



The New ROI of HR: Return on Intangibles

By David Creelman and Dave Ulrich

Do intangibles matter? Asking that seems like a rhetorical question, but if we go back 20 or 30 years, the answer would have been "What are they?" and then when the concept was understood, "No." Up to the early 1980s, the typical company was worth just about the same as its book value. This made sense in a lot of ways. If a company had a building and three injection-molding machines, why would you pay more for the company as a whole (market value) than you would pay for its component parts (book value)?

However, in the 1980s something happened to the stock market. The market value of companies started increasing faster than book value. According to research by Baruch Lev, by 2000 the average S&P 500 company had a market value six times higher than book value. The ratio has fallen since that peak, but most of a company's value can no longer be found on the balance sheet. It is found in intangibles.

We could do a similar analysis looking at the income statement rather than the balance sheet. Again, Baruch Lev's research has shown that market value is becoming less and less correlated with earnings. Two firms in the same industry with the same earnings may have dramatically different market value. Something is driving market value other than earnings. That something is intangibles.

For a CEO, the importance of intangibles shows up in one number: the price-earnings ratio. For a CEO with a PE ratio of 40, an extra \$100 of earnings is worth \$4,000 of shareholder value. For a CEO with a price-earnings ratio of 20, an extra \$100 of earnings is worth only \$2,000 to the shareholders. That second CEO may have lots of plans on how to boost the earnings 10 percent, but if the company doesn't address the intangibles that drive the PE ratio, investors are not going to be happy.

So, intangibles matter. They affect the market value of any publicly traded firm. And in not-for-profit firms, they represent the goodwill of those who invest in, fund or sponsor the organization.

What are intangibles and does human resources have a role to play? Well, that is the multibillion-dollar question. We can start answering that by looking at the simple question as to whether there is any evidence that HR can drive business results.

Does HR matter?

Finance professionals realize intangibles matter—the numbers are very clear; but still in their heart of hearts they may not be convinced that HR really matters.

Fortunately, we have a wide array of data from academics like Mark Huselid, Jeffrey Pfeffer and Theresa Welbourne (to mention a few) showing that HR really does make a difference to business outcomes. A wide array of studies of high-involvement practices shows that whether you are looking at auto manufacturing, the survival of companies that have just gone public or high-tech silicon chip fabricators, HR matters to business results. This is not a minor effect. Jeff Pfeffer sums up the evidence by saying that good HR practices account for gains of 40 percent or more in most of the studies he reviewed.

The academic data is backed up by the work of consultancies like Ernst & Young, Gallup, Deloitte & Touche and Watson Wyatt—all of which have shown that good people management pays off in both financial and nonfinancial results.

The research data that shows HR makes not just a difference, but a big difference, is conclusive. Still, we need something more. We need an intellectual framework to help us understand how managing organizational capabilities—including human capital—drives intangibles; and the secret of doing that is understanding the architecture of intangibles.

Organizational capabilities and human capital

Too often when managers talk about intangibles, they immediately jump on some particular aspect such as market share, brand, R&D or leadership. However, if we are going to be serious about this, we need to be systematic. We believe the architecture of intangibles has four steps:

1. First is the fundamental issue of keeping promises and managing expectations.
2. Second is a clear strategy—a story about our future that shows how the organization will create value through growth.
3. Third is having the core technical competencies needed to deliver that strategy. These technical competencies might be marketing's ability to manage its distribution channels or manufacturing's ability to maintain Six Sigma quality—the specific technical competencies required depend on the strategy.
4. The fourth and final step is capabilities—those things that make a company stand out in the minds of customers. It might be a shared mind-set, such as Nordstrom's companywide commitment to service. It might be speed, such as Apple's speed to market with the iPod line. It could be learning, such as McKinsey's ability to leverage the global learning of its consulting team. It might be accountability, such as FedEx's ability to be absolutely positive it can deliver overnight. Or it could be leadership, as with GE's ability to develop leaders both inside and outside GE. And this is by no means a complete list of possible capabilities.

It's not too hard to begin thinking about how HR might begin supporting a critical capability like shared mind-set, learning or speed. And from capabilities we have a clear line of sight to how a company creates value in the eyes of its shareholders. HR professionals can be architects, coaches, facilitators and deliverers of capabilities.

Furthermore, capabilities are not just abstract concepts. They can be measured. Talent can be assessed in the percentage of skilled employees, engagement and productivity. Speed can be assessed with measures like time to market, time to change over production and time to commercialize a product. Shared mind-set can be assessed with surveys of the culture and focus groups. Capabilities represent the deliverables or outcomes of good HR investments and they can be managed.

What the *Fortune* 50 tells Wall Street

Are companies telling investors anything about organization and human capital intangibles? None of the *Fortune* 50 report their information in a well-thought-out framework like the four-step intangibles architecture we just described. However, what will surprise many HR managers is that the *Fortune* 50 does convey a lot of information about human capital management in their annual and corporate responsibility reports. IBM is the leader, devoting almost 15,000 words to human capital management between its annual and corporate responsibility reports. Chevron, GE, Kroger and Dow all devote 6,000 to 7,000 words to the topic. On average, the *Fortune* 50 comes in at just about 2,500 words. (See *Reporting on Human Capital: What the Fortune 50 Tells Wall Street* at www.rbl.net)

They report on the HR practices we are familiar with, such as training, staffing, communication, compensation, safety and diversity. A particularly good example of reporting comes from IBM on diversity. First, IBM gives a rationale on why diversity should be of interest to shareholders. It's not because diversity is nice. IBM explains it seeks to grow revenue in midmarket businesses and its market research shows many of these businesses are led by women. The company then goes on to describe its diversity practices, such as holding managers accountable for various diversity initiatives and outcomes. This makes sense; obviously, investors who accept the strategy rationale will want to know "What do you do to build your diversity?" The description of practices responds to that question. Finally, IBM gives metrics, breaking down the number of women and ethnic groups by management level.

Dow does a nice job in presenting a graph showing trends in the percentage of female managers. This gives investors what is probably the single most interesting diversity data in an easy-to-understand form. What's particularly important is showing the historical data so investors can see trends. Not all companies provide this kind of data—if they want investors to understand the data, they should.

Chevron goes an extra step by providing not only safety trends but benchmark data. Again, this helps the investor make sense of the data—it helps them understand what a good level of safety is.

Individually, the *Fortune* 50 companies do not do a great job of reporting on human capital. Collectively, however, we see good information on rewards (Kroger), on leadership development (GE), on frontline staffing (Albertson's) and other useful information about human capital management.

Companies are making baby steps, and as any parent knows, baby steps are worth getting excited over. If we focus on the best of what the *Fortune* 50 does, we can see that it is practical to provide useful and understandable information about organization and human capital to investors today.

What is and what should be

One way to think of the current state of organizational and human capital reporting is that companies are providing a "vital signs report." They are providing a few useful metrics to show the company has healthy HR practices and outcomes. They tend to measure what's easy, not what's right—but it is a good place to start. In fact, one of our principles is start from where you are. Yes, we'd all like to do spectacular work on intangibles using the architecture we propose, but it is better to take on a small project with a high likelihood of success rather than a large one that may well fail. If you haven't done vital signs reporting yet, start there, then move on to bigger things. Many investors know that intangibles matter, but hesitate to ask for intangible reports because even they don't know what to ask for.

The next step is what we call an "HR insights report," where you start focusing on those measures that matter most—the ones most clearly linked to company performance. This is the point where you can begin to think in terms of capabilities, perhaps picking just one capability and working on that.

What if you make a mistake? Well, of course you'll make mistakes, just as anyone venturing into a new area will. When we talk to HR leaders, fear of getting measures wrong seems to be the biggest problem in moving forward. This is a fear that needs to be overcome. Perhaps the reason for that fear is that HR has not done a good job of engaging other stakeholders. HR should not be working on this topic in isolation. The CFO will care, the head of investor relations will be interested, of course the CEO will want to be kept in the loop, and the HR committee of the board of directors may even decide this is so important it should take the lead.

Once you have some experience reporting on organization and human capital, and have your stakeholders on side, then you are ready to work on a "strategic report on intangibles." At this level, you need to define how the architecture of intangibles that we described earlier applies to your organization. You need to be clear about what capabilities matter most to your strategy. And you will want to do an intangibles audit.

We believe that you should start now, with a 90-day project of doable scope. Make sure the stakeholders are on your side, and get a project team working on it. The cycle time for this kind of reporting is one year. It will take several cycles to be comfortable with what you are reporting. And so the time to start is now.

The future of HR

What is really exciting is that investors are beginning to take an interest in organizational and human capital. If investors are interested, you can bet the board will care, and so too will the CEO. This puts HR in the spotlight in a way it never has been before. It won't be easy, but it is a powerful mechanism to ensure that truly strategic, intangible-building HR practices will spread. There has never been a more exciting time to be an HR professional.

David Creelman is CEO of Creelman Research (creelmanresearch.com), based in Toronto. Dave Ulrich is a professor of business at the University of Michigan and a principal at The RBL Group (rbl.net), a consulting firm based in Provo, Utah. Ulrich also is the co-author, with Wayne Brockbank, of The HR Value Proposition (Harvard Business School Press, 2005).