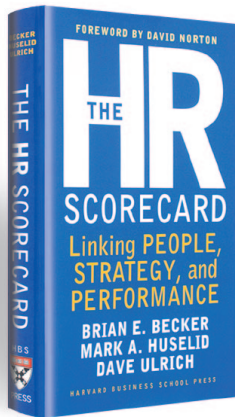


SOUNDVIEW Executive Book Summaries®

FILE: PERSONNEL/
HUMAN RESOURCES

By Brian E. Becker,
Mark A. Huselid and Dave Ulrich

Linking People, Strategy and Performance

THE HR SCORECARD

THE SUMMARY IN BRIEF

Most CEOs and senior line managers are skeptical of the role of human resources in their companies' success. While many executives say they believe that "people are our most valuable asset," they don't understand how HR functions make that vision a reality. The root of the problem is simple: It's hard to measure the impact of HR functions on company performance and success.

The performance measures that most HR departments use don't measure HR contributions to company success. For example, as an HR manager, you may believe that having a capable and committed work force and a training system that helps your employees learn faster than the competition are true competitive advantages and part of the company's strategic plan. Yet, you most likely measure items such as total compensation, employee turnover, cost per hire and the percentage of workers who were evaluated in the last 12 months. None of these measures relate directly to employee commitment or learning — the competitive advantages you identified.

A new approach is necessary. Rather than concentrate on a bottom-up perspective emphasizing compliance and traditional HR, you must move to a top-down perspective emphasizing the implementation of strategy. You must then develop an innovative assessment system that measures HR's contribution to what matters most to CEOs: firm profitability and shareholder value.

This summary shows you how. In the following pages, you will:

- ✓ **Learn about a seven-step process that will lay the foundation for your HR department's strategic influence company-wide.**
- ✓ **Understand how to move from the seven steps to an HR Scorecard that identifies and measures the HR "deliverables" needed to make the corporate strategy work.**

The most potent action HR managers can take to ensure their strategic contribution is to develop a measurement system that convincingly showcases HR's impact on business performance.

That system is the HR Scorecard. 

CONTENTS

HR as a Strategic Partner

Page 2

Implementing HR's Strategic Role: A Seven-Step Model

Pages 3, 4

Creating The HR Scorecard

Pages 4, 5, 6

Cost Control vs. Value Creation

Page 5

Cost-Benefit Analyses For HR Interventions

Pages 6, 7

Competencies For HR Professionals

Pages 7, 8

Implementing The HR Scorecard

Page 8

THE HR SCORECARD

by Brian E. Becker, Mark A. Huselid and Dave Ulrich

— THE COMPLETE SUMMARY

HR As A Strategic Partner

After struggles with a lack of focus and billions of dollars in losses in the early 1990s, Sears' management team developed a strategy to turn the company around: For Sears to be a compelling company for investors, it had to be a compelling place to shop; for it to become a compelling place to shop, it had to become a compelling place to work.

Sears then went about validating this vision with hard data. The company developed objective measures for each "compelling" goal. For example:

- **Support for ideas and innovations helped make Sears a compelling place to work.**
- **Focusing on becoming a fun place to work helped make Sears a compelling place to shop.**

Sears then developed a series of competencies and behavioral objectives designed to reach each goal. These competencies became the foundation on which to build recruiting, training, performance and compensation structures.

So precise were the measures Sears developed that managers could say with confidence that a 5 point improvement in employee attitude drove a 1.3 point improvement in customer satisfaction, which in turn drove a .5 percent improvement in revenue growth.

HR Deliverables

The human resources function has traditionally been seen as overhead — a cost center rather than a value-creating function. However, human resources can become a valuable strategic partner that helps the company achieve its goals. The key is to identify and measure the HR "deliverables" that support corporate strategy — and the HR systems that create those deliverables. For Sears, the deliverable was making Sears a compelling place to work. The HR systems behind the transformation were recruiting, training, performance and compensation structures — for example, a reward structure that recognized employee ideas and innovations.

The HR Architecture as a Strategic Asset

If the focus of corporate strategy is to create a sustained competitive advantage, the focus of HR is to maximize its contribution to that advantage through its architecture. HR's architecture is really three dimen-

sions that make up the value chain:

- **the HR function** — made up of HR professionals with strategic competencies;
- **the HR system** — the company's high-performance, strategically aligned policies and practices; and
- **employee behaviors** — strategically focused competencies, motivations and associated behaviors.

If the focus of corporate strategy is to create a sustained competitive advantage, the focus of HR is to maximize its contribution to that advantage through its architecture.

The HR system is the linchpin of HR's strategic influence. The most effective model is a *High-Performance Work System* (HPWS). In an HPWS, each element of the HR system is designed to maximize the overall quality of human capital throughout the organization. Specifically, the HPWS:

- links its selection and promotion decisions to validated competency models;
- develops strategies that provide timely and effective support for the skills demanded by the firm's strategy;
- enacts compensation and performance management policies that attract, retain and motivate high-performance employees. ■

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Implementing HR's Strategic Role: A Seven-Step Model

For human resources to make the maximum contribution toward establishing value for your company and its shareholders, your executives and HR department managers must take the seven steps outlined below.

Step 1: Clearly Define Business Strategy

Business strategies tend to be very generic. They might be to “maximize operational efficiency” or “increase presence in international markets” or “improve productivity.” Unfortunately, these goals are so vague that employees don’t know what they are supposed to do to implement them. Here’s where HR experts step in. Once you know your company’s business strategy, focus on how to implement it. The key is to state the company’s goals in such a way that employees understand their roles, and the organization knows how to measure its success in achieving them.

Step 2: Build a Business Case for HR As a Strategic Asset

Human resource professionals need to build a clear business case for why and how HR can support the strategy. That business case must include a recommendation for the implementation or expansion of a High-Performance Work System (HPWS).

Step 3: Create a Strategy Map

Develop a strategy map that illustrates how the company creates customer value — essentially a diagram of the value chain. To draw the diagram, you need to ask a series of questions about your company’s strategic objectives, including:

- Which strategic objectives/goals/outcomes are critical?
- What are the performance drivers for each goal?
- How do we measure progress toward these goals?
- How do employees need to behave to achieve these goals?
- Does HR provide employees with the necessary competencies and behaviors?

Once you think you have a picture of the company’s value chain, translate the information into a conceptual

How HR Destroyed Value

What HR should not do is illustrated by the actions of a banking business that attempted to cut costs by moving to a part-time teller staffing model. When the company let go its full-time tellers and hired part-time ones, it looked as if it were saving money. But after a short time, it became obvious that something was wrong. When full-time management positions opened, there were few interested tellers. Hiring had to take place from the outside. The reason is that tellers attracted to part-time positions aren’t interested in management positions; by cutting its full-time staff, the company lost its most promising pool of promotion candidates.

model using language and graphics that make sense in your organization. Test for understanding and acceptance in small groups of opinion and thought leaders throughout the firm. The strategy map you create contains hypotheses about which organizational processes drive firm performance. The map might show, for example, that a *short research and development cycle* is key to the performance and success of your company.

Step 4: Identify HR Deliverables Within the Strategy Map

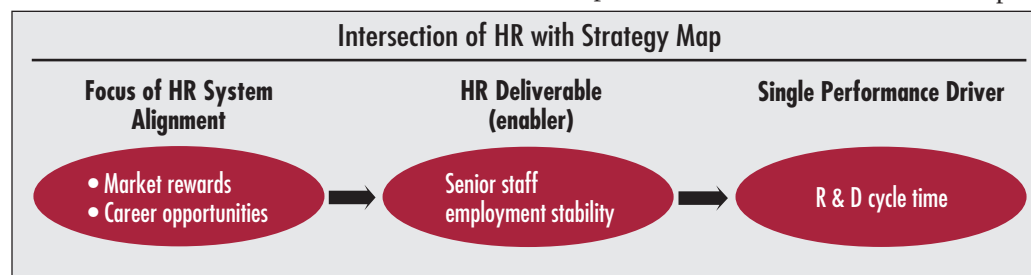
Think in terms of identifying strategic behaviors HR can deliver. For example, if your firm decides that achieving a short research and development cycle requires *employee stability* (in other words, low turnover), you will want to design HR policies that encourage stability.

Step 5: Align HR Architecture With HR Deliverables

Your company’s HR architecture must be designed to allow HR to deliver the training, recruiting and retention goals necessary for the company as a whole to achieve its strategic goals.

For example, in step 3, you identified R&D cycle time as an important performance driver. In step 4, you identified employee stability as the HR deliverable that enables that performance driver. In step 5, you might identify market rewards and career opportunities as HR system elements that ensure employee stability and thus improve

R&D cycle time. This intersection of the HR system and the company’s strategy (represented by the strategic performance driver) is illustrated at left.



(continued on page 4)

Implementing HR's Strategic Role: A Seven-Step Model

(continued from page 3)

Step 6: Design the Strategic HR Measurement System

After you have laid the groundwork, it's time to design your HR measurement system. Develop valid measures of the HR deliverables required to meet your strategic objectives. Take the example of employee stability. There are several ways stability can be measured. You will have to define who is a senior staffer (perhaps those with more than five years of professional experience) and what you mean by stability (perhaps all turnover or only voluntary turnover, but not promotions). The HR measurement system you develop will become your HR Scorecard.

Step 7: Implement Management by Measurement

Once the HR Scorecard is developed, you will have a powerful new management tool. A good example is what happened at GTE when it implemented an HR Scorecard system. GTE had always measured turnover rates, but hadn't really related those rates to the company's overall profitability. Once the Scorecard was implemented, GTE saw exactly where turnover rates were up. HR interventions were then developed to stem turnover, with dramatic improvement in overall business unit performance. ■

Creating the HR Scorecard

The HR Scorecard is a strategic HR measurement system that will help you measure, manage and improve the strategic role of your HR department.

The Scorecard consists of measurements of:

1. **HR deliverables.**
2. **HR policies, processes and practices.**
3. **HR system alignment.**
4. **HR efficiency.**

To introduce these four dimensions of the HR Scorecard, we'll use the case of a company we'll call HiTech.

HR Deliverables

HiTech wants to focus on its R&D function and explore HR's potential role in the company's strategic plan. The R&D unit has profitability goals for both revenue growth and productivity improvement. These are the two important performance drivers of its strategy.

HiTech's **revenue growth** derives from increased customer satisfaction, which is boosted by product innovation and reliable delivery schedules. Product innovation depends on experienced, talented staff in research and development. Reliable delivery depends

Cause and Effect at GTE

A good performance measurement system allows you to draw causal inferences about the relationship between a decision and a result. For example, you might need to know whether a change in the incentive system will produce a change in employee performance and if so, how much. The most commonly used measure of a statistical relationship between cause and effect is the correlation coefficient. Correlation coefficients describe the extent to which two variables change together and range from -1.00 to +1.00.

GTE's Network Services Unit hypothesized that market share was driven by customer valuation of its service, which in turn was driven by customer service quality, brand advertising and inflation. The driver for customer service was assumed to be a set of employee behaviors focusing broadly on employee engagement. Thus, GTE created an "employee engagement index" or EEI, based on seven questions from a GTE employee survey. When the data was analyzed, GTE found that a 1 percent increase in the EEI resulted in a 1/2 percent increase in customer satisfaction.

on optimal staffing levels in the manufacturing units.

HiTech's **productivity improvement** results from optimal production schedules — which also depend on optimal staffing levels in the manufacturing units.

Thus, the two HR deliverables that will support the company's strategic goals of revenue growth and productivity improvement are:

- experienced, talented staff in R&D, and
- optimal staffing levels in the manufacturing units.

HR Policies, Processes and Practices

The next question to ask yourself is, "What are the high-performing policies, processes and practices that will help generate the HR deliverables required to support my company's strategy?" The authors call the set of policies, processes and practices that specifically help to generate strategic HR deliverables a High-Performance Work System (HPWS).

To develop and keep an experienced, talented staff in R&D at HiTech, human resources must create competency-based selection methods and retention programs for prospective and current employees. This allows only talented employees to be hired. Regular performance appraisals are also important to ensure that employees are maintaining the required talent and experience level.

A short recruiting cycle — that is, the length of time

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Creating the HR Scorecard

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it takes for HR to fill vacancies — will maintain staff levels at optimal levels, the second HR deliverable.

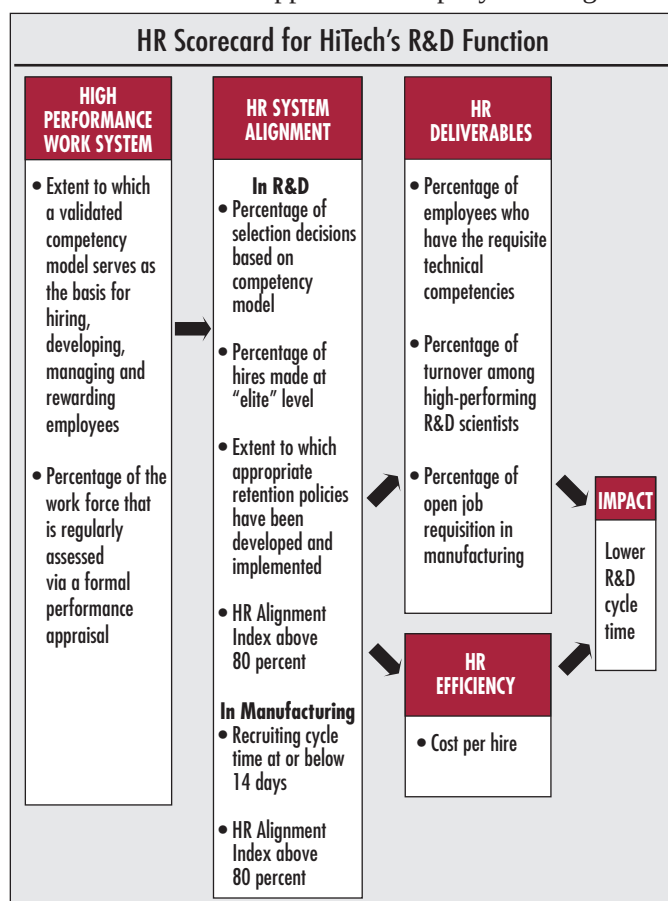
HR System Alignment

Here is where you focus on the specific elements of the system that must reinforce each other to produce the HR deliverables. For example, competency-based recruiting is essential to HiTech's strategic priorities. Therefore, HiTech can measure how well its HR system is aligned to its strategic goals by monitoring how many new employees were selected based on the competency model — and how many of those employees came in at the highest quality level.

The HR department must also provide the types of benefits that will *retain* R&D staff (thus allowing HiTech to meet its product innovation needs). And since the recruiting cycle time for the manufacturing division affects optimal staffing levels, HR must attempt to keep this cycle as short as possible.

HR Efficiency Measures

The final step in developing the measures for an HR Scorecard is to identify the exact tasks at which HR must be efficient to support the company's strategic



Cost Control vs. Value Creation

Traditionally, HR efficiency was measured by the *internal* costs it saved. Reducing HR costs, however, does not create long-term value to the organization. One reason is that the cost savings are not substantial enough to affect shareholder value. And any competitive advantage gained from an efficient HR function will be quickly lost as competitors adopt the same practices.

However, if HR helps the company's line operations to reduce costs, it is significantly contributing to the company's success. For example, if HR's efficient recruiting processes create a high-level R&D staff, which, in turn, enables the company to lead on innovation, HR has created value.

Of course, human resources can't focus exclusively on creating value while ignoring the need for internal efficiency. Your HR Scorecard needs to emphasize HR's value creation, but should be tempered by attention to efficiency. Specific, cost control comes through measuring HR deliverables, HR system alignment and the High-Performance Work System. Cost control comes through measuring HR efficiency.

goals. HiTech, for example, could identify cost per hire as a strategic measure. While cost per hire might be higher than average, this cost represents a strategic investment in the company — because the benefits of the company's hiring processes will also be higher than average.

Which Measures Go into the Scorecard?

To transform the four dimensions into an HR Scorecard, you need to determine the right measures for each dimension.

The High-Performance Work System, which is key to maximizing employees' performance, is the foundation for building HR into a strategic asset. Questions that will create **High-Performance Work System measures** to use in the Scorecard include the following:

- How many exceptional candidates did we recruit for each strategic job opening?
- To what extent has the company developed validated models for hiring, developing, managing and rewarding employees?
- How many new hires were selected based on those models?
- How many hours of training do new employees get?
- How many employees get formal performance feedback from multiple sources?

(continued on page 6)

How One Company Made HR Central to Its Strategy

When a major international consumer-products firm wanted to dramatically restructure its leadership capabilities it took four steps. First, it determined that leadership talent was a strategic requirement: The company with the best leadership talent would win in the marketplace. It then developed its own proprietary leadership competency model. The next step was to take the executive search process in-house. Finally, in support of the process, it added a powerful staffing information system that let managers rapidly and effectively identify available managerial talent. While HR departments traditionally support the search for corporate staff, this department's detailed, strategic-driven and measurable leadership search process transformed a traditional HR activity into a corporate strategic asset.

Creating the HR Scorecard

(continued from page 5)

- What percentage of employees are eligible for incentive plans and profit sharing?

The **HR system alignment measures** must be directly linked to the HR deliverables that impact company strategy. As discussed above, start by identifying the strategic HR deliverables, then identify and measure the system elements that make a significant contribution to particular HR deliverables (see chart on Page 3).

Because both the HPWS and system alignment measures are intended for internal HR use, you can simply represent the “score” of these measures as toggles on the scorecard. These toggles would indicate “satisfactory” or “unsatisfactory” in the case of HPWS measures and “alignment” or “misalignment” for system alignment measures.

When choosing **HR efficiency measures**, you must separate measures that impact a company's strategy from those that don't. *Core efficiency measures* are those HR expenditures that make no direct contribution to the company's strategy implementation, but must still be taken care of. Examples include workers' compensation cost per employee and the percent of correct entries made to the HR information system. *Strategic efficiency measures* assess the efficiency of HR activities that produce HR deliverables. Although it is important to know the costs of workers' compensation benefits and the accuracy of internal data entry, these items don't add to the overall strategic value of HR to the company. However, strategic efficiency measures, such as the cost per hire, cost per

training hour and HR expense per employee, can yield considerable strategic value.

Finally, many HR managers are tempted to think of **HR deliverables** only in terms of organizational capabilities, such as corporate leadership. However, the HR deliverables in the Scorecard can have a more concrete, measurable impact on the success of the company's strategy. HR enablers (such as employee stability) that are tied to specific performance drivers (such as R&D cycle time) make a more compelling case for HR's strategic importance. ■

Cost-Benefit Analyses For HR Interventions

A complementary process to the HR Scorecard is an HR cost benefit analysis. While the Scorecard identifies where your company's HR department wants to be to achieve strategic goals, HR cost benefit analysis helps your company choose how it will get there by looking at the Return On Investment (ROI) of HR programs and policies.

Determining the ROI of a particular HR policy or practice isn't complicated. Essentially, you need to assess the total costs and total benefits associated with the investment and then calculate benefits less costs. The challenge lies in collecting or estimating data. Costs are borne today, but benefits are most likely going to show up in the future. Come up with plausible estimates.

What to Count, What to Ignore

To generate estimates, you need to know what to count as cost and what to ignore. There are two major types of cost — fixed and variable. Fixed costs are those that don't vary with the level of production. For example, if your company has a training center, some costs associated with the building are fixed — they don't change whether you have one class a week or ten in the facility. But other costs are variable — they increase or decrease depending on how many classes use the building. It takes more electricity to run the computers and the restrooms require more supplies when usage goes up.

Again using the training center as an example, how would you estimate the cost of providing a new training program for mid-level managers? Suppose the training center is operating at 60 percent capacity and your proposed program would boost that to 80 percent? Do you take the fixed costs of running and maintaining the center and add them to your cost estimate? Using conventional accounting principles, you would. But that will increase the costs of your project and decrease the ROI. Instead, it may make more sense to just add in the additional variable costs.

(continued on page 7)

Cost-Benefit Analyses For HR Interventions

(continued from page 6)

Employee Performance

You also have to understand the financial impact of employee performance. Determining the ROI in people requires comprehending the impact of high- and low-performing employees on the firm. The question is whether, on average, employees in a particular job contribute a little or a lot to the firm's success.

Assuming employees in a category contribute to profitability, you next need to gauge the variability of the impact of employee performance on firm financial performance. For example, if the very best employees in a job category only contribute a little more than the average employee, there is no need to invest additional resources in attracting, selecting and developing people like the best employee. But if the difference on the bottom line is great, you will want to consider making the investment.

Net Present Value

Assuming you have determined that training will make an average worker into an excellent worker, you can finish calculating the ROI of your proposed training program. The hardest part of the calculation is that much of the benefit you will reap won't occur immediately. You will need to calculate the Net Present Value (NPV) of the benefit the company will reap over the years. NPV analysis draws together costs and benefits over multiple time periods, and compensation for uncertainty, lost opportunity costs, and costs of capital to assess the overall potential value of a proposed HR program.

To calculate net present value, you need to restate the program's costs and benefits (both present *and future*) in today's dollars. Then, subtract the present value of costs from the present value of benefits, to yield the net present value for the program you are proposing.

YEAR	EXPLANATION	AMOUNT	x	FACTOR	=	PRESENT VALUE
1	Program development cost	-\$250,000		1		-\$250,000
1-5	Increased wages	-\$130,000		3.433		-\$446,290
1-5	Increase in annual cash flow from operations	+\$270,000		3.433		+\$926,910
NET PRESENT VALUE:						\$280,620

Beware of Sunk Costs

Don't be so enamored of projects that you persist in pouring more assets into them only to get diminishing returns. Suppose you had begun restoring an old car and have invested \$25,000 in it. These are your sunk costs. If you sold it today, it would fetch you \$15,000, a \$10,000 loss. If you finish the car, it will cost an additional \$20,000 and be worth \$30,000 and your loss would increase to \$15,000. The same applies to programs you have begun but which are obviously not going to pay off as you expected. Don't throw more resources at the project, only to guarantee that the loss will be greater.

For example, assume that you are planning a new integrated performance management and incentive compensation program. The total program cost will be \$250,000. You estimate that the program will increase annual profits \$270,000 per year for five years. Because the program involves incentive pay, it will also increase wages by \$130,000 per year. Should you roll out the program, assuming your company's marginal cost of capital is 14 percent?

The answer is yes, since, as the calculation below shows, the net present value is \$280,620. (Note: The factors used in the calculation can be found in any introductory financial analysis textbook.) ■

Competencies For HR Professionals

How do you make sure you have the skills to implement the changes to your company's HR system and become a strategic asset? Doing so may require competencies that are new to you. Indeed, this approach to HR requires transforming the profession.

The past decade has seen the professionalization of HR. For example, the National Association for Human Resource Management now boasts more than 150,000 members. There is a certification assessment sponsored by that association, as well as graduate degrees in human resources. Underlying this movement toward professionalism are a body of knowledge, a set of expected behaviors and specific outcomes for those doing HR work. These are the core competencies HR professionals need.

Competence refers to an individual's knowledge, skills, abilities and personality characteristics that directly influence his or her job performance. HR competencies can be broadly classified into five categories.

(continued on page 8)

Competencies For HR Professionals

(continued from page 7)

These are:

Knowledge of the Business. HR professionals must understand how the company they work for operates. That understanding lets you adapt HR activities to changing business conditions. Only by knowing the financial, strategic, technological and organizational capabilities of your organization can you play a valuable role in strategic discussions. You don't have to have the ability to manage all these business functions, but you must at least understand them.

Delivery of HR Practices. HR professionals at the very least must be experts in their specialty. Knowing and being able to deliver state-of-the-art, innovative HR practices builds your credibility and respect. You must continually update your knowledge and skills, and adapt what you learn to your organization's unique needs and strategy.

Management of Change. Another essential skill for HR professionals is the ability to manage change. You need to be able to refocus your organization and the HR department in response to new strategic directions. To orchestrate change, you must be able to diagnose problems, build relationships, articulate a vision, set a leadership agenda, solve problems and implement goals.

Management of Culture. Companies with strong cultures (measured as the extent to which employees share the values of the firm) achieve higher performance than those with weak cultures. HR professionals are keepers of the culture because the systems they implement for employee selection, training, promotion and reward determine whether the company's culture remains or becomes strong.

Personal Credibility. In addition, HR professionals must have personal credibility by living their company's values. These values typically include openness, candor, the ability to be a team player, the capacity to treat individuals with respect, a concern for due process and an insistence on the highest performance for HR executives and their staffs. In short, you must build a high level of trust.

Strategic HR Performance Management: A New HR Competency

A new competency can be added to the five basic ones outlined above. That competency is *Strategic HR Performance Management*. It is defined as the ability to orchestrate a company's strategy implementation through the use of balanced performance measurement systems. It is essentially measurement-led management.

To build this competency, human resource managers

must understand strategic measurement along two dimensions. They must know what to measure and how to measure it. The "what" is strategy implementation. The "how" is the technical process of measurements. You will need to:

- **Exercise critical causal thinking as you develop hypotheses about what creates value for the company.**
- **Understand principles of good measurement.**
- **Estimate causal relationships between HR and form performance.**
- **Communicate HR strategic performance results to senior line managers.**

Implementing The HR Scorecard

Developing an HR Scorecard and actually implementing one are two different things. You will need to build acceptance of the Scorecard within your organization. Change is difficult to implement in any organization. Most problems occur not from misunderstanding of what to do, but from a lack of discipline about how to do what needs doing.

Here are seven guidelines for the successful implementation of your Scorecard:

Leading Change. You will need to enlist two sponsors — a line manager and the head of HR. You will also need someone on the team who specializes in HR measurement and an advisory team to supervise the work.

Creating a Shared Need. You must create a business case for the use of the Scorecard. Share this with line management and the HR department and allocate between 3 percent and 5 percent of the HR budget to measurements.

Shape a Vision. You must articulate the desired outcome of using the Scorecard by preparing the key measures to be tracked. Define decisions that will be made based on the measures, and figure out how you will collect the data needed for the measurements.

Mobilize Commitment. Identify the key players whose support you need and engage them.

Build Enabling Systems. Put the right people on the project, give them incentives, have them report to the right people, and invest in the technology needed.

Monitor and Demonstrate Progress. Develop a project plan.

Make It Last. Start with simple measures, make them visible, post the results and change the measures as required by changing conditions. ■