C E Center for Effective Organizations

WHAT IF—ORGANIZATIONS WERE BUILT FOR TALENT?

CEO PUBLICATION
G 07-23 (533)

EDWARD E. LAWLER III
Center for Effective Organizations
Marshall School of Business
University of Southern California

2007

Center for Effective Organizations - Marshall School of Business
University of Southern California - Los Angeles, CA 90089–0806
(213) 740-9814   FAX (213) 740-4354
http://ceo-marshall.usc.edu

For at least the last decade, it’s been hard to pick up a business book, article, or corporate annual report without seeing statements that stress the importance of human capital— people. We’ve seen numerous articles and books about the war for talent, how human capital drives the market value of corporations, and the importance of intellectual and knowledge capital in today’s global economy. It is not just academics and business publications that stress the importance of people; executives are doing it too. Annual reports regularly contain comments by CEOs about how people are their company’s most important asset. Surveys of executives confirm that many believe that finding and developing the right talent should be one of their top priorities.

To some degree it is politically correct to say that human capital is an organization’s most important asset. Thus, some executives may say it simply because it is politically correct and it does sound “right,” but that doesn’t mean it isn’t true. There is evidence that suggests it is true in an increasing number of businesses. More and more of most organizations’ market value does indeed depend on their intangibles-- and human capital is an important intangible. Particularly in developed countries, more and more work is knowledge work that requires human capital excellence in order to be performed at a high level. In addition, the availability of financial capital is rarely capable of being a differentiator when it comes to competitive performance. On the other hand, the potential exists for outstanding human capital to provide a critical competitive advantage, because it often is scarce and strongly influences corporate performance. Thus, even though executives may just be giving lip service to the importance of human capital, more often than not, they probably are correct.

The Gap Between Words and Actions

It is one thing for executives to stress the importance of human capital; it is another for organizations to be designed and operated in ways that reflect the importance of human capital. There is little question that most corporations are designed and managed to operate in ways that are based on the belief that human capital is a critical asset. They utilize bureaucratic structure-based approaches to management which focus on optimizing the utilization of financial capital, machinery, equipment, and natural resources, and do not ask people to add a great deal of value. Work processes are designed to create simplified standardized jobs, and individuals are controlled through well-defined hierarchical reporting relationships, budgets and close supervision.

I believe the gap between what is said by executives about the importance of people and how organizations are managed is at best unfortunate and at worst a major contributor to poor organizational performance. Let's look first at the situation where executives say people are important, but they are not and should not be a source of competitive advantage. When all is said and done in some businesses, it should not be about people, it should be about natural resources, cash, government regulations or some other tangible corporate asset. In this situation, executives who talk about the importance of people, but don't act on it, come across as hypocritical leaders but may still run effective organizations, because among other things, effective leadership of people just isn't that important.

But what about situations where people can be an important source of competitive advantage? Here saying one thing and doing another is a major negative when it comes to organizational effectiveness. In addition to experiencing a suboptimal approach to management, employees are told that they shouldn't be managed as they are. As a result, executives who say

people are important come across as both hypocritical and very poor managers and strategists, a major problem when people should be a major source of competitive advantage.

Closing the gap between how most organizations operate and what executives say about the importance of people is not easy, but it can be done by making changes in three key areas where the importance of human capital should be apparent: corporate boards, the human resource management function, and the information systems of organizations. Let's look at each of them separately with an eye towards seeing what companies need to do to operate in a way that places a high level of importance on human capital.

Corporate Boards

It is easy to state what corporate boards should be like in organizations where human capital is the most important asset. Corporate boards should have both the expertise and the information needed in order to understand and advise on talent issues at all levels of the organization. Let's look first at the issue of expertise.

A good deal of research-based knowledge exists about the retention, motivation, and development of human capital. Accessing and utilizing this knowledge requires in-depth expertise. Thus a board should have at least one member who has an in-depth understanding of the research and knowledge in this area. A good comparison point here is the presence on boards of individuals with expertise in financial capital. The typical board has at least one individual who understands capital markets and can give advice on them. In addition, they have someone with an accounting background. In the situation where human capital is critical, it is reasonable to expect that a board would have a similar level of expertise in human capital.

When it comes to financial capital, boards regularly receive information about the financial condition of the organization. When it comes to human capital, the same should be true if it is of similar or greater importance. Board members should get regular information about the condition of an organization's talent and its utilization of that talent. Among other things, this should include information about the attitudes of the talent, the skill development levels of the talent, the availability of back-up talent for key positions, and the ability of the organization to attract, retain, and develop new talent.

Finally, it is reasonable to expect that the board should spend at least as much time on human capital issues as it does on financial and physical capital allocation issues. It is particularly important that boards spend time on succession planning for the top level management positions in the corporation. No one who stresses the importance of human capital argues that there is anything more important for the future of an organization than the type of talent it has available to fill its very senior positions. Thus, the board should have up to date, in-depth knowledge of what executive talent is available and how well developed it is.

The research on boards suggests that organizations fall far short of operating in ways that reflect their putting a high value on human capital. Let's start with the first point about having members who are true experts in human capital management. It is hard to come up with exact figures on how many boards actually have a member, or members, with deep consulting, academic, or practitioner experience in human capital management but there are a number of observations that suggests that boards typically do not have many, if any, members with human capital expertise.

For example, almost no U.S. board has a member who has been, or is, a Vice President of Human Resources for a major corporation. In the past, TRW and UPS had their Vice Presidents

of Human Resources on their boards, but no longer. Further, virtually no human resources consultants sit on today's corporate boards. This, of course, is significantly different from the number of venture capitalists and financial experts who sit on corporate boards. The same pattern is clear among academics. Finance and accounting professors are on numerous corporate boards but professors of human resource management and organizational behavior are rarely on boards. There are exceptions, of course. For example, Dave Ulrich, a well-known human resource management professor and consultant, is on the board of Herman Miller, but membership on a board is a rarity among HR professors.

When I have interviewed board members and asked them who they rely on for HR expertise, they often point to one or more of the CEOs who are on their board. When asked why they rely on CEOs, they point out that CEOs have had considerable management experience and therefore must have expertise in human capital management. The problem with this argument, of course, is that CEOs rarely have a deep expertise in human resource management. There is an interesting comparison here: CEOs often do have considerable experience with managing financial assets but they are rarely the "go-to person" on a board when it comes time to make decisions about financial capital because they don't have the depth of knowledge that is needed in this area. Why should the human resources area be different if it really is important?

There is little question that boards spend less time on human capital issues than on financial capital issues, particularly since Enron and Sarbanes/Oxley. There also is little question that boards spend more time on operations issues than on human capital issues. One reason for this is that they do not get systematic information about the condition of an organization's human capital. For example, in many cases they don't see the results of attitude surveys, turnover analyses, and succession plans. In some cases, this is because they don't exist;

in others, it is because management does not share them with the board. This failing is a particularly serious problem with respect to talent at the senior management level. This is an area where boards spend relatively little time compared to its importance. Finally, boards do not get good analytic data on the organization's human capital. Particularly missing are analyses that show how HR metrics predict future organizational performance.

Some boards do encourage their members to visit company facilities and talk to employees as a way to give them a sense of the condition of the human capital and its management practices. This is obviously a step in the right direction but it is not a good substitute for rigorous analytic information about the condition of an organization's human capital nor is it a good substitute for the board reviewing the succession plans of an organization and being able to assess the quality of its management talent. Boards can get an opportunity to do the latter simply by having managers make reports to the board or join in board meetings. This is an important way for boards to get a sense of the human capital in the organization but it is an all-too-infrequent activity in most boards.

Overall, when it comes to how the boards of U.S. corporations are staffed, structured, organized, and operated, the most reasonable conclusion is that they are much more focused on financial capital than on human capital. Indeed, when it comes to their ability to provide direction, and assure the quality of the human capital in an organization, perhaps the most accurate grade for them would be an F. Organizations simply do not have the expertise or information they need to effectively provide strategic advice and direction when it comes to human capital.

The HR Department

In an organization that believes human capital is its most important asset, it follows logically that the HR Department should be its most important staff group. This means that HR should have the best talent, the best information technology resources, and it should be a valued expert resource to the firm when it comes to strategy, change management, organization design, and talent management.

HR should be staffed with individuals who understand the business as well as know the intricacies of human capital management systems. It shouldn't be staffed with just individuals who are planning on a career in HR. Career HR people certainly should exist, and they should have advanced degrees and in-depth expertise, but the human resources department should also be seen as an important career stopping point for anyone who aspires to a senior management position in the organization-- just as operations and finance are seen as critical career stopping points in organizations that treat financial capital as their most important asset.

It is particularly important that HR have information technology resources that allow it to produce state-of-the-art information systems about their human capital. Without the right information systems, it is difficult for the HR organization to produce the kind of quantitative data that will allow for fact-based decisions about talent management to be made. Again, the comparison to financial capital is obvious. Financial capital decisions are made based on carefully collected and analyzed data.

When it comes to strategy development, HR should be very involved because it has expertise about the company's most important asset— talent. Sometimes this is expressed as HR needing to "be at the table" when key business strategy decisions are made, but I'm not sure that a seat at the table is enough. If human capital really is an organization's most important asset, HR should "set the table" for strategy discussions by framing the issues in terms of the current

condition of the organization's human capital and what talent is available in the market. This should lead to a determination of what the business strategy should be.

There is a great deal of evidence to suggest that the current condition of the HR department in most major corporations falls far short of what it should be. Simply stated, in most corporations it doesn't get the best talent, the best IT resources, and it is not an expert resource when it comes to strategy, change management, organization design, and talent management. Even the best HR departments may not reach this standard.

When it comes to talent, HR usually does not get the best talent coming out of business schools. It pays lower salaries and is not seen as a great place to start your career if you want to become a CEO, COO or senior executive in anything except HR. As a result, HR is not on the preferred career track for the very best MBA students. Only a few of today's top executives have, in fact, ever worked in the HR organization. Yes, there are exceptions— Anne Mulcahy, for example, at Xerox— but there are very few.

In most organizations, the HR function itself is staffed with competent professionals but few of them have had jobs outside of HR. As a result, they don't have the kind of line management experience that allows them to put their work in HR in the context of the larger business. This in turn means that they often have difficulty providing the kind of strategic direction and advice that is needed when human capital is an organization's most important asset. PepsiCo, GE, and IBM are often cited as leading HR departments, but even they do not systematically rotate their top management talent in to the HR department. They do, however, recruit top talent into the HR department.

Rarely are the HR programs in corporations subject to the same kind of analysis and effectiveness tests that are utilized when the other key assets of a corporation are considered.

For example, rarely does HR know or ask about the return on investment of its various policies and practices. HR typically lacks the kind of analytic skills that allow it to assess the cost effectiveness of HR programs and determine their impact as well as the impact of proposed changes in job designs, organization structure, and the other policies of the organization. It also often lacks a true decision science when it comes to making decisions about how to best allocate human capital and what type of talent development moves are particularly appropriate.

The lack of any type of decision science is particularly apparent in the area of reward systems and talent management. There is a general lack of analysis when it comes to computing the return on such key reward decisions as how to allocate stock options, the value of new benefit programs, and the impact of pay-for-performance programs. Usually little, if any, data are available about the return on training programs, developmental moves and most other talent development practices and programs. Again, the analogy to financial assets is obvious. There is good information in most organizations about how products and services perform on various financial indicators and these can be used to make decisions about the allocations of financial capital and the continuation of activities. All too often, the same is not true when it comes to making decisions about human capital.

Information Systems

There is an old saying that what gets measured get attended to. The implication of this for human capital is very straightforward. It will be a central focus of an organization only if the organization has measures that are as relevant, rigorous, and comprehensive as the measures that pertain to its financial assets and physical capital.

To be effective, a human capital information system needs to look at the performance of human capital in the context of its contribution to organizational effectiveness. It needs to give a good indication of how productive individuals are, and how that relates to organizational performance. It needs to measure the competencies and capabilities the organization needs in order to perform well. It also needs to inform both management and investors about the performance and condition of the organization.

As has already been noted, the ability of the HR function and corporate boards to effectively deal with human capital is highly dependent upon the type of metrics and analytics that they have. They need to have comprehensive data on the condition and utilization of the organization's human capital. But they are not the only ones that need this information. Given that an organization's intangibles account for an increasing percentage of its market capitalization, it makes sense for investors to both request and receive information on an organization's human capital. If, in fact, human capital is an organization's key asset, then investors have both the right and the need to get regular updates on the condition of that asset. For example, they should get information on turnover rates, money spent on development, employee engagement, and the organization's competencies and capabilities.

As already noted, the metrics and analytics that are available in most organizations fall far short of what they need to be. They generally lack the precision and comprehensiveness of the metrics that are used to assess the condition and utilization of the financial capital of an organization. They are rarely, if ever, reported to investors. Occasionally an organization makes an acknowledgement in their annual report of an accident rate or reduction in turnover but, in fact, hard data about human capital is rarely presented in any systematic way in public documents.

Many organizations today do make some attempt to find out about the condition of their human capital. They increasingly do attitude surveys, measure turnover, the number of job offers accepted, and other human capital measures. What they rarely do is regularly produce a scorecard of the human capital metrics that are directly tied to financial performance. What organizations need to do and don't do is develop a set of key human capital indicators that they can demonstrate are linked to organizational effectiveness and that are repeatedly measured so that trends can be established.

Overall, what organizations do with respect to human capital information systems is minimal and is far less than what they do with respect to financial capital measurement. When it comes to human capital metrics and analytics, most organizations simply do not do what they should do if they take seriously the view that human capital is their most important asset. The consequences of this include poor strategic planning, inadequate succession planning, poor utilization of people and the failure to effectively manage an organization's most important asset.

A Look at the Future

We have looked at three areas: corporate boards, HR functions, and information and measurement systems. In all three areas, there is an enormous gap between how organizations are managed and how they should be managed and designed if human capital truly is their most important asset. The obvious question at this point is why this gap exists. Is it because executives don't really believe what they say when it comes to the importance of human capital? Is it because they don't know how to design an organization when human capital is the major asset? Or is it that they are trapped by the past practices of their organization and can't change? Are they threatened by change? The answer is undoubtedly a combination of all of these.

The bottom line is that there are many good reasons for most senior executives to resist designing and managing organizations in ways that treat human capital as their organization's most important asset. As a result of this, change is difficult and slow. Indeed, it may take the emergence of a whole new generation of managers before it will come about, but there is little doubt that it will. It is already quite visible in companies such as Google, Whole Foods and Starbucks. Why are these companies ahead of the curve? Perhaps the best explanation is that they all have a founding CEO who says and acts like human capital is his company's most important asset.