a "human capital wheel", Watson Wyatt have a "human capital index", and PricewaterhouseCoopers have a department called "HR Analytics". This last one won a prize within the consultancy for innovation in 2000. Researchers such as Mark Huselid and Jeffrey Pfeffer in the US, and David Guest, John Purcell and Lynda Gratton in the UK, have done long term studies to demonstrate the benefits of a positive approach to human resource management.

It is not surprising that they find positive correlations between people and performance. Companies like Johnson and Johnson and Cadbury knew many years ago that the better people are treated, the more successful the organisation is likely to be. However, it is not enough to simply preach the latest research results. These days managers are bombarded with ideas on how to do everything better. And what really governs their lives are *numbers*. The challenge therefore is to find some quantifiable methods which enable us to understand people's worth and their contribution to 'value' in the organisation.

The realisation of how critical the contribution of people is – and especially high value talented people - to organisational success has probably never had a higher profile than now. The need for sound measures to manage them as assets - rather than mere costs - is essential for the modern organisation.

1.2 Shareholders vs Stakeholders

Organisations exist to create value for people, either individually or collectively. Charities convert money, expertise and caring attitudes into benefits for people in many different ways. The public sector organisation brings value in services and information to different sections of the community. Business creates monetary value for its owners, and in so doing brings value to many other individuals and organisations. Are shareholders, owners and investors, more important than others with an interest in the success of the organisation – people and groups of people that we call “stakeholders”? Most CEO’s of commercial companies will say their ultimate goal is to build value for the shareholders. Major decisions, especially about ownership, are taken with this in mind. But if in so doing they destroy value for other stakeholders, the evidence is that they do not achieve their goal in the long term. If customers no longer want to deal with them, employees no longer want to work with them, suppliers find them too difficult to trade with, and the community loses confidence in them – then these stakeholders who are essential to their continuing success are lost. Without their support, no shareholder can have sustained returns.

The chorus in the great film “Cabaret” sang “Money, money, money makes the world go round”. But, as we all know, it is a myopic mercenary who believes that the human condition is all about money, even though it can make life easier. And yet the pure economist model implies that money for the shareholders is *all* that business exists for. It is not just a matter of ideology, but an issue about realism. Society needs business to provide employment and build financial stability for individuals; to create and distribute products and services; and to take a responsible role in supporting communities. Business creates wealth that can be shared – this is its ultimate “added value”.

The foundation of our thinking therefore, in value creation, is knowing how value is added to *all* stakeholders, both financial and non financial, both now and in the future. We need a clear idea about what matters to them, and how to meet their needs, so that they will want to go on working with us.

1.3 The Challenges to be Grasped

Every day we can see the outcome of the lack of balance between thinking of people as costs or as assets. Of course in a sense they are both simultaneously. But let us have a look at some of the challenges we need to grasp, and where our inability to do so has a serious impact on the effectiveness of our organisations.

Challenge #1

When we make decisions to cut costs from an organisation, we have clear numbers to work with. Everyone understands the systems and measures for costs; but when we talk about their corresponding value (if indeed we do) we may only have words. And numbers always speak louder than words. We lack a commonly accepted framework for the value and contribution of people. It is only when people leave that we miss the *value* they contributed – often so much so that we hire them again as consultants. Consultants go on a different cost-line than salaries and headcount – so that’s OK!

Making business decisions purely on cost grounds is yesterday's business model. Hundreds of books today will advise how to create economic value, how to build empowered innovative organisations, develop visionary leaders, secure evangelistic customers and win the war for talent. These imperatives are a million miles away from the kind of management accounting that has had a stranglehold on organisations for the last fifty years or more. They require a new language, which is about building futures not documenting the past.

The challenge is simply stated: ***balance cost numbers with value numbers, so that both have equal status in decision making.***

Challenge #2

Every person brings a different combination of capability, and contributes to the organisation in a unique way. When one joins or another leaves, there is an impact on our human capital "stock", which is more than a mere adjustment in headcount. Each individual employee lends the organisation his or her "personal human capital" in exchange for value in various forms – salaries, challenge, development and so on.

How do we recognise the intrinsic diversity in worth of people, and find a way to value it through understanding their personal human capital?

Challenge #3

The phrase "*adding value*" is often used loosely, meaning "making a worthwhile contribution". But adding real value to stakeholders is a serious business – it is the only reason that organisations exist at all. The phrase is incomplete if we do not specify at least "to whom", and preferably "by doing x". This should be the basis of performance management. Such measures might be either financial or non-financial, but it is only some form of *quantification* that enables us to know whether our capacity to add value is increasing or decreasing. Every asset (including individual people) should be linked to the value that is created for one or more stakeholders.

We need to measure the value – financial and non financial - that is added to each stakeholder from each of the people that we have.

Challenge #4

It would be unfair to accuse *all* organisations of giving much more attention to the short term than the long term. Operational efficiency has to be balanced with investment. But the reality is that short term pressures easily dominate resourcing decisions. People whose role is to focus on the future may be given the lower priority when it comes to restructuring resources. "Shareholder value" is still linked in many minds with *current* profitability. It is true that this provides the dividends for shareholders and owners, but the value of a share reflects the collective judgement of investors in the *future* of a company. What they look for is the prospects of the revenue streams to come, and historical profits may or may not be a guide to that.

Stories regularly appear in the financial press about CEO's who have tried to set a long term strategy and yet been brought to heel because quarterly profits have suffered. One headline in 2000 concerned Procter and Gamble, well known for its visionary thinking and excellence in management. Durk Jager, a veteran of P&G set out his vision in "Organisation 2005", but earnings fell and the share price with it. John Pepper was brought out of retirement as Chairman and a new CEO appointed. "I want to express my gratitude to Durk Jager for his visionary leadership and many contributions to P&G over 30 years," Pepper said. "We have an accelerated pace of product innovation that never would have been possible without his leadership. This is his legacy. His emphasis on innovation and a culture that reaches out for breakthrough provides a strong foundation for future progress." "It was a personal decision to step aside," said Jager with due corporate loyalty. "I am proud of the vision we set out to achieve with Organization 2005, and we've made important progress. It's unfortunate our progress in stepping up topline sales growth resulted in earnings disappointments. I'm confident that with the leadership of AG Lafley and John Pepper and the strength of P&G people, the company will achieve its full potential." He was expressing the difficulty of building for the future and at the same time guaranteeing present financial performance, so readily seized on by financial analysts. One year later under the new leadership, profits were still struggling.

The challenge here is: ***to be able to value future returns from intangible and people-related investments with as much credibility as the well-trying methodologies for physical asset investment.***

Challenge #5

Organisations set goals, both short and long term, to measure progress. Each of these goals has *drivers*, "input" factors that determine the desired outcome, and they in turn have their own influencing factors. A sound performance management system should monitor all the drivers and influences that affect the goal, just as much as the desired outcome itself. It is not long, as you follow down the logic of the performance chain, before you come to people-related issues as a critical dependency. The measures for these are as important as any others in driving success.

A credible set of measures and indicators enables practical, and better, decisions to be taken about important business issues like:

- acquiring new people
- rebalancing the workforce
- maximising performance and productivity
- developing individuals and groups
- resource allocation and options for outsourcing
- investing in people and organisational development
- benchmarking
- setting up partnerships and alliances
- managing mergers

The drivers of performance outcomes are as important to measure as the outcomes themselves

Challenge #6

The pace of restructuring in organisations seems to be always on the increase – through acquisitions, mergers and disposals, or simply re-organisation. The rate of failures in the restructuring of organisations is well documented – research by KPMG in 1999 showed 53% of mergers studied failed to bring added shareholder value. Although commercial firms may pay significant premia for the intangible assets of another company, much of this value is often lost through the pursuit of cost-driven “synergies”. Lawyers and accountants focus on liabilities and numbers; meanwhile the really valuable assets like expertise, experience, customer relationships and knowledge may be lost in the process.

How do we ensure that value is increased, and not lost, when organisations merge and restructure?

Challenge #7

Investors find it very difficult today to find out the information they need to judge the capability of an organisation to deliver value in the future. The likelihood that statutory bodies will soon require more to be declared on intangibles is almost certain. To prepare for this, organisations need to get it right internally first. A system for regularly reporting what is happening with *selected* and *strategic* intangible assets needs to be set up and have the same importance and credibility as that for the familiar financial inputs and outcomes

The time will come when organisations will be required to publish relevant and reliable data on their intangible assets. The challenge is to know first how to do it effectively internally.

1.4 The Slippery Slopes of Measurement

Gordon Petrash, formerly Director of Intellectual Capital at Dow Chemicals and a pioneer in the movement to recognise the significance of intellectual capital, has been consistently saying:

“If you can visualise it, you can measure it, and if you can measure it you can manage it”

This assertion is one of the drivers behind this book, particularly as it concerns people. We start from the principle that everything *can* be quantified in a way which enables us to manage it, and cause changes in it. Whether we are talking about the capability or potential of people, the culture in which they work, or their motivation – just to give some examples – measures can be found and tracked. Managers are conditioned to working with numbers, and nothing has a greater impact. Yet, we need to treat numbers that relate to people with care and caution – ensuring the processes used to obtain them are sound and being clear what we want from them. A *comparison* over time, or against a particular benchmark or target, is often more useful than the *absolute* measure itself. It is the context that gives meaning to the figures. For example, if an employee opinion survey indicates 65% of people are

satisfied, this has little significance in itself. Its real meaning only becomes apparent if we compare it with the same measure in a previous survey or with similar questions in other organisations.

Why are most organisations still so unsophisticated and haphazard in this area?
There are several reasons.

- it is not easy! People do not fit consistent patterns, like buildings or machines. There are many dimensions to be considered, not just pounds or dollars. Attempts to apply well accepted financial principles to the valuation of people have failed because of the number of assumptions that have to be made. People are not static either, they move around organisations and between them.
- because of the complexity, we need several kinds of measure and processes of measurement. Each measure has to establish its own credibility as a logical driver of, and link to, the ultimate financial numbers.
- there are dangers in forming conclusions about measures without fully understanding the range of factors that can determine a particular outcome. We need to understand its *causality*. For example, we might measure attrition rates in the knowledge that our pay rates are below the market, and *assume* this is a significant factor. In reality the dominant *cause* might be less to do with pay and more to do with the quality of management.
- human resource professionals have often been cautious about championing the need for measurement. Many feel it is their role to balance the prevalence of numbers with “humanity”, and not to try and compete with accountants on their own ground. This is not to say many do not measure the efficiency of their own processes, or create sets of helpful statistics, or attempt to establish return on investment for some programmes and initiatives. But systematically quantifying the worth of individuals and their contribution to stakeholders has generally been neither a priority, nor an aspiration.

Since the mid nineties, some progress has been made. Supporters of the “balanced scorecard” – a system designed by Robert Kaplan and David Norton and first published in 1992 – have grown steadily. This approach does look for measures of the drivers of financial outputs. It balances financial indicators with those for customers, process efficiency, and “learning and innovation”. Some users of the Scorecard have replaced the latter with a more general “people” element – and most find this area the most difficult to find good indicators for. David Norton himself says in his Foreword to Becker, Huselid and Ulrich’s *HR Scorecard (2001)*:

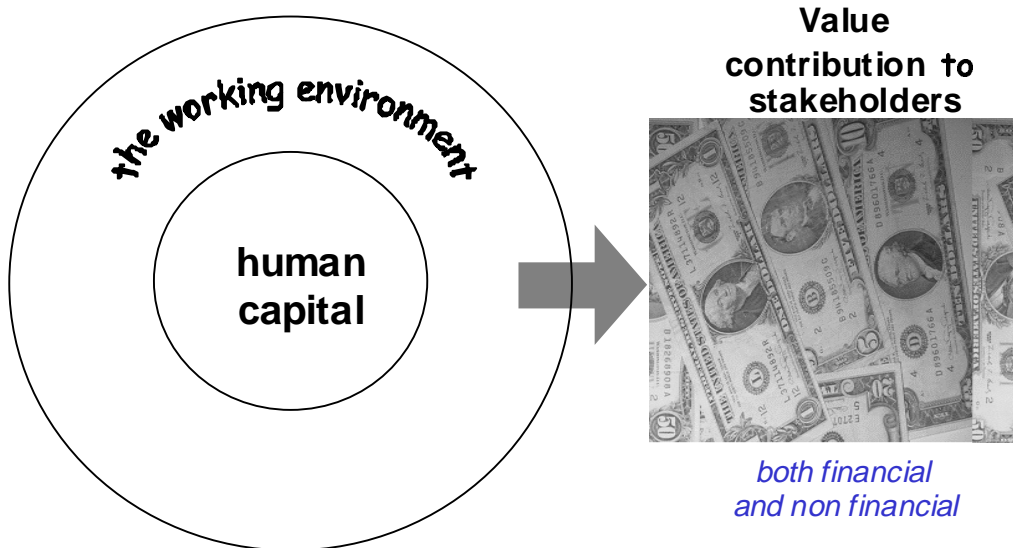
“But the worst grades are reserved for the typical executive team for their understanding of strategies for developing human capital. There is little consensus, little creativity and no real framework for thinking about the subject. Worse yet, we have seen little improvement in this over the past eight years....human capital is the foundation of value creation. The asset that is the most important is the least understood, least prone to measurement, and hence the least susceptible to management...”

In parallel with the development and application of the Scorecard, some pioneering Scandinavian companies have taken a different starting point. Beginning with the

components of intellectual capital they have developed a range of indicators to cover each, including people. Some have gone so far as presenting them publicly, and examples will be found in the last chapter.

1.5 The Human Capital Monitor

Figure 1.1 – The Different Requirements for Measurement



This book provides a coherent model for measures that relate to human capital. It will be of benefit to those using the Scorecard, but will provide a stand alone means of recognising the vital contribution of people to value creation.

There are three distinctive areas which require measurement, and they are illustrated very simply as in figure 1.1.

People loan their *human capital* to us, and we provide an *environment* in which they can *contribute value* to stakeholders in our organisation.

This is encapsulated systematically in the ***Human Capital Monitor***, each column relating to the three areas of measurement.

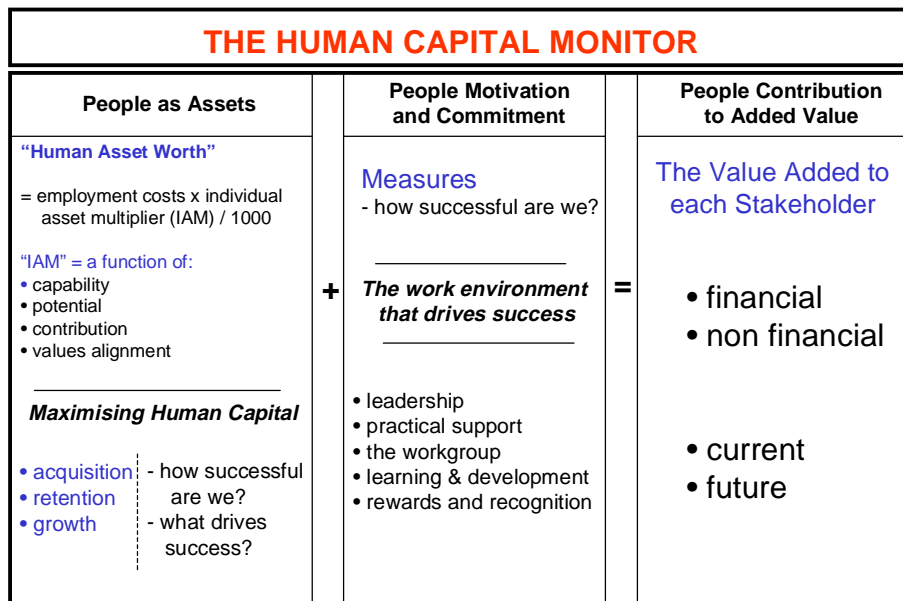


Figure 1.2 The Human Capital Monitor

- ◆ First, we want to have some indicators of the intrinsic worth of the people and teams who are available to us – not necessarily in any absolute or financial way, but relative to one another. We need to know whether some people have “greater human capital” than others, and whether our “stock” of human capital is *increasing* or *decreasing*. This implies we can track the flows of human capital into, out of and within the organisation. When we look at the costs of people, we also need an indicator of value that will enable us to keep a balance in perspective. Also, there may be some people whose cost is greater than their worth to us. These are “liabilities” rather than assets – people who are subtracting value from the organisation. In summary, we want a sense of the “*balance sheet*” effect of human capital.

The formula, which is expanded in chapter four, is for a measure called “*Human Asset Worth (HAW)*”. It combines a person’s employment costs (as a starting point of their value) with a combination of four key components which are summarised in the “*Individual Asset Multiplier (IAM)*”. The product of these is divided by 1000 so that the resulting figure is clearly not in a monetary currency. The four components that make up a person’s worth to us are their capability, their potential, their contribution, and their alignment with our values.

Our human capital is maximised through three key activities – persuading people to join us, keeping them, and developing them. There are factors we can identify for each of these processes that influence our success at them – these need their measures too. They complete the first part of the Monitor.

- However good the people I recruit may be, their contribution is strongly influenced by their *working environment*. It impacts the level of their motivation, commitment and loyalty, and encourages or restrains the full use of their ability.

It is vitally important therefore to identify the factors that make a difference in the environment and to be measuring the level of strength or weakness that they have. The Monitor chooses five such factors – leadership effectiveness, practical support in the workplace, the nature of the workgroup, the culture of learning and development, and the systems for rewards and recognition. We need to constantly take our dipstick into these areas, and find out whether we are optimising the value people bring, and/or whether these factors are getting stronger or weaker.

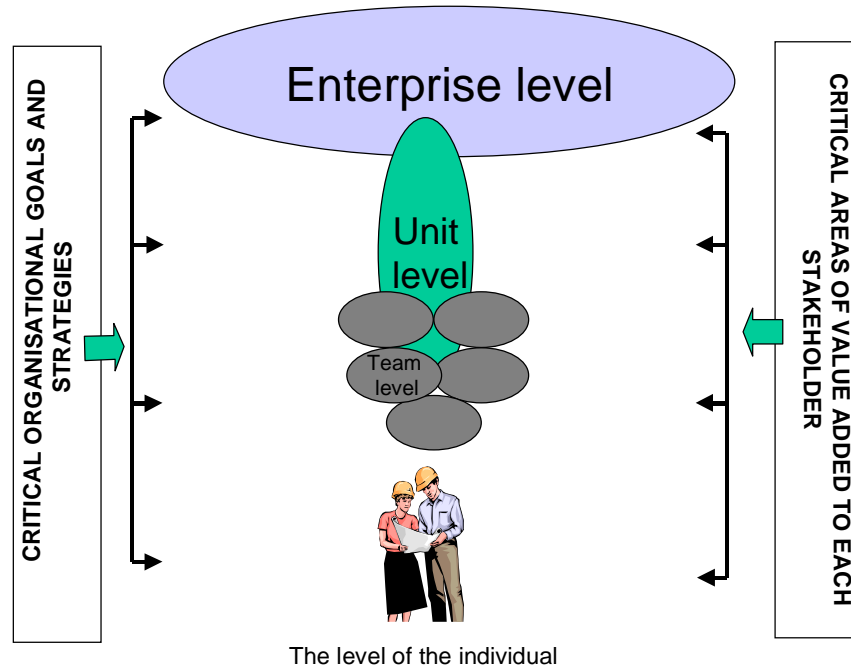
- Thirdly, we want to be able to measure the *contribution* of my human capital in terms of how people are adding current and future value to stakeholders.

All the people in a commercial organisation collectively produce financial wealth which can be distributed. But they also work in teams and individuals to provide specific financial and non financial value to one or more stakeholders. We need some organisation-wide indicators of their contribution, but also should link every individual with a measure of the specific areas of value their role is designed to add. We want to distinguish too between the *current* contribution to maintaining value, and those people and activities dedicated to creating increased value in the future. This is about the “*profit and loss effect*” of human capital.

For non commercial organisations the same need exists, except that the financial indicators have a “value-for-money” rather than “wealth creating” perspective.

1.6 Choosing the number and level of our measures

If we try and measure everything at every level, we will be swamped and find we have so many numbers that there are too many to manage. Figure 1.3 shows four levels – the enterprise as a whole, organisational units, teams and individuals - that we want to consider within the context of the two key driving forces in any organisation:



- the critical organisational goals and strategies
- the areas of value that matter most to each stakeholder

Figure 1.3 The involvement of different levels with key organisational drivers

Measures at the “enterprise level” can be somewhat crude levers for management, since they hide a multitude of sins and virtues in the detail. For example, total attrition figures quoted for an organisation which include many different categories of employees have little meaning. Aggregated opinion surveys may show common threads which are organisation-wide, but the many local working climates are the real clues to people’s commitment and satisfaction so that we have to have data broken down to units and teams. Nevertheless, there are two rationales for measures at this enterprise level:

- indicators we might want to publish year on year as information for investors or stakeholders – for example financial value added, investments in employee development, community involvement, innovation measures.
- those we want to benchmark with other similar organisations – such as attrition, overall satisfaction, suggestions per person, reward levels.

How do we decide which measures to choose at the lower levels?

We start with our goals and strategies, and the final outcome measures that provide their quantitative targets. They may for example be growth levels, profitability, market share, service leadership, best value in providing public services, and so on. Each is driven by a number of factors that will influence success, and it is often the case that one or two factors have much more effect than the others. Thus if we aim at service leadership over our competitors, it may be affected most by the completeness of the customer database (20%), call centre staff capability (55%), and the extent to which a service engineer solves problems in one visit (25%). Our prime (but not necessarily

exclusive) focus would be on the second – looking then for the factors that influence staff capability, and so on in a “*staircase of cause and effect dependencies*”. Each step leads to the next set of factors, and *every factor should have its own measure*.

Each staircase may have four or five steps between the ultimate goal and the most basic driver of success. The advantage of this approach is that it lead to very specific areas of the operations of the organisation, and quite quickly to individuals or groups of people in those areas. We are brought directly to aspects of their capability, and the environment that supports them.

We can do the same for the key areas of value added for each stakeholder.

Figure 1.4 illustrates the principle. The term “Critical Input” is used for the most important influencing factor at each step.

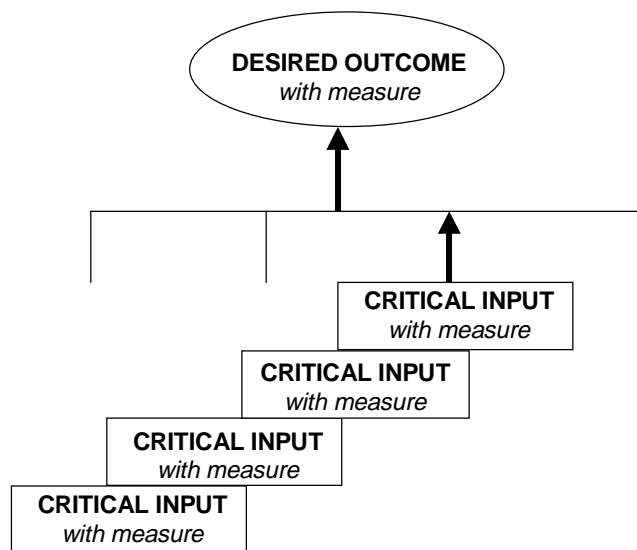


Figure 1.4 – The staircase of cause and effect dependencies

Building each of these critical staircases leads us to the sets of measures which will support our strategies and stakeholders, and defines for us what we need for each level and for each part of our organisation.

These are the principles for selecting specific measures that form part of a Human Capital Monitor, which itself may be used at any of the levels above the individual.

1.7 The Structure of this Book

This chapter has been an overview of three questions to be answered in this book:

- ***Why is it essential to have a system of measurement for our human assets?***
- ***How should we go about measurement?***

- ***How can it make us manage more effectively, and create more ultimate value?***

An organisation that wants to think and act seriously in the belief that people are our most important assets is described in the text as a “value creating organisation”.

Chapter 2 discusses the meaning of ‘value’ and the role of people in the processes of creating value.

Chapter 3 looks at the process of measurement in the context of people

This leads us into looking at the components of the Monitor in more detail.

Chapters 4 and 5 focus on the intrinsic worth of people as assets – the first column of the Human Capital Monitor. We examine what constitutes their worth, and particularly the challenge in defining levels of capability and potential.

Chapter 6 is about how we can maximise human capital through acquisition, retention and growth, and related measures.

In chapter 7 we move to the second column of the Monitor, to look at motivation and commitment and what influences these. Chapter 8 discusses how we can build a supportive environment to make the best of people’s talent.

Chapter 9 describes the last column of the Monitor – showing how we define and track the critical indicators of value to each stakeholder.

Chapter 10 focuses on managing the human side of mergers and acquisitions, and how we can ensure value is not lost in the process.

The final chapter reviews what is happening on the public reporting of human capital measures.

An appendix reviews the literature on measurement of intellectual capital generally, and all the references used in the book are summarised at the end.