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**MAKE HUMAN CAPITAL A SOURCE OF  
COMPETITIVE ADVANTAGE**

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**Make Human Capital A Source of Competitive Advantage**

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## **EXECUTIVE SUMMARY**

For at least the last decade, it has been hard to pick up a business book, article, or corporate annual report without seeing statements that stress the importance of human capital. Surveys of executives confirm that many believe that finding and developing the right people should be one of their top priorities. However, it is one thing to stress the importance of human capital; it is another for organizations to be designed to reflect the importance of human capital.

This article looks at four areas where human capital should have a major impact on design: corporate boards, leadership, the human resource department, and information practices. In all of these areas there is a large gap between how most organizations operate and how they should operate in an organization that is built for human capital.

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. They should focus on developing managers who can provide leadership.

The HR Department should be the most important staff group. 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.

There is an old saying that what gets measured gets 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 of its financial assets and physical capital.

## **Make Human Capital A Source of Competitive Advantage**

Survey after survey has found that executives believe finding and developing the right talent should be one of their top priorities and that their company's human capital is one of their most important assets. Yet few corporations are designed to operate in ways that recognize the importance of human capital.

Most companies understand how to leverage financial capital, machinery and equipment, but when it comes to human capital, it is a very different story. Jobs are designed to follow a simplified, standardized approach to the execution of work processes, and individuals are controlled through well-defined hierarchical reporting relationships, budgets and close supervision. Rather than encouraging people to be important contributors, most of the systems in organizations are designed to control their behavior. If we really took human capital seriously, we'd run companies in a very different way.

Yes, we would treat people well and say they are important, but we would do much more. We would design organizations so that people are a source of competitive advantage. Hiring some highly talented individuals won't do it! Training programs won't do it, either! Even being a best place to work won't do it.

Making human capital a source of competitive advantage requires much more than making some quick fixes to a control-focused organization. It requires attracting and retaining the right people

as well as organizing and managing them effectively. Attracting and retaining the right people is not easy, but most organizations can get it done if they devote enough resources to it. Actually developing and employing organizational structures and operating systems that lead to an organization's human capital being a source or the source of competitive advantage is another story. It requires the right managerial behaviors as well as the right design of most of an organization's major operating systems in order to create a Human Capital centric (HC-centric) organization.

What does a company that's truly built to leverage its human capital look like? First, it has corporate board members armed with sufficient expertise and information to advise on human capital and organizational effectiveness issues. In fact, the board would regularly receive the kind of detailed information about the condition of the organization's human capital as it does about its financial situation. Second, it would develop executives who practice shared leadership and are committed to developing leaders throughout their organization. Third, it would consider the Human Resources function its most important staff group. HR's ranks would be filled with individuals who understand the business as well as know the intricacies of human capital management systems. Finally, it would have information systems that report accurately on the strategically important competencies and capabilities of the organization and of each employee.

### **Corporate Boards**

Corporate boards can and should do a lot when it comes to human capital management in HC-centric organizations. Boards should examine the effectiveness of their organization's human capital management systems as well as the status of its people. Boards need to know at least as

much about the condition and utilization of their organization's human capital as they do about the condition and utilization of its financial and physical assets. Boards need metrics that accurately report on the condition of the organization's human capital. They also need analytics that show how the management metrics drive corporate performance. They need to use this information when they make strategy decisions, do evaluations of senior managers, and make decisions about organization design, change, and effectiveness.

Knowledge about human capital management and organizational effectiveness is an obvious foundation that boards need in order to make high-quality human capital management decisions. Essentially, boards have two major sources they can draw upon for knowledge. The first is their own members, and the second is nonmembers who are asked to make presentations or consult to the board and its committees. The key question, therefore, is: Do either board members or the individuals they look to for information and advice have a deep expertise in human capital management? The answer for major corporations in most cases is no. HR executives are not on boards and in fact don't consistently attend board meetings. Unlike experts in finance and experts in accounting, experts in HR typically are not on boards.

Finance and accounting professors sit on numerous corporate boards, but membership on major corporate boards is a rarity among professors of HR management and organizational behavior. One of the few exceptions is David Ulrich, management professor, who sits on the board of Herman Miller Inc., the office and home furniture company. Herman Miller is itself atypically preoccupied with human capital issues; one of its former CEOs, Max De Pree, is well known for his book *Leadership Is an Art*.

When I have asked board members who they rely on for HR expertise, they cite the CEOs on their board. There is no doubt that many CEOs have some understanding of the human capital issues that corporations face, but they rarely have the kind of in-depth expertise that a professional in HR can bring to a board. Effective human capital management requires a great deal of expertise in organizational systems and a great deal of understanding of motivation, competencies, traits, and organizational behavior. Skilled managers often have a good understanding of people and some organizational systems, but they rarely have the kind of expertise that a knowledgeable expert can bring to bear on the major human capital decisions that organizations need to make. Human capital decisions need to be based on research evidence, facts, data, and informed judgment. Because of this, boards need to have at least two members with an in-depth knowledge of human capital management.

Corporate boards need to do more than just focus on how their organizations manage people. They need to be expert people managers themselves. Boards need to evaluate the performance of the CEO and other senior executives, and they need to evaluate their performance as a board and that of their members.

Why evaluate board members? Because members of the board are a critical part of human capital of any organization. Thus they need to be evaluated and rewarded. A valid ongoing evaluation process can form the basis for decisions about continuing board membership. As a result, it can have a motivational impact that stock-based reward programs lack.

In terms of evaluating others in the organization, the board's most important responsibility is to evaluate the CEO. Today, virtually every Fortune 1000 company has a formal evaluation process for the CEO. Well over 80 percent of board members say that they do a very effective job of evaluating the CEO. This may be a bit optimistic, since boards have few agreed-upon standards upon which to determine what an effective CEO evaluation looks like, but it is encouraging. It would be more encouraging if the board members had expertise in management and boards evaluated the human capital management performance of the CEO as regularly and as rigorously as they evaluate the financial management performance of the CEO.

### **Leading**

Without question, executive leadership is very important to the effectiveness of all organizations. The quality of an organization's CEO, and the quality of those who hold senior executive positions, clearly affects the performance of the organization as well as the motivation and satisfaction of employees.

But senior leadership is only one of the major determinants of organizational effectiveness. Many studies, in fact, show that the *key* determinant of most employee behavior is not the leadership of the CEO or the senior executives but the behavior of an employee's immediate supervisor or supervisors. These are the individuals who can provide the most important day-to-day motivation and sense of direction to the members of an organization. These are the managers who should possess—and pass along—technical and organizational knowledge when it comes to strategy implementation, change management, and work processes. They are also the ones whose



behaviors shape the culture in a much more tangible way than the behavior of the senior executives.

Mark Hurd, the CEO of Hewlett-Packard, has argued that leadership should be a “team sport” that is played by everyone. Effective leadership at all levels is particularly critical to the success of H-C centric organizations for two reasons. First, it is what substitutes for the bureaucratic controls and structures that are absent. Second, it is the best source of the kind of motivation and culture that makes human capital a competitive advantage. As Sam Palmisano, the CEO of IBM has said, “you just can’t impose command-and-control on a large, highly professional workforce.”

What do effective leaders do? They focus on the following activities.

### **Look to the Future**

Effective leaders learn from the past by debriefing the successes and failures that have occurred, but their major focus is on the future. An important part of this focus on the future is setting expectations, and providing an inspirational view of how the performance of people can provide winning business performance. How does this get done? A piece of the answer lies with understanding the competitive environment and how it is changing. Many competitive advantages can quickly become outdated as other organizations copy them. Thus leaders need to constantly monitor the external environment to see what the next source of competitive advantage is likely to be and prepare their organization for it.

## **Manage Performance**

At the top of the list of key activities for every manager should be managing performance.

Performance management systems are only effective when they are owned by senior management and used as tools by managers at all organizational levels. These systems will not work if they reside in an HR silo and are performed because HR says they are important.

Jeff Immelt, GE's CEO, stated what CEOs need to do in GE's 2005 annual report: "Developing and motivating people is the most important part of my job. I spend one-third of my time on people. We invest \$1 billion annually in training to make them better. . . . I spend most of my time on the top 600 leaders in the company; this is how you create a culture. These people all get selected and paid by me."

Effective execution of a performance management process begins with having a well-designed system that employees understand, but it takes more than a good design to be effective; it takes managers who have good interpersonal and communication skills. Often managers are uncomfortable with some of the interpersonal aspects of the appraisal system and they may well need training in how to do goal setting, give feedback, and administer rewards. That said, there is no substitute for having managers who can set effective goals, communicate why goals are important, and how they relate to the overall direction of the business. Managers must also be clear about how goal accomplishment and goal achievement are related to rewards.

In addition to having a well-designed performance management process, H-C centric organizations need to provide managers with the right performance metrics. Effective performance management requires information. Such obvious results as productivity and sales are not enough; it also requires information on the reaction of employees to leadership behaviors, customer reactions to service delivery, and of course data on how effective managers are in developing talent.

In the late 1990s, CEO Tom Siebel recognized that the way Siebel Systems managed workforce performance was no longer adequate. His answer was to introduce a web-based performance management system. Each quarter the executive team met and set quarterly goals. They were posted and cascaded down the organization so that everyone had their own goals. Every employee could view the objectives of any other employee, including those of Tom Siebel himself and other members of the executive committee. This allowed people to understand how others were allocating their time and attention. The individual performance evaluation process ran parallel to the objective-setting process. The managers were all responsible for evaluating their own direct subordinates by the fifteenth of the first month of each new quarter. The results had to be posted to the *mySiebel* performance management module.

### **Minimal Distance**

Some highly visible CEOs have adopted a model of leadership often called the “imperial” model. They make decisions and develop strategies without significant input and discussion. Their decisions are above criticism and challenge. They adopt lifestyles that make them celebrities and their companies become vehicles that make them “rock stars.” This leadership style is supported

by technology that is designed to keep leaders in touch with their organizations 24/7. But in reality, most imperial CEOs are dangerously separated from the people they lead.

In an organization that values its human capital the gap between leader and led should never be large. It is simply too important for leaders to gather information from others and to be seen as role models for them to be distant from those they are leading. Leaders need to be approachable. They need to be told when they do something wrong or have made a mistake and they need to be able to hear it. Only if they are understood by and understand the critical capital in the organization, which is the talent that works there, will they be able to create a high-performance organization.

In addition, managers need to demonstrate visibly that they value employees. When cost-cutting is a priority, they should explore alternatives before cutting staff. When it is necessary, they should be sure it is executed in a way that fits their company's employer brand. When leadership training is done, they should take part.

Some recent firings of CEOs suggest that corporate boards are recognizing that imperial CEOs may not be the best CEOs. In 2005, CEO Carly Fiorina was fired by the board of Hewlett-Packard. Hank Greenberg, who has been described as the prototype "imperial CEO", was forced out at American International Group after three decades. Perhaps the most visible case was the firing of Bob Nardelli by Home Depot following his dreadful decision to have his board of directors *not* attend Home Depot's annual meeting!

When Frank Blake became the new CEO of Home Depot he recognized the importance of moving away from the imperial leadership style of his predecessor. In addition to taking a much lower salary, he discontinued the catered executive luncheon that the company's top management team had enjoyed under Bob Nardelli and "suggested" that the members of senior management eat in the cafeteria with the other employees. This act sent a clear message to the employees that he intended to be a different kind of leader.

### **Effective Communications**

Perhaps the most common mistake that top executives make is not recognizing the importance of communicating directly and effectively with employees. One CEO who recognizes the importance of communication is Tim McNerney, the CEO of Boeing. Boeing has a global workforce of 160,000 employees, so communicating with everyone is not a simple task.

When asked recently if he was going to spend more time with customers and stock analysts, McNerney replied that it is more important for him to spend time with Boeing's employees than to spend it on increasing his profile and his visibility in the press. According to him, employees "have got to know that working with them is more important to me than public forums where I'm making big speeches."

### **Leaders Developing Leaders**

One outstanding way for senior executives to show their commitment to leadership development is to actively participate in leadership development programs. Depending on their skill sets they can be active teachers or simply show their support by attending sessions. A number of highly

visible CEOs in fact have been excellent role models of how senior executives should behave in this respect.

When Roger Enrico was the CEO of PepsiCo, he regularly taught sessions on leadership with his direct reports. Similarly Bob Eckert of Mattel has sponsored numerous leadership development programs at Mattel and has taught and participated in them. Enrico and Eckert exemplify what effective leaders of HC-centric organizations need to be. It is not being an imperial leader who can single-handedly take an organization by its neck, shake it, and send it in the right direction. It is being a leader who can turn leadership into a team sport and who can develop a company of leaders.

CEO A. G. Lafley is convinced that *the* key reason for the success of P&G is the quality of its managers. Lafley takes leadership development very seriously; in fact, he estimates that he spends about a third to half of his time on leadership development. His concern is also reflected in the behavior of his senior managers. Dick Antoine, the senior vice president for human resources, regularly reviews the individuals in the top four or five management levels in P&G to identify high-potential employees. He shares his assessments of the candidates for senior positions with members of the P&G board. Directors, for their part, are expected to go into the field and meet potential senior executives.

### **Create Shared Leadership**

There is no single key to establishing shared leadership other than the commitment on the part of senior management to developing it. Senior management support is clearly the building block on which the whole concept of shared leadership needs to rest. Senior management support is critical because the people at the top need to be teachers as well as advocates of shared leadership. Nothing will kill a shared leadership culture faster than a senior management group that dismisses leadership efforts by individuals below them.

What does it mean for senior management to support shared leadership throughout the organization? Above all else, they need to be sure that the recruitment, selection, and retention processes of the organization put an emphasis on identifying individuals who are comfortable taking leadership roles whenever a leadership moment occurs.

Goldman Sachs is a good example of a company that has developed shared leadership. At Goldman Sachs, everyone, no matter how junior, is expected to lead. As Henry Paulson, its former CEO, puts it, “We’re global and multicultural like other professional service firms. We also have huge capital commitments and risks to manage. It takes many, many leaders. Goldman Sachs is leaders working with leaders.” Because Goldman Sachs has been such a good developer of leaders, it, like GE, has become a major source of leadership talent.

### **HR: The Key Staff Function**

Imagine a world in which HR has the best talent, the best IT resources, and executives throughout the firm use it as an expert resource when it comes to business strategy, organizational change, organization design and talent management. It is staffed with individuals

who understand the business and talent management. It is a critical career stopping point for anyone who aspires to senior management in the organization. It is able to assess the cost effectiveness of HR programs and to determine the impact of job designs and structure changes on financial performance. It has valid benchmark analytics and metrics that allow it to compare how well the human capital of the organization is performing and also what the current level of skill, motivation and commitment to the organization is.

In an H-C centric organization, the HR department simply cannot be the stepchild it currently is in most organizations. As the expert resource and system designer for an organization's most important resource, it needs to be first rate in everything it does. No organization currently has it exactly right when it comes to its HR organization, but some are close. For decades, PepsiCo has recruited outstanding talent for its HR organization. They and GE in fact have staffed their function so well that they have become academy companies for HR talent.

### **HR Administration**

Failure to provide good service can lead to HR organization being discounted in other areas. HR administration has to be done in a cost-effective, timely, high-quality way. In the past, this has not always been easy to accomplish because HR administration involves a lot of detail and complexity that make it labor-intensive and slow. But there is good news!

Information technology can provide a way to get HR administration done at a lower cost and more effectively. Web-based applications can now do virtually all HR administrative activities.



What is more, most of them lend themselves to self-service. Employees can visit a Web site and sign up for benefits, change their address, enroll in training programs, and set their goals and objectives for the year. Managers can give out bonuses and raises, transfer employees, and find internal talent to fill positions with a visit to their company's intranet.

One organization that has created a Web-based HC-centric talent development system is Eli Lilly. Information provided by employees is vetted by their supervisors, but the primary responsibility for providing the information rests with the employees. Not surprisingly, this has increased the accuracy of the previously secret system because employees usually know more about themselves than anyone else. Lilly makes a Web-based tool available to all employees on their desktops. A click on the career icon takes employees to a portal with their personal information and the job opportunities that are available. Managers, for their part, can use the intranet to search for new employees and can also get information on issues like the number of candidates available for different positions and the number of candidates with particular skill sets. Thus managers can assess pipelines in particular talent areas, the ratio of potentials to incumbents, and the gender and ethnicity of various talent pools.

Once an organization decides to use Web-based systems for HR administration, the key decision becomes whether or not to outsource those systems' operation. Accenture, IBM, Fidelity, and Hewitt Associates are among the major firms that have entered the HR outsourcing business. At this point, the outsourcing of multiple HR processes to a single vendor is a well-established practice and has gained a number of major customers. Unilever, Bank of America, IBM, Prudential, PepsiCo, Sun Microsystems, and BP are just a few examples of the major

corporations who have entered into long-term, multiple-hundred-million-dollar contracts for HR BPO.

For most companies I believe that outsourcing is the right way to handle HR administration. It essentially gets HR out of doing a set of administrative activities that often are no-win activities for internal staff groups. But more importantly, it frees up HR to focus on talent development, strategy execution and organizational effectiveness.

### **Business Support**

The ultimate business support role for the HR function is improving the performance of the organization by improving managerial behavior and the quality of decision making about human capital management and organizational design. Members of the HR function cannot and should not manage and lead people throughout the organization. What HR can and should do is improve the leadership and managerial performance of individuals throughout the organization. In addition, they can help shape both strategy and strategy implementation, a very obvious and important value-add in organizations whose most important asset is its human capital.

### **Information Systems**

The financial information systems of most well-run corporations are a good standard against which to test human capital information systems. A human capital information system needs to give the same amount of attention and rigor to measures of human capital costs, performance and

condition as the financial information system does to measures physical assets. The information system needs to look at how an organization is performing in critical areas where human capital is a key determinant of performance effectiveness, and report on its condition. It cannot just report the traditional financial numbers, because they are often misleading in organizations that are human-capital intensive. Measures are needed that report on the productivity, condition, and value of talent and how effectively it is being utilized.

### **Information about Individuals**

The starting point for any human capital information system should be information about individual employees. It is needed for strategists to make the connection between the specific characteristics that employees bring to the table and the successful development and execution of the company's strategy. At minimum, companies need to be able to answer these two questions: What business skills and relevant competencies does each individual employee have? And to what degree are those skills and competencies used in their current work assignments?

Lilly's system includes some key metrics. It tracks succession metrics including the overall quality of the individuals in its managerial pipeline and the number of positions with multiple "ready now" candidates in the organization. For senior positions, the system shows three potential successors. Targets are set for talent pools and when areas or jobs fall below the target, it is the responsibility of management to develop the needed human capital to bring the metric score above the goal for that particular position. Lilly creates a quarterly scorecard that tracks pipeline data as well as diversity and turnover rates.

To create a complete system, companies also need to gather data from individuals about their motivation and their attitudes toward work, career, and the organization. Specifically, data are needed that reflect the degree to which individuals are motivated to perform their jobs, whether they plan to continue to work for the organization, and how well they understand the organization's business plan and organizational model.

### **Capability Information**

To have a competitive advantage, it is not enough to assemble a group of great individuals; these people must function together in ways that deliver outstanding organizational performance. That is why HC-centric companies also need to monitor and assess their *organizational* capabilities and core competencies. Organizations need to know what the skills and competencies of their people add up to. Do they lead to better customer service? Higher-quality products? More innovation? Faster product development?

An old saying is worth repeating here: what gets measured gets attention (that is, gets done). Organizations that are designed to gain a competitive edge by their ability to have their human capital perform in ways that differentiate them need to measure the performance capabilities that differentiate them. They also need to understand how the management of people can make outstanding levels of performance possible. Human capital must be organized and led, trained and developed in ways that lead to the development of the right core competencies and

organizational capabilities. An organization's capabilities and competencies are its means of creating value. Measuring them is as important as counting inventory and keeping track of cash.

It is impossible to determine the human capital measures that need to be collected and how they should be interpreted without using analytic models. Data aren't useful unless they can inform strategic and operational decision making. Doing this requires answering three questions: What are the important determinants of each human capital metric? What are the consequences of the metric being at different levels? And what is the cost effectiveness of change? Only if these three questions are answered can human capital data be fully and effectively used. What makes metrics useful is not just that they measure performance in a meaningful way but that they themselves can be influenced by things that the organization can control and afford to change.

### **It is Time**

It is beyond politically correct to say that human capital is an organization's most important asset. For many organizations, it is a reality that demands action. What kind of action? The answer is both simple and complex: organizations need to be designed to make human capital a source of competitive advantage. There is no way to get the rate of change, the amount of innovation and the focus on customers that is required in many businesses without adopting an approach to management that is designed to optimize the performance of an organization's human capital.

Creating an organization that relies on human capital for competitive advantage involves more than just improving on recruiting or adding new metrics. It means designing every organizational system with an eye to attracting, developing, retaining and motivating the best people. It is not a simple thing to do, but that is a significant positive for those that do it. It means they can have a competitive advantage that is hard to duplicate.

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