

Whitepaper



Workplace Relationship
Development Indicator

Managing Your Human Capital: The Ultimate Determinant of Organisational Performance?

By Colin Beames (MBA, BA, BEng, MAPS)

Corporate Psychologist

Principal, WRDI Institute Pty. Ltd.

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Introduction

Human capital is at last being recognised as a critical corporate asset in today's economy. High performing organisations are seeking ways to extract the most value from their human assets, and to unlock the latent potential of their human capital. Given the widely held premise that people provide organisations with an important source of sustainable competitive advantage, maximising business performance through people is now the aim of the game! The effective management of human capital, not physical capital, may well be the ultimate determinant of organisational performance.

This white paper explores the concept of human capital, how it differs from other forms of capital, the problem of accounting for human capital, relevant research findings, development of a human capital measurement framework, the new role of HR in human capital, and a survey tool that measures and diagnoses some key aspects of human capital.

Contents of This White Paper

Introduction	p. 2
The Importance of Human Capital	p. 3
About Human Capital	p. 4
How Should Human Capital be Accounted For?	p. 6
Latest Research Findings Linking People Investment and Management Practices to the Bottom Line	p. 9
Human Capital Management	p.12
New Management Roles in Managing Human Capital	p. 16
Developing a Human Capital Measurement Framework	p. 17
The WRDI™ and Human Capital	p. 19



The Importance of Human Capital

Why Human Capital has Emerged as a Key Asset

In the 19th and early 20th centuries, the key assets most firms competed with were physical assets, with most of the top firms owing their success to ownership of natural physical assets, including minerals, oil and land. As the 20th century progressed, the physical assets shifted from natural resources to plant and equipment, and financial assets became more important as determinants of competitive advantage.

By the late 20th century, the terms of competition changed quite dramatically, with dominant physical assets and financial assets no longer determining success. The revolution in information technology, globalisation and knowledge management has driven a new organisational order. Many of the today's top firms in the world by market capitalisation, began quite recently, with little or no physical or financial assets (e.g., Microsoft, Cisco, Intel, AOL, and Wal-Mart). The vast majority of these firms depend on the following intangible assets (which are human capital centered), for their competitive advantage:

- superior human assets for their advantage (e.g., research scientists, code writers, distribution experts, product innovators);
- knowledge assets (patents, brands, know-how, experience);
- network / social assets (relationships with suppliers, distributors, customers, alliance partnerships, educational institutions, and reputation).

Human Capital Management - Creeping Up the Corporate Agenda!

The knowledge economy requires a considerably higher level of human development than the industrial economy, for the conversion of the labour force into knowledge workers. It demands a significant expansion in investment in education, training, research and development – the major formal generating activities. The management of human capital is emerging as a powerful management philosophy and creeping up the corporate agenda. It has now become very much part of today's business language. Human capital is at last being recognised as a critical corporate asset in today's economy.

Risk Management and Reporting on Human Capital

The importance of human capital is now being reflected in boards, investors and analysts placing pressure on financial executives to show how human capital is being managed within their companies. Of course directors and senior executives have a responsibility to exercise due diligence and manage risk. The concept of "risk management" is well accepted in the legal world, applies to physical assets, and the auditing of financial assets. However, it is spectacularly deficient in its application to perhaps an organisation's most critical asset – its human capital, and in particular, key talent. If management was as poor at identifying and reporting on any of the other

"The concept of risk management is well accepted in the legal and financial worlds...it is spectacularly lacking in the area of human capital."



major resources at their command, their stakeholders would express immediate concern.

The primary reason for the failure to report on human capital is the lack of valid and reliable measures – a source of considerable frustration for those seeking to manage this vital asset. The management of human capital policies and practices has thus remained largely without objective, fact-based metrics that provide a strong case for human capital decision making.

The challenge for organisations is to get to grips with the value that people bring. They need to better understand, and put in place, key measures of the value which people add to the organisation. This would enable stakeholders to make better informed decisions about the long-term viability of an organisation and its ability to generate value in a fast changing world (Brown, 2002).

About Human Capital

What is Human Capital?

Human capital includes the knowledge, skills, experience and initiative possessed by employees. Employees add value to the firm to the extent that they will perform future services. Some of this value is added directly by transforming the firm's product, but much of it is less tangible. Examples of how this added value may manifest include:

- developing effective strategy;
- solving problems;
- building quality customer relations;
- coordinating the work of departments;
- exercising judgment in novel situations, etc.

Human capital has economic value to firms - it directly impacts upon organisational productivity and profitability. More recently the term human capital has been applied to selection, training, compensation, and human resource (HR) management practices in general (Cascio, 1991).

There are three main ways in which a firm can enhance and effectively utilise their stock of human capital.

I. Through the Individuals that are Hired.

By distinguishing between ability levels with new hires, firms could easily justify this approach by recouping their initial investment through higher productivity and less training.



2. Through Training and Development of Existing Employees.

Firms that invest in skill development expect increased employee productivity / performance to offset such training costs.

3. Through HR Management / People Management Practices.

Firms that have effective HR Management / People Management practices can create motivating environments, maximise the utilisation of the human capital at their disposal, and just as importantly, retain that capital.

Note:

Firms have other options to the above (i.e., acquisition and internal development), in accessing human capital. These include outsourcing (i.e., contracting out, temporary employees), and through alliances. Outsourcing is more likely to be used for lower skilled employees engaged in more peripheral activities.

How Does Human Capital Differ from Other Forms of Capital?

Without denigrating the humanity of people, they can be viewed as an asset. Like any other physical asset, human capital needs to be acquired, maintained, developed and ultimately disposed of. Disposal may relate to voluntary or involuntary resignation (retrenchment, sacking), or retirement. However, human capital differs from other forms of capital in three key aspects.

I. Human Capital is Transferable

Human capital commands a price on the market. It is valuable to other firms, and most importantly, it is transferable. This transferability constitutes a critical difference between human capital and physical capital. The essential characteristics of human freedom make it difficult to capture the value of investments in human capability as a property right of the investor or an institution. Therefore firms do not actually “own” human capital – it is embodied in employees, who are free (within limits), to move from one firm to another. Even if they stay with a firm, employees’ contribution depends upon their willingness to perform. Therefore, control costs, or the costs of retaining and motivating employees (such as reward systems), must be considered human capital investments as well.

However, there is a perception that employees are apt to leave organisations after large investments have been made in developing them. Whilst this may well be the case for some individuals (probably more so with graduate recruits after their completion of an initial training and development program), the typical root cause of employee turnover is not the investment made in employees. In fact avoidable or dysfunctional turnover is more likely to be caused by the absence of enabling and operational human capital infrastructure.

“Human capital commands a price on the market....it is valuable to other firms....and it is transferable.”



“Avoidable or dysfunctional turnover is more likely to be caused by the absence of enabling and operational human capital infrastructure.”

2. Human Capital Value Depends on Performance

Human capital becomes economically valuable when manifested in performance. The value of human capital therefore depends upon the demands placed upon employees. However, since firms invest in employees, but do not actually own their human capital, they must devise methods for ensuring that individuals act in the firm's interest. To that end, firms need to develop high levels of employee engagement or commitment, which includes a more mature form of loyalty (as opposed to the “blind” loyalty of the past). This form of commitment and loyalty should be more to the vision, values and goals of the organisation, where firms are able to capture the imagination of their employees, harnessing their energy, and seeing what is possible.

However, research by Murlis and Schubert (2001) from the HayGroup confirms that many companies are not succeeding in engaging the “hearts and minds” of their employees. From a study over four years of about 1 million employees from more than 330 companies, these researchers reported that:

- a huge % of “engine room” employees are disengaged; and
- the amount of value-added discretionary effort that people apply to their jobs varies tremendously.

3. Human Capital is Active

Human capital differs from other capital in that it is the only capital that is dynamic or active – it is the force (Fitz-enz, 2002). It is the one thing that can look three or five years ahead. It can drive the change in redesigning systems. Without human capital, nothing can happen in organisations.

How Should Human Capital be Accounted For?

CFOs' Dilemma

Given the increasing importance of human capital, how should it best be measured? This question poses a major challenge to existing methods of accounting and valuation. The scale of that challenge is partly reflected in the size of the gap between the value of a company's tangible assets in its balance sheet and the stock market-value. The growing disparity between market and book values:

- not only reflects the growing importance of intangible assets; but
- dramatically exposes the limitations of traditional accounting practices in identifying and measuring the value-adding elements of the firm.

In the area of mergers and acquisitions (M & A) pricing, human capital is increasingly playing a crucial role.



“Many measures are ‘lag’ indicators....”

“Accounting for people as costs perpetuates a chronic under-investment in employee capability.”

The CFO’s Role

The role of CFO is one of chief resource allocator – helping direct the company’s resources to the most productive investments. However, many CFOs are in a predicament – unable to apply ordinary financial discipline to managing what is often their company’s largest investment. Furthermore, in this vast area of spending, it is perceived that there are few tools or methodologies in place to help guide meaningful decision making. Organisations know little about the returns they get for their considerable investments in people.

Many measures are “lag” indicators (e.g., capture the outcomes of what has been produced in the past). It’s like trying to win a game of football by watching the scoreboard! Whilst there is a need to monitor progress and outcomes, what is more critical is knowing which “levers to pull” to produce those outcomes.

Treating People as Costs!

Company accounts record the costs associated with people, but not the benefits they bring! This is despite the fact that most organisations now accept that people represent the key driver of value in organisations. The oft repeated mantra that “people are our most important asset” is hardly reflected in traditional current accounting systems that treat people as costs, not assets. Little is known about what investments companies make in their people to back up such a declaration.

Furthermore, accounting for people as costs perpetuates a chronic under-investment in employee capability (Bassi, McGraw & McMurrer, 2003). Reasons for such accounting methods include a:

- lack of valid and reliable human capital measurement tools;
- lack of agreement on what should be measured; and
- perceived “grey” link between non financial measures and the bottom line.

The treatment of all people related expenditures (including those associated with employee development), as expenses, creates an external force from financial markets that promotes under-investment in creating human capital (Bassi et al, 2003).

Undue Focus on Short Term Results

With the undue focus on quarterly earnings, far too little attention is being paid to assessing the capabilities necessary for creating future value (Bassi et al, 2003). The challenge for executives and directors is to break free from a management perspective that is unduly influenced by short term factors. For example, there is compelling evidence that retrenchments in downturns typically end up destroying shareholder value in the not-too-distant future (Cascio, Young & Morris, 1997).



Competing Investment Options

Organisations must perpetually make choices among competing options in determining where to invest their resources. Budgets must be divided among all the factors of production that are deemed necessary for an organisation to be effective – buildings, plant and equipment, technology, R & D, and people (including salaries, benefits and development).

Investments in people (either through hiring certain individuals “on the market” or developing them in-house), or via human resource management, carry both out-of-pocket and opportunity costs. They are justified only if they produce future returns via increased productivity or profitability. Since firms are likely to undertake additional investments up to the point at which the marginal cost equals the marginal return, the value of human capital investments depends on the contribution of employees to a firm. With investment predicated on a rate of return, the return on people should be identical to returns on other factors of production.

However, one of the difficulties in investing in people is demonstrating the return on such investments. Unlike other types of investments (e.g., R & D which leads to new revenue streams associated with new products; advertising campaigns which lead to increased sales), the effects of investments in developing and managing people are much more difficult to isolate. The returns are not always immediate and investment is therefore harder to justify. The problem with an ROI approach is that even when done correctly, it does not provide the insight for improving future outcomes (Bassi et al, 2003).

Investment in Key Talent

Attraction and retention - the biggest challenges post - 2000. There is a war for talent and it will intensify! The average executive will work in 5 companies.

The War for Talent, The McKinsey Quarterly (1998)

Talent development, engagement and retention have been elevated in many enterprises to the top tier of objectives, on a par with generating revenue and managing costs.

Training and Development (2002)

Human capital tends to be practiced most rigorously in the assessment of small concentrations of individuals who are seen as highly talented and critical to the firm's future. It is in these people where the corporate memory resides. They are often the people charged with winning market share, attracting investors or new clients, securing large contracts, and having the technical and operational know how to complete large projects. The higher the potential for employee contribution in a firm, the more likely it is that the firm will invest in human capital (via human



resource management activities), and that these investments will lead to higher individual productivity and firm performance.

Latest Research Findings Linking People Investment and Management Practices to the Bottom Line!

In the global economic boom of the 1990s, human resources are the competitive edge for both companies and countries. In the global economic competition of the information economy, the quality and innovativeness of human resources will spell the difference.

(Naisbett & Aburdeen, 2000).

There is a small but growing body of empirical research emerging concerning the relationship between investment in people, people management practices, and organisational performance.

Investment in People

Based on an analysis of 750 large publicly traded firms (both inside and outside the US), Pfau and Kay (2002) of Watson Wyatt concluded that:

- superior human capital practices are a leading indicator of financial performance; and
- organisations with the best human capital practices provide returns to shareholders that are three times greater than those of companies with weak human capital practices.

Another study by Bassi and McMurrer (2002) focused on the effect of investments in employee education and training within 600 publicly traded US firms. From 1997 to 2001, a hypothetical portfolio of firms that made the largest investment in employee development, subsequently outperformed the S & P 500 index by a factor of two in the year following the training investment.

The tentative conclusions from these findings are that:

- there is a financial payoff to organisations that invest in exceptional human capital development and management;
- those organisations who enjoy the payoff do a good job of developing and managing people; and
- there is a general under investment in people.

However, information on corporate spending in areas such as training and learning for employees – factors that clearly drive future wealth creation – is basically not available publicly. Conversely, other key investments such as R & D expenditure are reported publicly.

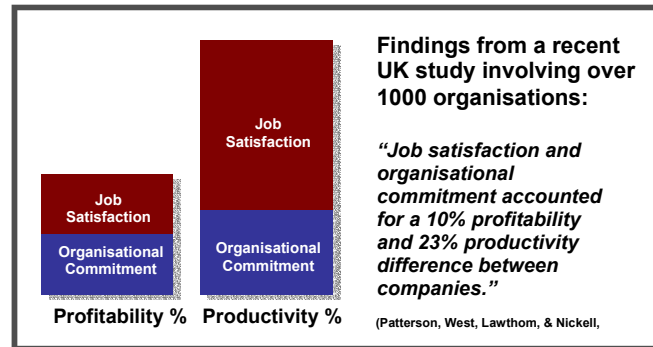
“Information on corporate spending in areas such as training and learning for employees – factors that clearly drive future wealth – is basically not available publicly.”



People Management Practices, Employee Engagement and Job Satisfaction

The link between good people management practices and the bottom line is demonstrated in a landmark U.K. study of around 1000 firms by Patterson, West, Lawthom, and Nickell (1997), which found that:

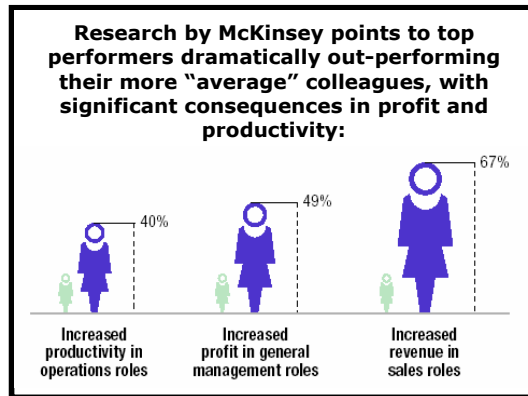
- the management of people had a greater effect on a business's performance than competitive strategy, quality focus, manufacturing technology and investment in R & D put together;
- job satisfaction and organisational commitment accounted for a 10% profitability and 23% productivity difference between companies; and
- good HRM practices (i.e., appraisals, training and development, employee involvement and team working), accounted for up to 19% of the differences in profitability and productivity between companies.



Fitz-enz (2002) speculates that in order for organisations to make quantum leaps forward, they must be able to engage the imagination of human beings. Meyer, Paunonen, Gellatly, Goffin and Jackson (1989) found that higher levels of affective (organisational) commitment or engagement is linked to enhanced employee performance. Other researchers have linked higher levels of job satisfaction with enhanced performance (Judge, Thorensen, Bono & Patton, 1998).

Talent Management

McKinsey's research (Axelrod, Handfield-Jones & Welsh, 2001), found that companies doing the best job of managing their talent deliver far better results for shareholders. Companies scoring in the top quintile of talent-management practices outperform their industry's mean return to shareholders by a remarkable 22 percentage points.



The Loss of People

There has been a plethora of examples in recent times of stock market sensitivities to the departure of key people from organisations, both positive and negative. The typical cost of voluntary turnover ranges from 0.5 to 2.5 times the annual salary of the job in question (Cascio, 1998). The costs of turnover and loss of key talent in particular, can thus have a significant adverse impact on the bottom line.

The direct replacement costs (e.g., recruitment fees, training expenses), comprise only a small portion of the total cost of turnover. Indirect or less visible costs (which are not immediately apparent in an organisation's financial reporting), include:

- lost customers or damaged customer relations;
- additional marketing and sales expenditures needed to win replacement customers;
- reduced productivity at the start of employment;
- loss of intellectual capital;
- lost opportunities (particularly in the development of new technologies and products);
- a decrease in the "bench strength" required for effective succession planning;
- advantage to competitors from their knowledge acquisition of their new recruit's ex-employer;
- decreased morale and increased stress among remaining employees; and
- the negative effect on an organisation's reputation.

There is strong evidence to show that increased employee loyalty and retention has a positive impact on customer satisfaction and retention (Reichheld, 1996). Small improvements in the rate of employee retention, and in turn customer retention, lifts profitability.

Employee retention is a key driver of customer retention, which in turn is a key driver of company growth and profits. Research at MBNA's credit card business showed that a 5 percent increase in customer retention translates into a 125 percent increase in per-customer profits. Reichheld (1996)



Human Capital Management (HCM)

The Value of Employees Increases Over Time

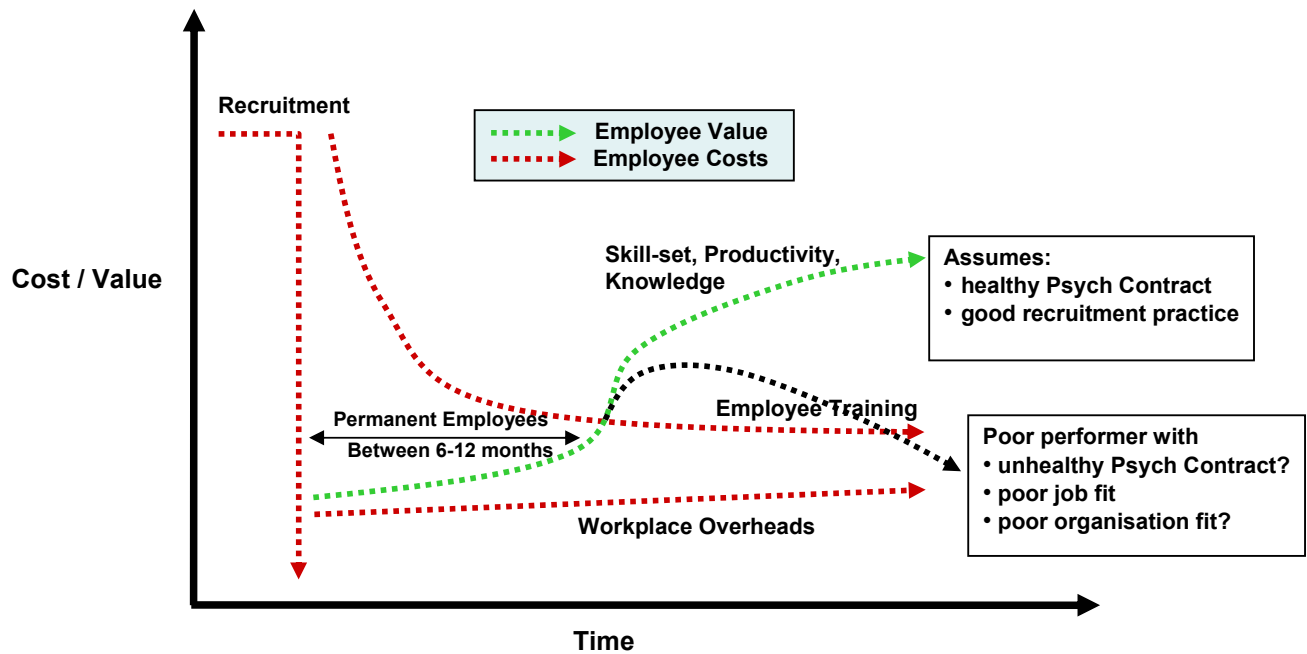
Human capital management (HCM) is a business philosophy focused on attracting, retaining, measuring, managing and leveraging an organisation's employee asset base. The underlying assumption behind HCM is that the value of employees increases over time through:

- improved productivity as employees become more familiar with their work environment and job functions;
- increased skills and knowledge levels; and
- strengthened relationships with external organisations (from customers to partners) and improved satisfaction.

While the management of human capital should be an enterprise-wide strategy, nowhere are its benefits more apparent than in customer-facing functions. The ability to maximise skills and experience in the sales and marketing functions has a direct impact on top-line revenue, while customer service – whether through a call centre or in the field – directly impacts client satisfaction, customer retention and customer life cycle. High levels of service are important since the number of completely satisfied customers is one of the few predictors of long-term profitability (Jones & Sasser, 1995)

Rodgers and Howlett (2002), liken employee acquisition and value to that of customers. Just as the costs of acquiring new customers are high (when sales resources are deployed and execution of marketing campaigns are factored in), the costs are high of bringing new employees on board. Over time, these costs drop significantly as customers become better acquainted with the organisation, its products and services. The value generated by customers increases over time – they cost less to service as they become more familiar with the way the organisation operates.

Likewise, the value equation for employees increases over time. Employees become more productive as they settle into organisations, acquiring skills and knowledge that are deployed to the company's benefit. Similarly business relationships with suppliers or alliance partners become more profitable over time. The flip side to attrition is to understand the value derived from retaining employees.



(Adapted from Webster Buchanan Research 2002)

“Retention of key employees constitutes a core business strategy.”

Retention of key employees therefore constitutes a core business strategy! However, responsibility for retention and employee development is often left to line management, supported by the HR department from an administrative perspective – a piecemeal approach that leads to big disparities in the quality of employee management.

More About Turnover and Selective Retention

Turnover is a multifaceted phenomena relating to individual, organisational, and environmental factors (Beames, 2002a). Ultimately, retention of valued people is directly related to how an organisation manages its relationship with those people (Beames, 2002b). This relationship theme is explored further in the following section.

Notwithstanding turnover considerations, what is also important is retaining the “right” people. Commitment is not only about staying, it is also about buying into the vision of the company (Fitz-enz, 2002). In fact what employees do while they are with organisations is as important if not more important than how long they stay (Allen & Meyer, 1996).

The organisation that will thrive in the new reality are those with employees who have the option to leave but choose to stay. Those that fail will be populated by employees who are there only because they are afraid to go elsewhere.

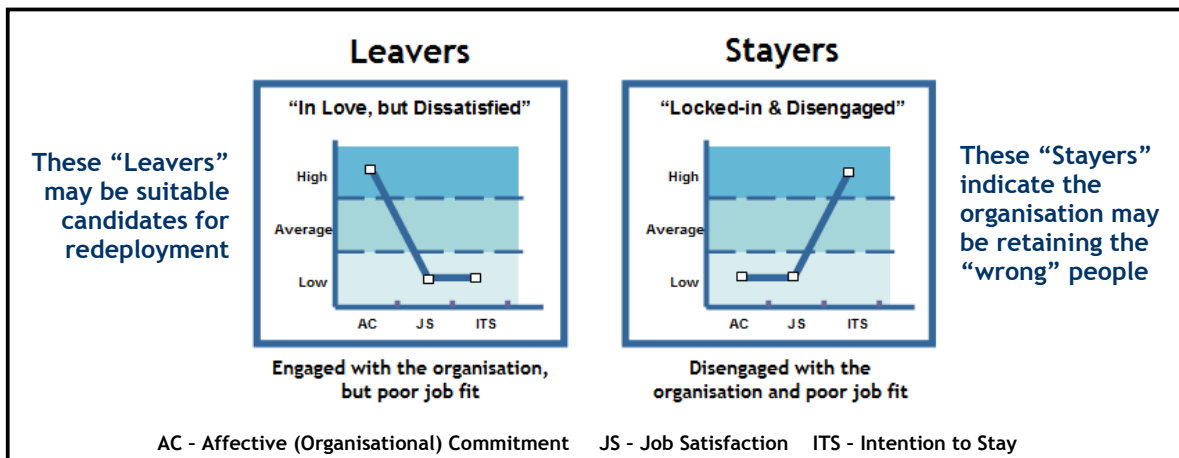
Noer (1997)



Beames (2002a) has developed an innovative typology which classifies employees according to employee affective commitment (or engagement), job satisfaction, and intention to stay. It may be the case that an organisation is retaining the “wrong” people – a workforce which is unengaged, dissatisfied, but unlikely to leave (i.e., the “walking wounded”). Given that lower workforce alignment (i.e., lower affective commitment and job satisfaction) is linked to:

- lower performance;
- reduced employee well being; and
- lower levels of customer satisfaction;

this is hardly a basis for an organisation to move forward and respond dynamically to the challenges of the contemporary business world.



Diagnosing Retention - The Psychological Contract

Creating greater organisational agility, faster response times, and valuing people were identified as major issues facing HR management over the next three to five years. The people issues is expected to become even more problematic because of the decreasing numbers of skilled workers and "the changing psychological contract" whereby employees feel less loyalty in the past and a greater willingness to seek out greener pastures.

(International State of the Art / Practice Study conducted by the US-based Human Resource Planning Society, 1999)

Relationships are fundamentally important – be they in the personal domain or in the workplace. The nature and quality of relationships impact upon the commitment of the parties to that relationship. The psychological contract represents the “essence” of the employer / employee relationship. It is not a legal document as such, but it is nevertheless “real” in the minds of employers and workers (Guest, 1998). The psychological contract is a powerful determinant of the behaviour and attitudes of employees, although it is rarely discussed (Anderson & Schalk, 1998; Schein, 1978).



The psychological contract may be defined as the individual beliefs, shaped by the organisation, regarding the terms of exchange between individuals and their organisation (Rousseau, 1995, p. 9). It includes perceptions, expectations, beliefs, promises and mutual obligations. The psychological contract includes both:

- tangibles (e.g., monetary rewards); and
- intangibles (e.g., career development, flexible work practices).

Guest and Conway's (1997) study confirmed that the psychological contract is a key explanatory variable in contemporary relations, with the state of the psychological contract influencing behavioural outcomes such as motivation at work, organisational citizenship behaviour and intention to leave the organisation.

A number of studies conducted by the WRDI Institute (2003) have also confirmed that the state of the psychological contract (including the delivery of employees' expectations, levels of trust and fairness), influence affective commitment, job satisfaction and hence intention to stay with the organisation (i.e., retention). The psychological contract provides the key to understanding and diagnosing workforce relationships, alignment and retention.

Structuring Employer / Employee Relationships

Organisations that desire to become "employers of choice" must devise strategies and innovative programs which will satisfy a spectrum of both work and personal needs, including tangible and intangible rewards. They need to develop a competitive advantage in recruiting and retaining staff. They need to develop positive psychological contracts with their employees.

Anderson and Pulich (2000)

Organisations need to provide attractive employment propositions or "deals" (i.e., an appropriate mix of tangibles and intangibles), and deliver on those "deals", in order to retain their valued people. Examples of critical areas for human capital investment in these deals include the provision of:

- competitive and equitable reward systems;
- career growth opportunities (e.g., training and development).

In addition to the above, employee retention is also affected by the provision of intangibles in the deal such as recognition, job challenge, sufficient power and responsibility, promotion or advancement opportunities, supportive management, provision of a supportive work environment, etc.

Deals will vary across workforce segments (i.e., between senior managers to front line workers). The nature of deals should link to the business strategy and should



“Inappropriate deals can lead to excessive turnover.”

“The HR function has traditionally been regarded as a non strategic cost centre.”

mirror the nature of customer relations and service. For example, those established organisations competing through distinctive forms of customer service in stable environments, tend to train their employees extensively and foster a service orientation. These organisations seek a longer term relationship with their employees (and hence lower turnover), where cultural norms which support good customer relations are developed.

Inappropriate deals can lead to excessive turnover. For example, deals that excessively emphasise pay based on short term performance or results, when the development of longer term, quality, customer relationships are critical to business success.

Please Note:

The above themes are explored more comprehensively by Beames (2002b), who has outlined twelve key strategies to addressing retention issues.

New Management Roles in Managing Human Capital

Collaboration Between the CFO and HR Roles

HR management practices constitute investments in human capital. However, the HR function has traditionally been regarded as a non strategic cost centre. Furthermore, relationships between the finance and HR functions have traditionally ranged from hostile to cordial. Now there is evidence emerging that the CFO's view of human capital is evolving, with many coming to see human capital as a source of value add and competitive advantage.

A recent study called Human Capital Management (Mercer, 2003), which surveyed 180 senior financial executives of major U.S. and multinational corporations confirmed that CFOs now see human capital as a key value driver, with:

- 92% of CFOs saying that it plays a crucial role in determining customer satisfaction;
- 82% saying human capital impacts on profitability;
- 72% believe that it influences innovation and product development.

However, only 16% indicated that they understood the return on these investments “to a considerable extent”.

According to Philpott (2003), Chief Economist at the Chartered Institute of Personnel and Development (CIPD), improving the awareness and implementation of good people management practices is the missing x factor in improving the U.K.'s productivity performance. A CIPD survey Voices from the Boardroom (2002) showed that only 13 of the 48 board members interviewed about their views on HR are aware of the evidence that links people management practices with improved bottom line performance.



“The human capital perspective provides a new rationale for the role of the HR function.”

The changing business landscape makes it necessary for these two areas (i.e., CFO and HR), to come together in new, more collaborative ways. Now the HR role is being increasingly seen as a strategic partner. The management of human capital is now being seen as a shared responsibility by all the leaders of an organisation.

The New Role of HR

HR is finding itself under intense pressure to deliver value to organisations. In many instances, human resource activities are undertaken from a reactive perspective – making a hire to fill an existing vacancy, for example, or increasing compensation to stave off a threatened departure – or to deliver process improvements. The human capital perspective provides a new rationale for the role of the HR function. HR is no longer viewed as a cost centre, but rather as an asset provider, and a resource for developing and protecting human capital. The HR role is shifting:

- from the rigid, inward and traditional Human Resources Management System (e.g., policy, managing employee related data, assisting in areas such as recruitment and benefits, arbitrating in employee disputes);
- towards the strategic Human Capital Management system that provides high value business intelligence (i.e., that recognises the acquisition, retention, measurement and leveraging of key employees).

The challenge for HR practitioners is to:

- shake off their administrative image, freeing themselves from transactional, low value process activities;
- get access to the elite decision making team; and
- focus on value add activities (i.e., strategic workforce analysis and planning).

People management needs to form a central part of corporate strategy, alongside financial planning, plant utilisation, marketing strategy and other board level priorities. By focusing on employee value, HR becomes a business adviser to every part of the enterprise – providing strategic input, consulting at a tactical level, and above all, building and monitoring performance metrics. However, most HR functions are in transition from administrative department to strategic partner and are not geared up to provide the appropriate level of insight.

Developing a Human Capital Measurement Framework

Characteristics of a Measurement Framework

There is a need for human capital systems and measures that are not only of value to directors, but that can be used by management to optimise the value they create through effective investments in the development and management of employees. This measurement system needs to be forward-looking, predictive, and diagnostic.



It is generally acknowledged that measurement drives behaviour. Some guiding principles concerning human capital measurement systems include:

- what gets measured gets managed;
- measurements must be used for driving accountability in human performance (KPIs), not just as an end in themselves; and
- measurement systems must be simple yet powerful.

According to Bassi et al (2003), many business units “talk the talk” regarding their support for ongoing learning and people management practices, but when measurements are forthcoming, it becomes clearer that they don’t “walk the talk” very well. This type of hard empirical evidence is what is needed to get the “walk” and “talk” on the importance of employee development and organisational learning to be better aligned.

Some Key Measures

However, there is no “holy grail” in the measurement and evaluation of human capital. Notwithstanding, factors that consistently emerge from the research best practice literature as measures of the human capital foundation of an organisation, include employee:

- engagement (commitment) with the organisation;
- job satisfaction;
- turnover; and
- performance.

These factors are continual drivers of organisations’ non-financial performance measures, which in turn drive organisational results. They may be viewed as “lead” indicators – non financial performance measures that have been consistently identified in the research and best practice literature as the key drivers of future organisational performance.

Collecting information on these performance measures is an important, but not sufficient, step in developing measurement systems that are forward-looking and predictive. Being able to diagnose those factors that contribute to these measures, and hence apply appropriate interventions with predictable outcomes, is equally if not more important.

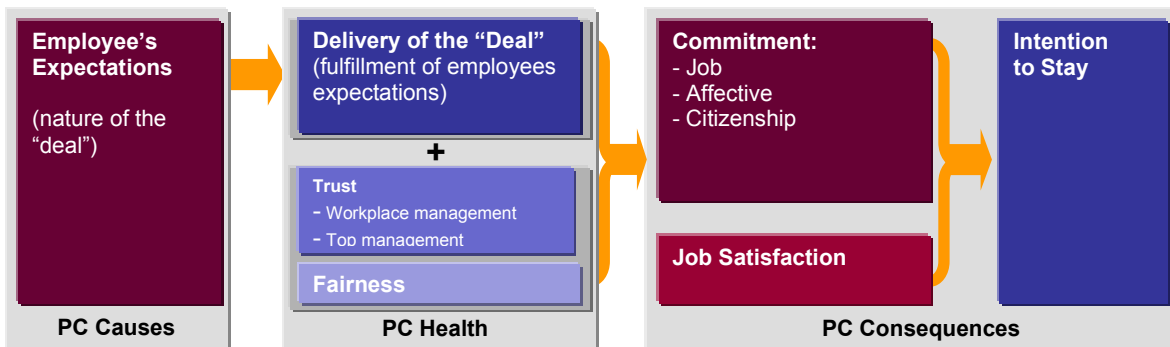
“They may be viewed as ‘lead’ indicators – non financial performance measures ...as the key drivers of organisational performance.”

The WRDI™ and Human Capital

The WRDI™ and the Vexing Problem of Human Capital Measurement

Recent innovations in HR metrics now make it possible to find solutions to the vexing problem of measuring key non financial human capital measures. The WRDI Institute has developed such a tool called the WRDI™. The WRDI™ – which is an acronym for Workplace Relationship Development Indicator – is a relationship

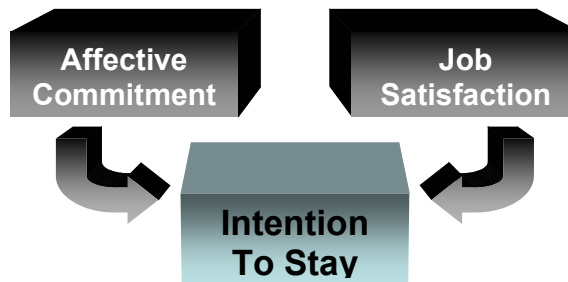
management survey tool. It has been adapted from Guest's (1998) model of the psychological contract (or employer / employee relationship). The WRDI™ measures and diagnoses the “health” and consequences of this relationship.



The WRDI™ Model of the Psychological Contract (PC): Causes, “Health” and Consequences

The three most critical consequences of the psychological contract are:

- affective commitment (employee engagement with the organisation);
- job satisfaction; and
- intention to stay.



Key Consequences of the Psychological Contract

Affective (organisational) commitment or employee engagement, and job satisfaction are the main predictors of intention to stay, which in turn is the main predictor of retention.

Selection and recruitment practices must therefore ensure:

- good people – job “fit” (i.e., high job satisfaction); and
- good people – organisational “fit” (high affective commitment).

Thereafter, employers should maintain healthy psychological contracts with their employees (i.e., deliver on the deal, develop high levels of trust, and treat their employees fairly – refer WRDI™ model).



The above three critical measures underpin an organisation’s human capital framework referred to earlier. They also serve as non financial Key Performance Indicators (KPIs) for managers.

WRDI™ Report Outputs

One of the WRDI™ report outputs - the Audit of Workforce Alignment (AWA) Report - provides summary information on three measures of an organisation’s human capital (i.e., the key consequences of the psychological contract). More specifically, the AWA Report predicts::

- how many employees are likely to be “at risk” of leaving, or likely to leave the target organisation; and
- how many employees are misaligned (i.e., have poor “fit”), with either the organisation and / or their job.

Typically this report (from approximately 20 WRDI™ questionnaire items), is produced initially to provide an overall assessment of workforce alignment and retention risk within an organisation (see example below). However, the AWA Report can be applied exclusively to an organisation’s key talent group which typically comprises between 10% of the workforce.

Audit of Workforce Alignment (AWA) Report

Executive Summary

Retention Risk	Management	Sales	Operations	Technical
Stayers	77	73	111	37
At Risk	18	27	41	11
Leavers	7	15	27	2

Alignment	Management	Sales	Operations	Technical
Engaged & Satisfied	71	59	80	35
Engaged but Dissatisfied	14	25	39	12
Disengaged but Satisfied	11	14	29	3
Disengaged & Dissatisfied	6	17	31	0

Please Note:

Not shown here - Organisational Development and Individual (Career Development) Reports. The Organisational Development Report provides the diagnoses of what lies behind the AWA Report findings (refer WRDI™ model). It includes complete psychological contract profiles by workforce segment based on the 90 items comprising the WRDI™.



The WRDI™ – A Scientific Approach

The WRDI™ incorporates rigorous psychometric properties. It provides a scientific approach to enhancing workforce alignment and managing retention risk. The WRDI™ diagnostic data:

- sweeps aside the mystery surrounding the commitment, satisfaction and retention of employees;
- provides critical human capital measures that link productivity and profitability;
- validates people management practices, quantifies retention risk, and determines whether an organisation is retaining the “right” people (i.e., selective retention);
- identifies causes of disaffection; and
- enables decision-making on targeted interventions that deliver predictable outcomes.

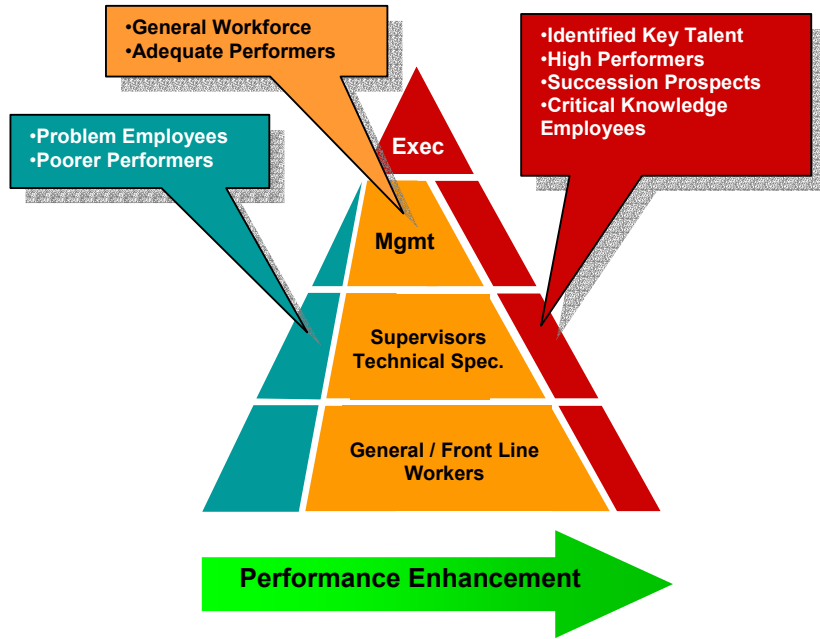
WRDI™ Findings as a Basis for Investment

WRDI™ findings provide a basis for investment decisions in human capital. For example, where a significant retention risk has been identified for a particular workforce segment or work group (which may include key talent), the first priority is to diagnose the causes of this risk. Such a diagnosis may reveal dysfunctional organisational factors or limitations which need to be addressed in the first instance. Otherwise investment returns from leadership or other training and development initiatives are likely to be sub optimal. Put another way, it’s equivalent to trying to put a “positive icing on a negative cake”!

“WRDI™ findings provide a basis for investment decisions in human capital.”

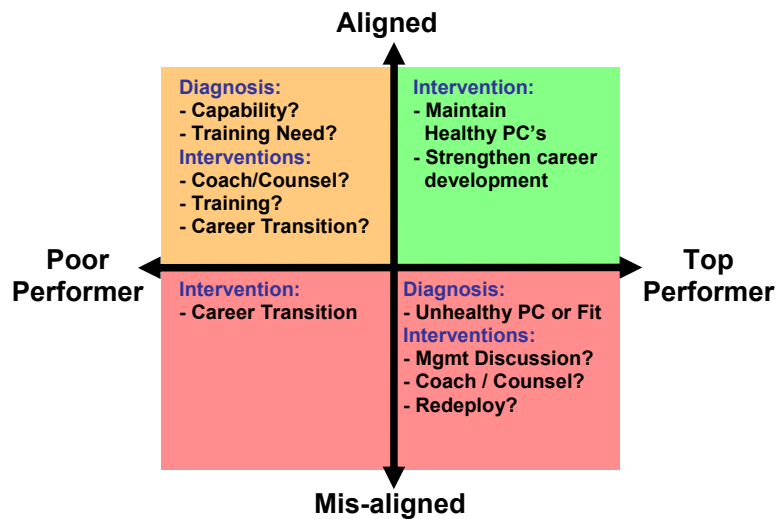
WRDI™ Findings: Performance Enhancement and Workforce Remodelling

Where an organisation has an effective performance management system in place, a more “fine grained” approach can be adopted towards the creation of workforce alignment, performance enhancement, and associated interventions. Ultimately the aim should be to enhance the alignment and performance of various workforce segments.



Diagnosis and Individual Interventions

Diagnosis and interventions can be applied as follows depending upon alignment and performance or role importance.



Please Note:

1. Alignment in the above diagram is the combination of affective commitment and job satisfaction.
2. The above interventions are embedded within a career development framework which incorporates, amongst other things, career dialogue workshops for managers, and career development workshops for employees.



“The CEO and executive team were presented with data indicating up to 40% of top talent in this organisation were at risk of leaving.”

WRDI™ Case Studies

A recent WRDI™ workforce audit of a high profile corporate uncovered some startling information about the “health” of the relationship with its workforce. This large domestic and global distributor of agricultural products was on an expansion trail, and the retention of key talent was critical to the company’s success. The WRDI™ was chosen because of its unique ability to diagnose and manage retention risk of top talent.

The CEO and executive team were presented with data indicating up to 40% of the top talent in this organisation were at risk of leaving. In addition to this raw statistic, they were provided with a diagnosis of the specific causes contributing to that risk. *Being presented with “in your face” diagnostic data is one thing, but having a prescription to fix any problems is even more important*, commented one senior executive. He went on to say that *the WRDI™ information was invaluable for the career development of our people and our long term planning and capability. We knew that some of our key people might have been targeted by the opposition, and now we know what we have to do internally, to ensure we keep these people on board and happy.*

So impactful were the findings (both key talent retention risk and the identification of pockets of distress in the organisation), that the WRDI™ has now become embedded as part of the language of executive management. This “blue chip” organisation has since abandoned their traditional climate survey in favour of the WRDI™.

In another project with a multi national recruitment firm, the WRDI™ data was analysed for various workforce segments. Senior management was more than “happy with their lot” whereas a significant retention risk was identified with the administration and support staff. The segmentation approach adopted avoids the assumption or over simplification of “one size fitting all” regarding diagnosis and interventions. Two simple systemic interventions were adopted at no cost to the recruitment company, viz:

- changing recruitment practices for administrators (the company had been recruiting graduates for roles in which they could never satisfy their career growth expectations);
- restructuring such that a new intermediate position between administrator and consultant (called an associate), was created as a “stepping stone” or articulation career path for those graduates who aspired to consultant status (the previous step from administrator to consultant was too big a jump).

On a much smaller scale, a key talent retention program with a biotechnology research company revealed that up to 50% of their top talent was at risk of leaving. This organisation had been experiencing a period of uncertainty against a background of significant growth and transition. Shoring up the retention risk of key scientists was critical to the completion of clinical trials, market perceptions and the next round of fund raising.



“WRDI™ findings provide the insight and a basis for prioritising, designing and implementing effective human capital interventions.”

A Vital Human Capital Measurement Tool

The WRDI™ constitutes a vital human capital measurement tool, providing reliable and predictive data about the state of an organisation’s key intangible asset – its relationship with its workforce. Applications of the WRDI™ are numerous, including:

- key talent retention and career development programs;
- “employer of choice” validation;
- organisational development;
- balanced scorecard measures on the learning and growth dimension;
- strategic planning for human resourcing;
- pre and post enterprise bargaining assessment;
- assessing readiness / capacity for change;
- assessing the effectiveness of change programs or initiatives, including mergers / acquisitions, etc.

WRDI™ findings provide the insight and a basis for prioritising, designing and implementing effective human capital interventions. The vision of bridging widely acknowledged gaps between human capital measures and organisational performance becomes a practical possibility with the WRDI™.



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Contact

WRDI Institute Pty. Ltd.

Headquarters:
Suite 502
89 High Street, Kew
VIC 3101, Australia

Postal Address:
PO Box 389
Kew East,
Melbourne VIC, 3102,
Australia

Tel: + 61 3 9854 6166
Fax: + 61 3 9854 6168

Email: info@wrdi-institute.com
Web: www.wrdi-institute.com

The WRDI Institute is one of the world's leading authorities on human capital, workforce alignment and retention. The WRDI Institute provides HR measurement and solutions in the following areas:

- Human Capital Assessment;
- Retention (including key talent retention risk assessment);
- Talent Management;
- Career Development;
- Organisational Development, including Workforce Alignment and Performance Enhancement;
- Industrial / Employee Relations (EBAs); and
- Post Recruitment Assessment.

The WRDI Institute has developed a suite of white papers on the following contemporary workplace themes:

- Creating "New Deal" Employment Relationships;
- Managing Your Human Capital: The Ultimate Determinant of Organisational Performance?
- Improving the Bottom Line: A Diagnostic Approach to Enhancing Workforce Alignment Through Career Development;
- About Turnover and Retention;
- Retention Intervention: A Strategic Approach;
- The Psychology of Mergers / Acquisitions;
- Employer of Choice: Putting Substance to the Rhetoric!
- The Balanced Scorecard and the WRDI™;
- Managing Expectations: Strengthening Recruitment Practices and Enhancing Retention.

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