

The New Human Capital Equation

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The 2006 CEO Briefing by the Economist Intelligence Unit (EIU), based on responses from 555 senior executives from 68 countries, highlights significant management challenges that face the world's corporate leaders. Two critical ones are:

- Recruitment and retention of high-quality people across multiple territories, particularly as competition for top talent grows more intense; and relatedly,
- Improving the appeal of the company culture and working environment.

In fact, respondents in the 2006 EIU study, by 55% to 45%, said that they expect to spend more on people than on technology in the next 3 years. That's an important feature of the new human capital equation.

There is no question that work-life initiatives can play a major role in meeting these challenges, as organizations strive to become employers of choice for the best and the brightest. In this presentation I will describe what leading firms are doing to become employers of choice, some new ways of measuring returns on investment in human capital, and some persuasive strategies for making the business case that work-life initiatives are solid investments. First, however, it is important to acknowledge the dismal state of human capital reporting.

Accounting for People

Unfortunately, the current state of financial reporting largely ignores human capital. Not only is it not on the balance sheets of public corporations, but as a 2-year study by Mercer Human Resource Consulting revealed, it is barely mentioned in annual reports. That analysis of the 100 largest publicly traded companies in the United States found that although firms spend approximately 36% of their revenues on human capital, few tell their shareholders about how that money is spent.

Only about 20% discuss human capital and its contribution to business success in their annual reports. Roughly 25% provide only limited references to the workforce, and others do not mention their people at all. The report also found that:

- Of those companies that do report on human capital, the information

- typically focuses on simple payroll or wage statistics;
- About a quarter of the companies offer platitudes (“our people are our greatest asset”), or a few lines about the caring nature of the organization;
 - Even when employees are discussed, the annual reports usually fail to provide hard facts about *how* the companies’ practices for managing human capital drive business results.

It is important to note that from a financial-reporting perspective, the Securities and Exchange Commission does require disclosure of top executives’ compensation, but there is no regulatory requirement that companies report their human capital practices other than the number of persons employed. As Mercer noted, “Imagine a company spending one-third of its revenue on a capital investment or an interest payment, and never addressing it with shareholders in its annual report. It’s unthinkable.”

The report concluded “The demand for human-capital reporting will escalate over the next few years. Investors let companies off the hook in the past, but we don’t think they will settle for the ‘sounds of silence’ much longer.”

Now let’s turn to a more positive issue: becoming an employer of choice.

Becoming an Employer of Choice

First of all, what is an employer of choice? It is one that differentiates itself from other employers in the competition for talent. However, there is no “cookie-cutter” recipe that will work in all situations. How organizations do this varies according to the features of their employment policies or work environments that they are most proud of. Here are some examples:

- Yahoo! emphasizes the powerful effect of “making a difference”—offering services that benefit society, and providing the opportunity to work on challenging projects that will have immediate impact (“Fueling the Talent Engine,” 2005)
- Lockheed Martin stands out because of its company-wide commitment to high ethical standards—the fabric that knits all of its businesses together. It has gotten feedback from new employees that the company’s emphasis on ethics on its Web site was a major attraction for them (Lavan, 2006).
- Xilinx, the world’s largest manufacturer of programmable logic chips, distinguishes itself from its competitors in the following ways: A compelling vision, challenging work, the people it hires, the styles and quality of its managers, its values and culture, and its results.

From 2000 to 2002, for example, in the midst of a worldwide slowdown in the high-technology business, Xilinx resisted the urge to do massive downsizing, as its competitors did, and instead used pay cuts, voluntary sabbaticals, and a company-wide shutdown for 2 weeks to get through the slump. Its “share-the-pain” approach won kudos from employees and allowed the com-

pany to emerge from the downturn with more new products and a greater market share than it had previously (Cascio & Wynn, 2004). Employees remember that, and new recruits are attracted to Xilinx because of it.

Two New Ways of Measuring the ROI of Human Capital

SYSCO Corporation of Houston, Texas is the number one foodservice marketer and distributor in North America. Its revenues exceed \$31 billion, it employs almost 50,000 people, and it serves 420,000 customers with approximately 300,000 different products. To illustrate the effect of effective HR management on the bottom line, and on the company's stock price, let us consider the financial impact of employee retention at SYSCO. Evidence indicates that work-life initiatives have a major impact on employee retention (Casper & Buffardi, 2004; Kossek & Nichol, 1992).

Because 75% of SYSCO's operating costs are people-related expenses, that implies about \$3 billion of expenses. SYSCO has about 10,000 marketing associates. Consider the financial impact when it can improve their retention rate from 70% to 80%. At a fully loaded turnover cost of \$50,000 per marketing associate, that turns out to be more than \$70 million savings per year. From 1998 to 2004 SYSCO improved its marketing associates' retention rate from 70% to 82%.

Next consider delivery associates, who are very critical to SYSCO's success because they know the customers (restaurants), they're the ones that the customers rely on to get the groceries to them on time and in good condition. In order to get them their groceries on time, the company needs to have the same person going to the same customer on a regular basis. SYSCO was able to move the retention rate of its delivery associates from about 65% in 1998 to 85% in 2004 (a 31% improvement). HR professionals computed fully loaded turnover costs for delivery associates to be about \$35,000. That's almost another \$50 million in savings. For night warehouse associates, the savings were \$20 million.

SYSCO made these improvements in retention by rolling out a company-wide work climate/employee engagement survey in each of its operating companies, and then leveraging best practices across all of its operating companies. For more on this see *HR in Alignment: The Link to Business Results* (SHRM Foundation, 2004).

According to SYSCO's Chief Financial Officer, every \$5 million in savings represents a penny per share (Carrig, April 12, 2004). Hence, let's tally the payoff for investors of improved retention:

- Marketing Associates: \$70 million in savings = 14¢ per share
- Delivery Associates: \$50 million in savings = 10¢ per share
- Night Warehouse Associates: \$20 million in savings = 4¢ per share
- Total gain for investors: 28¢ per share from 1998 to 2004 through improved retention

When was the last time you saw an HR program linked directly to shareholder returns?

Relationship Between Work-Life Practices and Firm Performance in Singapore Firms

In a large-scale, empirical study of data from a series of surveys administered by the Ministry of Manpower from 1996–2003, Kelly and Ang (2005) investigated the indirect impact of work-life practices through employee turnover, as well as the direct impact of work-life practices on firm performance.

Kelly and Ang defined firm performance in three ways: profitability (return on assets), employee productivity (logarithm of sales per employee), and stock return (one-year compounded stock return). What is unique about this study, relative to prior research, is that most prior research has examined the effects of work-life programs on employee turnover *within* a single firm. Data on employee turnover across a large sample of firms, in this study, 2,570 firms, are not easily available and, therefore, have not been examined.

Work-life practices in Singapore. Employee benefits in Singapore firms fall into two main categories: work-life benefits and resource benefits. **Work-life benefits** refer to benefits that allow employees to adjust their work hours or work location to accommodate their personal and family demands, such as various leave benefits and flexible working arrangements. **Resource benefits** refer to financial and other resources that firms give to employees either as a form of welfare benefit or as performance incentives, such as transportation benefits and stock options.

Kelly and Ang analyzed data separately for management and nonmanagement employees. In addition, they examined four variables to indicate the extensiveness of work-life benefits in a firm:

Number of work-life benefits (controlling for number of resource benefits)

- Annual leave entitlement
- Work-week pattern
- Availability of part-time employment

Graphically, the design of the study was as follows:

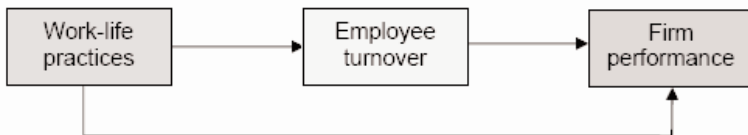
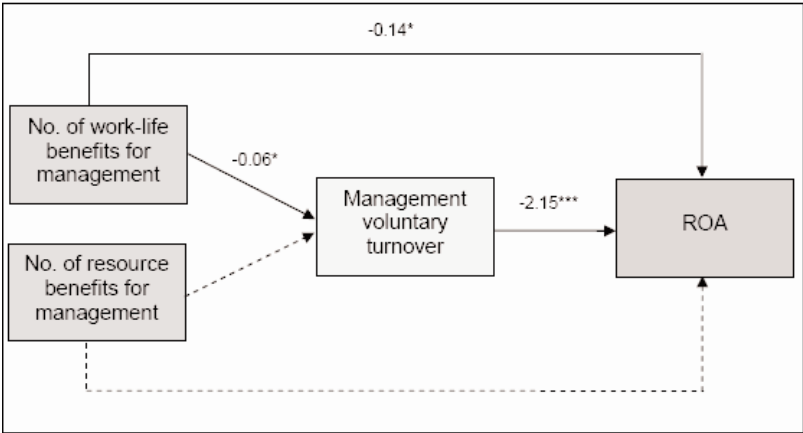


Figure 1. Relationships Between Work-Life Variables, Employee Turnover, and Firm Performance.

The study investigated the indirect impact of work-life practices through employee turnover, as well as the direct impact of work-life practices on firm performance. The researchers controlled for the size of the firm, firm ownership (publicly listed or private), industry (manufacturing or service), degree of industry concentration, and year (where multiple years of data were used). For stock return, they also controlled for the age of the firm and the systematic risk of the firm's stock (beta).

Figure 2 shows a typical result of the analysis:



Note: * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Figure 2. Relationships Between Number of Work-Life Benefits and Number of Resource Benefits for Management, Management Voluntary Turnover, and ROA.

Based on 1,178 observations from 2003, and controlling for the number of resource benefits, firms that offer more work-life benefits for management employees have lower management voluntary turnover (standardized regression coefficient = -0.06). In turn, firms with lower management voluntary turnover generate higher returns on assets (standardized regression coefficient = -2.15). Hence, the indirect effect of the number of work-life benefits for management on ROA through turnover is positive.

However, there is also a direct negative relationship between the number of work-life benefits for management and return on assets (standardized regression coefficient = -0.14), suggesting that implementing work-life benefits for management is financially costly for firms.

Overall summary of results. Employee turnover is costly. How costly? Another study of a chain of sushi restaurants in Singapore (Tay, Quazi, Kelly, & Ang, 2005), found that the cost of turnover among restaurant employees can be more than 75% of an employee's annual salary. Among managers, the

salary multiple is 1.5 to 2.5, excluding the cost of lost customer contacts and productivity (Cascio, 2000).

The results of the Kelly and Ang (2005) study indicate that voluntary turnover of both management and rank-and-file employees negatively affects firm profitability, employee productivity, and stock return.

Conversely, implementing work-life initiatives for both management and rank-and-file employees can be an effective business strategy for firms to reduce voluntary employee turnover. The study found lower voluntary employee turnover in:

- Firms that offer a larger number of work-life benefits to their employees,
- Firms that have a higher proportion of employees with more generous annual leave entitlements, and
- Firms that have a higher proportion of employees on shorter work-weeks.

Although work-life initiatives may be costly for firms to implement, the direct costs are offset by the indirect positive benefits that these work-life policies have on firm performance through reduced employee turnover.

- Flexible working arrangements can also benefit both employers and employees. For example, while part-timers may quit more often than full-timers, firms that offer part-time employment for their rank-and-file employees enjoy direct positive effects on profitability, productivity, and stock returns. These results suggest a second new way to express the ROI of human capital, namely, through reductions in voluntary employee turnover.

Making the Business Case That Work-Life Initiatives Are Solid Investments

For many employees, 9a.m. to 5p.m. isn't working anymore. Time is employees' most precious commodity. They want the flexibility to control their own time—where, when, and how they work. They want balance in their lives between work and leisure. Flexibility in schedules is the key, as organizations strive to retain talented workers (Conlin, Merritt, & Himelstein, 2002; Shellenbarger, 2003).

In fact, there are three key features to making the business case for increased flexibility: talent management (specifically, attraction and retention); human capital outcomes (increased satisfaction and commitment, decreased stress); and financial, operational, and business outcomes (Corporate Voices for Working Families, 2005). Here are some very brief findings in each of these areas from this important study of 29 firms.

Talent management. IBM's 2004 global work-life survey demonstrated that, for IBM employees overall, flexibility is an important aspect of employees' decision to stay at the company. Responses from almost 42,000 IBM

employees in 79 countries revealed that work-life balance—of which flexibility is a significant component—is the second leading reason for potentially leaving IBM, behind compensation and benefits. Conversely, employees with higher work-life balance scores (and therefore also higher flexibility scores) reported significantly greater job satisfaction and were much more likely to agree with the statement “I would not leave IBM.”

In the Corporate Finance organization, 94% of all managers reported positive impacts of flexible work options on the company’s “ability to retain talented professionals.” In light of these findings showing the strong link between flexibility and retention, IBM actively promotes flexibility as a strategy for retaining key talent.

Human capital outcomes—Employee engagement and commitment. Engagement fuels discretionary efforts and concern for quality. It is what prompts employees to identify with the success of their companies, to recommend them to others as good places to work, and to follow through to make sure problems get identified and solved. “Committed employees believe they have a stake in the organization, and that belief is reflected in their behavior.” Recent research by the Corporate Leadership Council concludes that every 10% improvement in commitment can increase an employee’s level of discretionary effort by 6% and performance by 2%; highly committed employees perform at a 20% higher level than noncommitted employees.

At Deloitte & Touche, one employee-survey item asked whether employees agreed with the statement “My manager grants me enough flexibility to meet my personal/family responsibilities.” Those who agreed that they have access to flexibility scored 32% higher in commitment than those who did not have access to flexibility.

Finally, AstraZeneca found that commitment scores were 28% higher for employees who said they had the flexibility they needed, compared to employees who did not have the flexibility they needed.

Financial performance, operational and business outcomes—Client service. Concern for quality and continuity of client or customer service is often one of the concerns raised about whether flexibility can work in a customer-focused organization.

To be sure that compressed work weeks did not erode traditionally high levels of customer service, the Consumer Healthcare division of Glaxo-SmithKline surveyed customers as part of the evaluation of its flexibility pilot program. Fully 89% of customers said they had not seen any disruption in service, 98% said their inquiries had been answered in a timely manner, and 87% said they would not have any issues with the program becoming a permanent work schedule.

What does all of this mean in terms of making the business case? As the CVWF (2005) report makes clear, for all of us, it is crucial to reframe the discussion and to position flexibility not as a “perk,” employee-friendly benefit,

or advocacy cause, but as a powerful business tool that can enhance talent management, improve important human capital outcomes, and boost financial and operational performance.

Each of us has an important role to play in framing work-life's contribution to meeting the significant management challenges that face the world's corporate leaders. Whether the problem is recruitment and retention of high-quality people across multiple territories, or improving the appeal of a company's culture and working environment, each of us has an important story to tell. Isn't it time we got on with the job?

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