Fundamental Factors

**Jay Chatzkel:** Why is a balanced focus on the interaction of human capital and financial outcomes the leading reason for long-term financial success?

**Dr. Jac Fitz-enz:** My view is that balance is a fundamental issue of nature. Remember from high school biology the process of homeostasis, wherein every living organism strives to stay in balance. It turns out that top performing companies always focus on balancing human and financial issues.

Homeostasis in organisations is a fundamental truism of top performers as I originally reported in “The Eight Practices of Exceptional Organisations.” But there is a downside potential to homeostasis, as well. That is, we can spend so much time on analysing and balancing, etc., that we stagnate an organisation, putting it into analysis-paralysis. Given that as the potential downside, it is still an absolute fundamental for long-term success.

What are some companies that you think achieve that? Or use it as their principle? Hewlett Packard, Federal Express and Motorola did it well for a long time, as well as a lot of smaller companies you’ve never heard of. We researched a thousand companies over five years, and came up with this finding.

“We studied these companies in both their human and financial performance over a five-year period. We pulled out the top ten percent of those and in doing our report found by accident that there were eight factors that were typical of these companies that were not typical of the other ninety percent.

And balance is one of these eight factors? Balance is one of the three fundamentals. The other two are long-term commitment to a basic strategy, a positioning in the market if you will and a positioning in the community and alignment of culture and systems.”
**Human Capital Value Added**

What is Saratoga Institute, and what is the set of macro human and financial metrics that Saratoga Institute is using? What have you learned by using them? As founder of Saratoga Institute I have been involved in the issue of measuring the effectiveness of people, quantitatively, for over 20 years. Since 1985 we’ve been publishing an annual report that tracks over a hundred different variables. Those go from macros like revenue per full time employee (FTE), down to micros such as time to fill jobs.

The objective of all this is to provide benchmark data by industry, company size, geographic region and growth rate, so that on any particular measure you could compare yourself to somebody else in one of those categories. We’ve done this in the U.S. with over 900 companies and we will also work with another 1000 companies in about a dozen countries in Europe, South America, Australia, South Africa, and Mexico.

The more important macro measures include some that we have coined ourselves and some that are fairly traditional. We call the new ones human capital value added. That is a function of teasing out of the profit of the company that which is attributable to people. The formula very simply is Revenue minus All Expenses, except for human expense, which is pay and benefits, divided by FTEs.

That gives an adjusted profit for human effort, per employee. That is better than revenue per employee because that is just a gross measure and we do not know what caused it. By using our new formula we can tell how much value added came from human effort.

There’s a corollary measure called human capital ROI, or return on investment, where we use the same formula. In this case, though, the divisor is pay and benefit costs. The result here is a ratio that for every dollar spent on pay and benefits there is a certain amount of profitability. To illustrate, we can get a ratio of $1.00 to $2.00 or $1.00 to $1.40 (U.S.) or whatever it might be. Those are two fundamentals that we have used now for a half dozen years.

Another more common measure is compensation as a percent of revenue.

That tells us what our cost is for people to generate that amount of money. If we extend that by adding in contingent labour we call it TLC, or Total Labour Cost. We can divide that into revenue and it gives another figure that now accounts for the money spent on contingents.

Since contingent labour is somewhere in the high teens and twenty percent of total labour, it is certainly a significant factor that we cannot ignore. We cannot just talk about people on payroll anymore.

Organisations have to be more flexible in the way that they employ people, part-time people, temporary workers of all types, and contract workers. The reality is that the contingent factor is getting more and more significant. We cannot ignore it.

**The Four Areas of Human Capital**

What are the characteristics of the four human capital areas of “acquiring, maintaining, developing and retaining”? Where and when do they touch operating units? A number of years ago we began to think of people as being assets.

I always have to put in a qualifier. I am not denigrating the humanity of people by using these terms. I am just trying to create a new lexicon or vernacular for understanding and analysing human effort.

We have to be able to use a language that business people use if we want to impress them. That will be by numbers and hard data. That is what got us towards thinking about people as human assets. This was before the word human capital came along. If we think of an asset, what we have to do with an asset is we have to first acquire it by buying it or leasing it or whatever. Once we have it, we have to maintain it. If it is a machine we have to oil it, do preventive maintenance and so forth.

With people we have to pay them, provide benefits and other types of support. One thing that is unique...
is development, because only people can be developed, not machines.

The way they touch the operating part of the organisation is that if we change the way we do any of those four things, we are most likely going to change the operation of the unit that we are talking about. The caveat is that a manager has to be a good manager. If he or she is an idiot, then putting good people under them does not help.

Assuming that we have good operating systems, good supervision and all the rest, if we do a better job of putting those assets in better, faster and cheaper, by definition, we have to get better performance out of that business unit.

That is how the action of acquiring, compensating, growing and retaining human assets, or human capital, affects business performance and the operating objectives.

The Power Shift
What is the effect on human capital of putting mobility and information in the hands of people?
There is a power shift going on and it is never going to go back to what it was. A lot of people are now grabbing information, grabbing mobility, and connectivity through the Web and the Internet. The inmates are taking over the asylum. Management in many cases doesn't even know it or they do know it and are trying to stop it. That is the great irony. Management, on one hand, is trying to engage people. On the other hand, when people do get engaged, management starts putting up barriers and says do not do this, do not do that, you cannot do this, our policy is that...

If people want to communicate, they are going to communicate no matter what you do. If you imprison them, they are going to tap on the walls.

As long as the economy remains viable at all, people are going to communicate. They are going to go off and do things and they are not going to tell you about it. From management's standpoint you better get with them. Otherwise, they are just going to drag you along behind.

What is the role of human capital in making a quantum leap?
In order to make quantum leaps, you have got to engage the imagination of human beings.

A quantum leap is launching a great new innovation, a great change in the organisation that significantly affects margins, or new products, but it is a major change in the organisation — a positive change in products, finance, processes or systems or whatever.

The CEO of Zurich Financial said, “It’s taken us 110 years to get x-billion dollars in sales. We’re going to double that in the next three years.” That is a quantum leap. In order to do that you have to engage the totality of the human being. Quantum leaps come from the imagination of human beings who can see what is possible.

That is why human capital is the key issue. Human capital is the one thing that can look three or five years ahead. It can drive the change in redesigning systems. Human capital is the only asset that is not passive. Human capital is the only active asset there is.
I am looking at a lot of capital equipment sitting here in my office, none of it is moving. It is going to sit here until it rots, unless I pick it up and use it. It is a depreciating asset.

Growing the ROI of Human Capital
What do you mean by saying that the ROI, the return on investment of human capital will be astronomical in companies that learn how to turn on the information and intelligence gathering capability that lies dormant in most employees?

I think everybody has agreed that we are using a very small amount of our human potential. We have heard quotes that we only use two or four percent of our brainpower. We can move that to a higher level. We are using an extremely small percent of the human potential of our work force. It's not only their brainpower but also their imagination, energy, etc.

Are We Prepared for the Future
How can you tell if we are being prepared for the future, and what indicators show that we are being prepared? There are macro and micro things and more direct and less direct, but here's a sampling, and in no particular order of priority. One that we talk about is called “readiness.” It is nothing more than the depth chart of the company or succession planning of the company. In all critical positions, do we have somebody ready to take over if that person drops dead or quits tomorrow? That is a readiness index.

We can also look at rates of voluntary turnover. That tells us going ahead that if we don't stem this, if it's too high, we are not going to be prepared for the future.

We can look at statements of commitment to the vision of the company and commitment to staying in the company. Commitment is not only staying.

Commitment is buying into the vision and having the energy to support it.

We can look at whether we have competencies in what looks like the things we are going to need in the future. If we’re beginning to see changes in the technology of our industry, are we starting to build competencies for that or are we going to wait until the last minute and then pay an exorbitant amount of money for people who have that competency?

We can look at something as simple as the mix of exempt to non-exempt people in a given function. Exempts are professionals and managers.

These are the people who do not get overtime. Non-exempts are labourers, clerical and administrative people.

If we have a high level of non-exempts to exempts, for example, a high level of clerical and smaller amount or percentage of professional people, it tells us this is a transaction department—a paper-pushing department. If we reverse that, and have 70% professionals in here and only 30% clerical, that means we have probably outsourced the transaction activities and we are more of the strategic or advisory function now.

That tells us what you can expect out of that group. We then lay that against what we want in the future and design that kind of a mix for the future.

Enabling People to Build “Tomorrow”
How do we enable people in organisations to be the builders of the organisations of tomorrow?
First of all, delegate. That is not new. A lot of this stuff is old—things we have talked about for twenty, thirty and forty years and have not done very well at, or have done sporadically. Delegate power. Delegate authority.
Delegate decision-making. Delegate the allocation of resources.

There are many cases where people have had to sign multiple forms to get very small things. That is not going to make it.

Demand and encourage innovation. Set up systems that encourage it, as well as systems that reward it. Set up systems where you learn from failures.

Process Management and Human Capital

How do you see the relationship between process management and human capital management?

Process management is how you do something. Human capital management is who is doing it. That is the differentiator. Clearly, we have to engage the human capital to change the process. The differentiating factor is who is doing what? It is the human activity versus the structured process or system. It is getting work done.

Is that a matrix?

No. I look at it more like fuel or energy. Let us use as an example an assembly line, where you spend $300 million to build an assembly plant. Engineers have laid it out and put the equipment, materials and all the rest in place. Then we come to the human capital. That is the person that flips the switch, who turns the plant on, and monitors it. There is always a human element. That is what human capital is. Human capital is the force, the "who" that designs the process and keeps it going, and in many cases is actively engaged in it.

How can we find the human capital effect on organisational processes? How do you know what difference it makes?

We could never get to a point where we can prove that something happened as a result of human intervention unless it’s very simple and obvious. In a complex organisation, we cannot prove anything. There are too many variables impacting the organisation at all times. All we can ever do is set up something where we can see some kind of correlation that this and that are working together to achieve “X”.

A classic example that we can take is a sales force—give them sales training, and give them equipment like a PC with a modem where they can key into inventory when they are sitting in front of the customer.

Then, we can see what happens with our sales. If sales go up, we can say it was a combination of these two things: we trained people on how to be better sales people and we gave them access to inventory so that they can answer the question of the customer on the spot.

Catalysts for the New Economy

What are the contributions of technology and human capital to an outcome? In terms of the new economy, what are the catalysts? Is the new economy a different economy based on these different understandings?

The economy is certainly different than it was before because of many different things, such as: technology, globalisation, emerging requirements that did not exist before, as well as the fact that anybody can be in the market today from anywhere in the world. It is a different market than it was. In addition, the speed of connectivity has also certainly changed the marketplace.

I think that because conditions have changed, people have also changed.

We can see it in customer requirements. Customer service demands are now much higher than they have ever been. Customer expectations are higher because customers see that it is possible for a well-functioning company to serve them better than it could ten years ago when it did not have the technology behind it.

What is the human capital dimension of this change? The answer goes back to the basics. The human being put the intelligence into the initial program. It was not a computer that did it. The fundamental is it is always human activity that drives everything. Machines do not drive anything except in the direction of which people push them.

What are some examples of organisations that manage their
human capital with systematic and proven evaluation methods? What difference has it made for them to do that? First, it is a good business fundamental to maintain a basic set of key performance indicators, which are both financial and human. This is not rocket science.

You have to make some decision as to what the key performance indicators are for your organisation and the balance cannot be solely financial. The next step is augmenting that with project measurement.

Did we get what we wanted? Was it because of human issues? Was it because of financial issues? Was it because of structural issues? Was it because of customer issues? What drove it?

If we have a basic set of key performance indicators and augment them periodically with project management measures and learning from both of those, then we can begin to get a payoff from all of this. The payoffs are that we can more effectively communicate performance expectations, understand what happened, understand the results of any activity, compare our results with any standards that we set internally or with benchmarks from outside, identify the gaps between what you expected and what you got; equitably and efficiently recognise and reward performance, and do better resource allocation because we know where we are getting our best ROI.

Are there any organisations that are doing this better than others? Sure. It is the ones who are better long-term performers. Go back to “Built To Last” or to my book, “The Eight Practices.” These are the General Electrics that have for decades outperformed the rest of the market. We will find these characteristic kinds of things taking place in them. They all have key performance indicators that are balanced.

The Next Five to Ten Years
Where do you see the field of human capital going over the next five to ten years?
People through knowledge are clearly the critical factors of the future. It is not land, capital and equipment any longer. It is people and knowledge/information. It is all the soft stuff. That is the driver. If we have got that in place, people will pick the right kind of hard assets that they need to manage.

The issue to me is whether human capital management and the whole field of intellectual capital, knowledge management, etc., as it goes forward will make connections to the business. We shouldn’t start a department that goes off and does knowledge management, intellectual capital management or human capital management. If we do that we end up with what happened to Organisational Development (O.D.). O.D. was the big thing that came out in the 1960s when I first got involved in so called “personnel work”. We have got to recognise that what drives all of this is business.

Business provides the capital. Business provides the rewards. Business provides the direction. Otherwise, we are operating in a vacuum. We have got to get it out of a department. We have got to make it part of the culture. If it were up to me, I would kill all these intellectual capital departments, knowledge management departments, chief knowledge officers and all of that. I would get them integrated into the way of doing business on a day-to-day basis. That can be done.

Learning, sharing, active communication, connecting as human beings, giving space to people to think, rewarding them for that is what we have to make active and stop putting labels on. That is where the future is.