Executive Briefing

HUMAN CAPITAL ANALYTICS

THE MISSING LINK: *Measuring Financial Returns on the Human Capital Investment*

"If you don't know your numbers, you're not in the game."

Human Capital Analytics:
The process of measuring and analyzing the investment in human capital to identify changes in human capital strategy that will continuously improve the human capital ROI thereby enhancing the economic value of the business enterprise.

By Frank DiBernardino and Adrianne Miller

INTRODUCTION

If your investments were underperforming, would you want to know about it? Of course you would.

So, how is your investment in human capital performing?

Not sure? You are not alone.

In business, revenues are driven by two types of investments: human capital and financial capital. And for many companies, the costs of human capital far surpass those of financial capital, as illustrated across industries in Figure 1.

Yet, metrics typically used to measure the performance of human capital—such as revenue or profit per FTE, turnover rates, costs per hire, and employee satisfaction percentages—do little to measure the financial return on an organization's sizable investment in people. This leaves Chief Human Resource Officers (CHROs) at a distinct disadvantage, often defending the validity of policies and numbers that—because they arise from HR-specific data sources and cannot be easily translated to bottom-line results—carry marginal credibility with other C-suite executives.

This paper explains why current approaches to measuring the value and financial performance of human capital investments are inadequate, and how a new decision support tool—the Vienna Human Capital Performance Index™—uses auditable data from an enterprise's Chart of Accounts to:

1. Measure the financial impact of all human capital investments,
2. Identify best practices and opportunities for improvement, and
3. Build collegial, collaborative relationships across functions and business units.

For the first time, human capital can be credibly and comprehensively evaluated in terms of ***Return on Investment (effectiveness), Productivity (efficiency), and Profit Sensitivity (liquidity)***—financial standards that convey instant recognition and meaning in the C-suite and in the boardroom.

THE INADEQUACIES OF CURRENT APPROACHES

While useful in other strategic applications, none of the traditional methods for evaluating business performance can isolate the human capital investment and determine whether it is improving or eroding a company's economic value.

Standard financial metrics—such as Return on Invested Capital (ROIC), Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), and cash flow proxies such as free cash flow (FCF)—are simply too broad to isolate and measure human capital performance.

Business unit performance measures and functional measures (Sales & Marketing, Operations, HR, etc.) have similar limitations. They are unable to isolate the economic impact of people, and they are too segmented to explain what is driving performance of the organization as a whole.

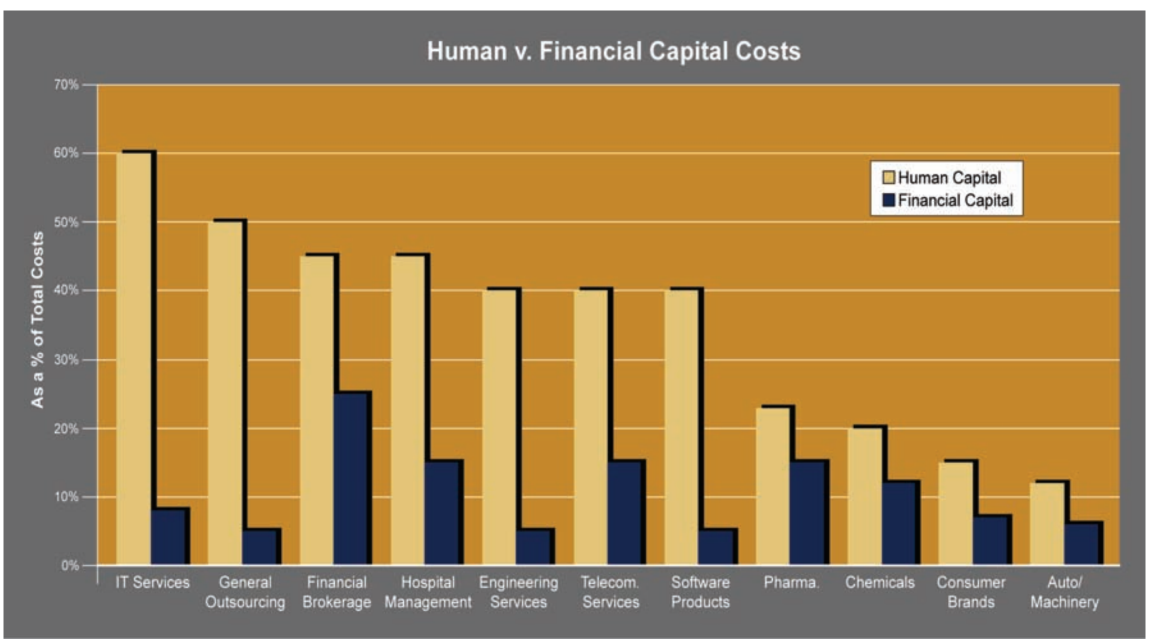

FIGURE 1 - *Source: Boston Consulting Group*

Worse yet, some of the most common human capital metrics can actually mask an organizational performance issue. Take, for instance, the time-honored measures of "Per Full Time Employee" (per FTE) and "Salaries and Benefits as a Percentage of Revenue." Both are incomplete and misleading because neither considers the aggregate of all internal and external human capital costs. Even good "per FTE" numbers (FTE expense as a % of χ) do not consider outsourcing costs. Likewise, any metric that draws numbers from HR-specific data sources is limited in its uses and cannot demonstrate a link between human capital performance and overall business results.

There has been good reason for the disconnect between HR and the corporate bottom line. The investments that companies make in people (pay, benefits, training and development, consulting services, etc.) are shown as expenses on the Profit & Loss statement. And nowhere on the balance sheet is the people investment shown as an asset. This thinking is a carry over from days gone by when labor was viewed only as a cost of manufacturing and the value of people in the enterprise was never taken into account. So, it is not surprising that existing measurement tools fail to adequately inform decisions on the strategic use of human capital. In business, people metrics pose a complex challenge because human capital assets are dispersed throughout the general ledger in ways that disguise their scope and inhibit their comprehensive management. The Vienna Human Capital Performance Index™ is an advanced tool that captures those costs and enables you to make good, informed decisions around the management of the human capital of the organization.

In the latest Strategic HR Management Survey Report, HR professionals identified their most prevalent barrier to making effective contributions in the workplace as "the inability to directly measure HR's impact on the bottom line" and a lack of "an established method for measuring the effectiveness of HR strategy through metrics and analytics."[1] In response to these shared frustrations, scholars and business leaders are calling for "financially rigorous" performance metrics "that highlight the productivity of people."[2] In order to boost strategic capabilities and demonstrate added value to the organization, CHROs "need access to data and information that have the same level of timeliness and validity as those provided to their counterparts in marketing and finance," and they must be able "to apply human capital data and information—on par with what the CFO would expect in Finance—to drive business decisions."[3]

"All decisions have costs involved. As business people, we have to know we're spending that money for good reason. We have to be responsible stewards of the shareholders' investment. And we need good tools to make good decisions."

— Tom Clardy, former Senior Vice President Human Resources, QVC

SEVEN GUIDING PRINCIPLES FOR PEOPLE METRICS

In our work as strategic human capital consultants, decades spent bumping up against the limitations of current metrics led us to ask the question, ***"What would be the necessary features of a new human capital measurement tool that can meet executives' needs and address current inadequacies?"***

Years of study and collaboration with human resource and finance executives led to the following conclusion.

To be comprehensively useful in strategic planning decisions, human capital (people) metrics must:

1. Measure the organization's entire investment in human capital—employee costs, costs in support of employees, and costs in lieu of employees.
2. Use standardized, auditable data sourced from the organization's financial system.
3. Define and measure data consistently over time.
4. Yield measures that are few in number, supported by diagnostic layers of detail.
5. Answer important strategic questions about what drives business results.
6. Provide a credible and clear line of sight between human capital performance and business performance.
7. Apply straightforward methods that are resistant to being "gamed."

Abiding by these principles, people metrics could finally meet the full range of executives' needs. They would inspire confidence by drawing numbers straight from the Chart of Accounts. Measures would accurately

[1] SHRM Research, 2006 Strategic HR Management Survey Report.
[2] Felix Barber and Rainer Strack, "The Surprising Economics of a People Business," ***Harvard Business Review***, June 2005.
[3] IBM Institute for Business Value, "A New Approach, a New Capability: The Strategic Side of Human Resources," IBM Corporation, 2006.

reflect every dollar a company spends on people, and they would be calculated and compared consistently over time. A small, simplified set of indicators would make human capital performance easy to observe and analyze. Data would identify the major drivers of business results, alert management to emerging problems, and facilitate diagnoses and solutions. Together, these features could finally close the gaps between Finance's and HR's strategic capabilities.

Working with a group of finance and HR experts, we followed these principles to develop a new solution to people metrics—the Vienna Human Capital Performance Index™.

Human capital metrics must consider the organization's entire investment in people—employee costs, costs *in support of* employees, and costs *in lieu of* employees.

THE VIENNA HUMAN CAPITAL PERFORMANCE INDEX™

The Vienna Human Capital Performance Index™ (the Vienna Index™) is a patent-pending business intelligence tool that uses auditable, credible financial data to measure and help improve the performance of a company's human capital investment. The Vienna Index was created, vetted, and tested by a team of strategic human capital specialists, CFOs, private equity investors and investment bankers.

Unlike other approaches that only measure the performance of the HR department or HR policy proxies, the Vienna Index yields company-wide strategic and operational metrics and provides cross-unit analyses that identify opportunities to improve profitability and increase enterprise value.

The Vienna Index consists of three strategic key performance indicators (KPIs) that measure Human Capital Return on Investment (effectiveness), Productivity (efficiency), and Profit Sensitivity

The Vienna Human Capital Performance Index™ Executive Dashboard measures results of Productivity, HC ROI, and Profit Sensitivity against Plan. These are combined into the Vienna Index rating and measured over time. The color scheme of the dashboards simulate the colors of a traffic light. Red indicates results are below Plan and signals there are opportunities for improvement. Green is a "go" signal that business practices are moving in the right direction. The line graphs track performance over time and against Plan.

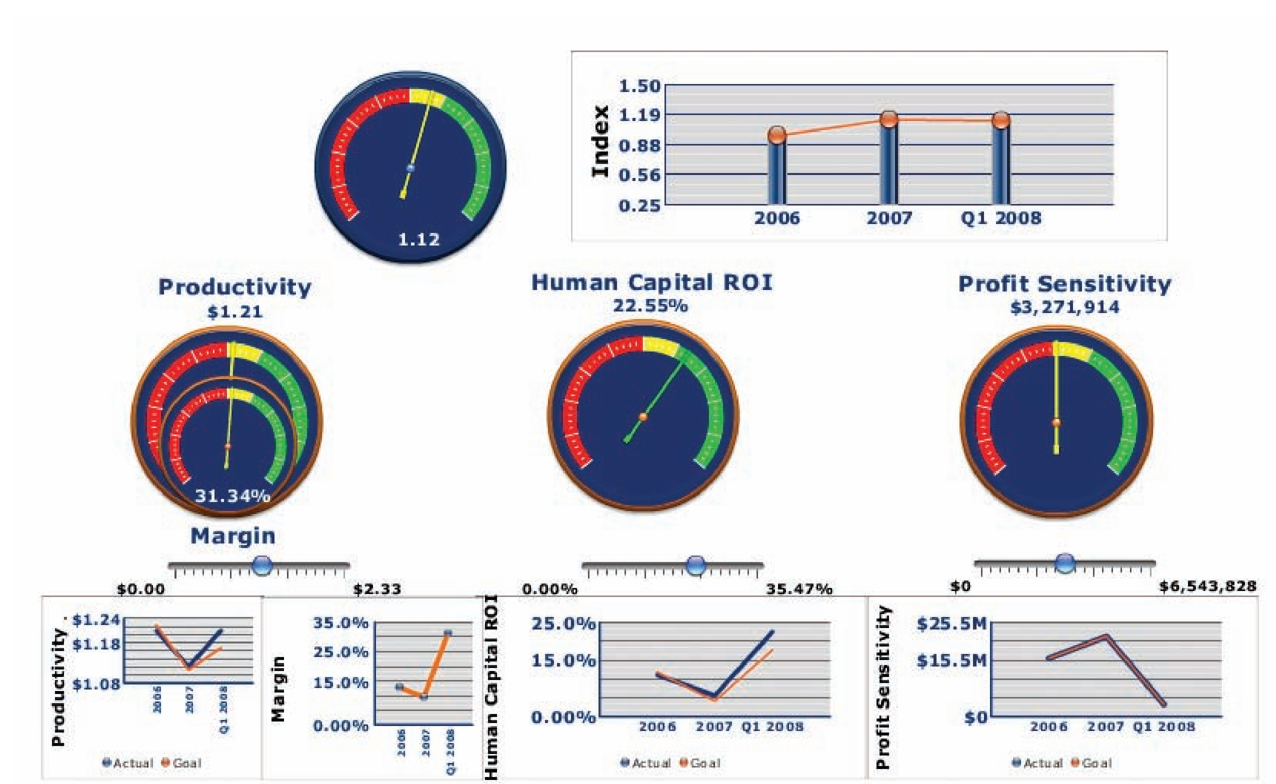

Exhibit 1 - *The Vienna Human Capital Performance Index™ XYZ Global Industries Executive Dashboard*

(liquidity). A company's Vienna Index number itself is the weighted average of its three KPIs. The Vienna Index and each KPI are measured over time and compared to goals set in the company's operating plan.

Human Capital Return on Investment (HC ROI)

$$\text{HC ROI} = \frac{\text{Profit} - \text{Financial Capital Costs}}{\text{Human Capital Costs}}$$

Human Capital Return on Investment measures the return on each dollar invested in human capital after adjusting for the cost of financial capital. This approach is known in the world of finance as a values-based formula. The premise is that human capital has added no incremental value to the enterprise unless it first generates enough profit to exceed financial capital costs. In *What the CEO Wants You to Know*, Ram Charan emphasizes the importance of this distinction. "If the return on assets does not exceed the cost of capital, there will be real discontent among the investors because management is destroying shareholder wealth."

In this formula, profit is expressed as EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). For the purposes of the Vienna Index, EBITDA is a credible financial standard that works for all kinds of business enterprises—both privately-held and publicly-traded companies. EBITDA works in all cases because it reflects profit irrespective of financial capital structure, which can vary greatly by industry and/or organization.

The Vienna Index™ Working Definitions

Financial Capital Costs = Interest, Depreciation, Amortization, and Cost of Equity

Human Capital Costs = Employee Costs, Costs *in Support of* Employees, and Costs *in Lieu of* Employees

Productivity

$$\text{Productivity} = \frac{\text{Revenue} - \text{Material Costs}}{\text{Human Capital Costs} + \text{Financial Capital Costs}}$$

Productivity measures the amount of revenue generated for each dollar invested in human capital, after adjusting for the costs of materials. This formula is an adaptation of the traditional financial measure for productivity (Revenue ÷ Assets), and it can normalize all kinds of enterprises by controlling for material costs (which vary greatly by industry). The premise is that material costs do not add value to the enterprise because they are not a driver of incremental revenue. (Remember, the only two drivers of revenue are human capital and financial capital.) So, the numerator must account for materials as a pass-through cost.

Profit Sensitivity

$$\text{Profit Sensitivity} = \frac{\text{Profit-}\textit{driven}\text{ Incentive Compensation (P}\textit{d}\text{IC)}}{\text{Profit Goal}}$$

Profit Sensitivity measures the ratio between profit-***driven*** incentive compensation (P*d*IC) and a profit goal determined by the organization. This formula is an adaptation of the quick ratio, also known as the acid test, used to measure liquidity. The quick ratio is the most stringent, current method used by finance professionals to ensure that liquidity levels are adequate enough to protect an organization's cash position. The Vienna Index's Profit Sensitivity indicator is a corollary of the acid test, but with a laser focus on the organization's compensation structure. Its premise is that profit-***driven*** incentive compensation is the most agile tool a business can use to protect its profitability. A high Profit Sensitivity ratio shows that the human capital investment is doing its part to maintain a stable earnings pattern and protect the value of the enterprise. P*d*IC is the portion of the compensation program that is connected directly to the level of business profits.

Category	*Financial*	*Human Capital (Patent Pending)*
Productivity (Efficiency)	Revenue / Assets	R—MC / HCC & FCC
Return (Effectiveness)	Profit / Assets	Profit—FCC / HCC
Liquidity (Acid Test)	Cash + AR / Current Liabilities	P*d*IC / Profit

FIGURE 3 - *Financial Capital Formulas and their Human Capital Corollaries*

Operating Metrics

For diagnostic purposes, this decision-support tool drills down into an organization's financial data to provide segmented analyses: by business unit, and by category and line item. A set of graphic dashboards and charts show these comparisons over time. This level of analysis helps to isolate root causes of performance issues and identify specific opportunities to improve Productivity, HC ROI, and overall business performance.

Delivery Platform

The Vienna Index is available for immediate use through Vienna Human Capital Advisors, LLC. Version 2.0, to be released in 2009, will give clients direct on-line access to the Vienna Index through a Web portal as an on-demand application. It will be a user friendly, turnkey solution. The on-demand delivery platform eliminates the time and monetary investments traditionally associated with software purchase, installation, customization, and maintenance. Likewise, there is no risk of incompatibility with existing computer systems.

IMPLICATIONS

In today's bottom-line business climate, where all industries are experiencing shifts toward a greater proportion of service-, knowledge- and talent-driven revenues, it is not a question of *if* the CEO will want to see a financial measure of human capital performance, but *when*. New U.S. Securities and Exchange Commission (SEC) regulations—requiring public companies to include detailed Compensation Discussion and Analysis (CD&A) statements in their annual 10-K reports—may serve as a catalyst for many corporations to begin formally reporting on the performance of their human capital investments. HR executives who want to be strategic partners in setting the course of their organizations are wise to keep ahead of this curve.

The HR professionals who became early adopters of the Vienna Index and/or advised its development have been thrilled with its ability to build a collegial and collaborative relationship between HR and Finance departments. By drawing data from the Chart of Accounts, the Vienna Index finally gives CHROs a business intelligence tool that can demonstrate bottom-line results and build credible business cases in the eyes of the CEO and CFO. And because the CFO has input into the process from the ground up, the CFO has reason to feel invested in its success. "I felt there was buy-in from the very beginning," said David Fitzgerald, Vice President of Human Resources at ACS, Inc. "Our first step was to sit down with Finance and comb through the P&L and balance sheet to choose the line items we'd use in our formulas. By the time we were done, I felt like they were on-board and comfortable with the whole process."

The standardized financial approach of the Vienna Index makes it easy for a CHRO to consistently chart performance of the human capital investment as a whole, and also, to identify specific opportunities to improve productivity and ROI across business units. As HR professionals well know, people problems tend to be multidimensional and require multifaceted responses. Hard numbers provided by this measurement tool make it easy for HR professionals or individual division/line managers to focus on the issues that are impacting business results. Cross-unit comparisons make it possible to look at problems systematically, discern their root causes, and look to high-performing business units to replicate the high-performing business units best practices.

Beyond reflecting past results, the Vienna Index data can be used by business leaders to test "what-if?" scenarios that project future outcomes and inform strategic planning decisions. It also enables the organization to set internal benchmarks against which progress is measured over time and across business units.

With this knowledge, CHROs are armed with more than anecdotal evidence, gut instincts, and trial and error. They can predict, with a high degree of certainty, how Productivity and HC ROI can be improved and to what extent they can impact company profits and shareholder value. Externally, this new measurement tool will allow leaders to compare their business performance trends to those of an industry peer group of companies. And hard data demonstrating an enterprise's value, performance, and liquidity can be readily available to help the CEO and Board weigh merger and acquisition opportunities.

> **"I expect HR to act like an ROI department."**
> *— John Chambers, CEO, Cisco Systems*

SUMMARY

In business, human assets and the returns on investments in people need to be isolated and managed with as much precision and intensity as a CFO manages financial capital. Traditional HR metrics are not able to measure how human capital contributes to the organization's economic performance, nor do they answer whether the human capital investment is improving or eroding enterprise value. The Vienna Human Capital Performance Index™ (The Vienna Index™) was created, vetted and tested for this purpose by a team of strategic human capital specialists, CFOs, private equity investors and investment bankers. It is the only financial method adapted from universally accepted accounting measures, and its metrics are designed specifically for human capital analyses to support CHROs' and CEOs' strategic planning decisions.

The Vienna Index is a whole product solution that measures human capital performance over time, diagnoses productivity problems, and helps to identify actions that can drive profits and improve enterprise value. Its financial formulas draw data from the Profit & Loss statement and balance sheet to chart human capital results according to three strategic key performance indicators (KPIs): Human Capital Return on Investment (HC ROI), Productivity, and Profit Sensitivity. Dashboards and graphs visually demonstrate how the human capital investment is performing as a whole (expressed as your "Vienna Index"), how KPI metrics are performing in comparison to the operating plan, and externally, how the company's performance compares to industry peers. Another set of operational metrics provides segmented analyses and cross-unit comparisons. These analyses and the ability to project measurable outcomes enable leaders to focus on discrete interventions that can replicate best practices and improve HC ROI.

Grounded in finance, this new approach to human capital analytics makes it possible for CHROs to gain equal footing as strategic partners in the C-suite. Equipped with the Vienna Index data, business leaders can work effectively and collaboratively toward a common purpose—to enhance enterprise value and build solid business cases linked to the financials that demonstrate the measurable value of their people-centered initiatives.

About the Authors

Frank DiBernardino is the founder and managing principal of Vienna Human Capital Advisors. For most of his career Frank has served as a human capital advisor to companies in the technology, pharmaceuticals, healthcare, manufacturing, financial services, and education industries. Frank has also served as the Health & Welfare National Practice Leader and Flexible Compensation National Practice Leader for Foster Higgins.

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