Making HR a Strategic Asset

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The story is a familiar one. Organizations increasingly rely on intangibles as the source of their competitive advantage. R&D, brands, customer relationships, not to mention more abstract “capabilities” like organizational flexibility, are recognized as sources of value creation. Yet, managing these intangibles as assets, in an environment where conventional accounting standards often measures them as costs, is particularly challenging. Nowhere is this challenge more obvious than for what most firms claim to be their most important asset, their people. Senior managers recognize they are in a “war for talent”, but they often manage their people assets like overhead (a cost to be minimized). The solution is to manage HR (Human Resources) as a strategic asset and measure HR performance in terms of its strategic impact. This requires a new perspective on what is meant by HR in the organization and a new understanding of how HR creates value in the organization. Both line managers and HR professionals need to think of HR, not in terms of a function, or set of practices, but rather as an “architecture” that must be properly structured and managed in order to create value.

Thinking in Terms of an HR Architecture

Conventional thinking about HR reflects the paradox facing line managers. If people “are our most important asset”, why is the HR *function* typically considered a cost center? Why do so many line managers think of HR as administrative overhead? In large part this perspective has been justified by the HR function’s traditional emphasis on administrative efficiency and compliance activities. With the increasing emphasis on innovation, speed and flexibilty, however, and the associated increase in the importance of intangibles, both line managers and HR professionals need to break out of their functional perspective and think about HR as a strategic asset. This doesn’t mean simply putting old wine in new bottles. We aren’t suggesting that the traditional administrative and compliance activities in HR have all of a sudden achieved strategic significance. Line managers and HR professionals both need to focus on the *organizational logic* required to make HR a strategic asset; namely the HR Architecture.

Simply put, when senior line managers describe "people" as a strategic asset, they are describing employee *strategic* behavior. Namely, they should be focusing on employee performance that implements the firm's strategy. But just as organizational performance is a function of both people and systems, the appropriate HR system is required to select, develop and reward employees in way that produces those strategic behaviors. Finally, while line managers often play a key role in managing the high performance HR system, the HR function must still have the perspective and competencies to drive this process. Figure 1 describes the organizational logic behind the HR Architecture. In other words both line managers and HR professionals, when thinking strategically about HR, need to think in terms of a value creating process that combines the HR function and the HR system to produce strategically focused employee performance.

Put Figure 1 – Strategic Architecture about here

Why HR is a Strategic Asset

It is easy to understand why organizations talk about people as an asset, but tend to manage them largely as a cost to be minimized. Aside from accounting principles that encourage this perspective, HR costs are easy to observe, while HR value creation is not. Largely because of the traditional perspective on HR, organizations have no way to measure HR's strategic performance. Nevertheless, we know that intangibles in the aggregate are an increasingly important source of firm value, and that *human* capital ought to be a part of that asset value. For example, Baruch Lev and his colleagues at New York University have demonstrated that an increasing share of a firm's market value can be attributed to the value of its intangible assets. Lev identifies several sources of intangibles including what he calls organizational assets and "sharp execution".[1] Similarly, then-CFO James Chestnut, after transferring the bulk of its tangible assets to its bottlers, observed that Coke's $150 billion market value derived largely from its brand and management systems.[2] The implication is that intangible assets are increasingly important as sources of value creation, and that both strategy implementation and management systems are key dimensions of these intangible assets.

HR is a strategic asset because it can play a critical role in both strategy implementation and management systems. Namely, the ability to execute strategy well is a source of competitive advantage, and "people" are the lynchpin of effective strategy execution. Reports in the business press conclude that the inability to execute strategy is the number one source of CEO failure[3]. Our own research provides a systematic demonstration of this same point. As part of a national survey of more than 400 firms, we asked respondents to rate the "suitability" of their strategy and how well it had been executed. Our analysis found that the ability to execute well had a 10 times greater impact on firm financial performance than strategic choice.[4] Does that mean that strategic choice is irrelevant? Of course not. We think it simply means that firms do a reasonably good job of choosing the right strategy, to the point where this is no longer a differentiator. What does differentiate firms, however, is their ability to execute strategy effectively.

Equally important we find that a key driver of effective strategy implementation is what we call *employee strategic focus* (ESF) – the extent to which employees understand how their job contributes to firm success. In a world where strategy is everyone's job, it is critical that the entire organization, not just the top management team, be strategically focused. Figure 2 illustrates how the quality of strategy execution increases with the level of employee strategic focus among firms in our sample. We also examined the drivers of employee strategic focus. Once again, we weren't surprised to find that what gets measured, get managed. Organizations with more balanced performance measurement systems (i.e. balanced scorecards) rated the strategic focus of their employees significantly higher than organizations that relied simply on financials to measure strategic performance. Finally, we found that ESF was also driven by the strategic alignment of the firm's HR system. When the organization's rewards, development and appraisal systems (the HR system) effectively encouraged behaviors that implemented the firm's strategy, ESF also improved.

Put Figure 2 about here

Organizational assets rise to the level of a strategic asset when they become a source of competitive advantage. Talent, commitment, and flexibility are desirable characteristics in a firm's human capital, but are not sufficient to make people a strategic asset. Strategic assets are "the set of difficult to trade and imitate, scarce, appropriable, and specialized *resources* and *capabilities* that bestow the firm's competitive advantage".[5] The ability to align both management systems and employee behaviors in way that works to implement the firm's strategy becomes an "invisible asset" that tends to be idiosyncratic to the individual firm and not easily imitated by competitors.[6]

Most senior managers intuitively understand that human capital has the potential to be strategically important. There is little beyond anecdotal evidence, however, to demonstrate its impact on financial performance, much less the contribution of HR. We've described a perspective for how HR *could* become a strategic asset, but is there any evidence that it really can have the impact that we suggest? Based on our research involving nearly 3000 firms over the last 10 years, the answer is very clearly yes. The pattern of those results is summarized in Figure 3. We find a very clear positive relationship between what we call a *high performance* HR system and various measures of firm financial performance (market value to book value and accounting profits). A high performance HR system is one that emphasizes employee performance in every aspect of the system, is internally consistent, and perhaps most importantly is aligned with the strategy of the organization. When we measure a firm's HR system based on an index that captures these features, we estimate that a 35 percent improvement in a firm's HR system index results in a10-15 percent increase in market value/book value.[7]

Insert Figure 3 about here

Managing and Measuring HR as a Strategic Asset

How do we make these ideas actionable? Where do you start? HR has always been challenged to make a persuasive business case for its strategic significance because the line of sight between HR and financial performance is rarely direct. In practice, if HR is to be managed and held accountable as a strategic asset, organizations must find a way to directly link HR to the strategy implementation process.

The solution to the missing link in the HR-firm performance relationship is the concept of the strategy map developed by Kaplan and Norton.[8] . As an alternative to traditional accounting measures they have offered a more "balanced" set of performance measures (i.e. the Balanced Scorecard) that captures both the financial results of managerial decisions, but also the "leading" drivers of those results.[9] The conceptual foundation of this "balance" is a set of cause and effect relationships that underpin the strategy implementation process in a particular firm. . The formalized result of this analysis, what Kaplan and Norton call a strategy map, is essentially the story of what it takes for the firm to implement its strategy. In effect it describes how value is created through the strategy implementation process. However, as Kaplan and Norton acknowledge (1996) organizations have made little progress in developing measures of how People (or HR) make a strategic contribution.[10]

The reason that most organizations lack the kind of measures necessary to capture the strategic influence of HR is the fundamental perspective both line managers and HR professional bring to HR. The absence of strategically relevant measures of HR's strategic performance is very likely an accurate reflection of the focus and energies of HR in most organizations. Just as form follows function in architecture, the available measures for HR performance no doubt reflect HR's traditional emphasis on administrative efficiency and compliance. In Dave Ulrich's terms, HR has focused on "doables" rather than "deliverables" (HR outcomes that solve important business problems).[11] As a result, HR performance measures capture "doables", which have little or no strategic import.

In sum, senior line managers and senior HR professionals have a common problem. Senior line managers who recognize the critical role of strategy implementation to their firm's success, need to find a way to manage and measure the strategic role of "people" in their organization. Similarly, senior HR professionals with the responsibility of making "people" a strategic asset lack a framework that allows them to bridge the indirect line of sight between HR and firm performance. Linking the perspective of the

HR Architecture with concept of the Strategy Map provides a solution to this problem (See Figure 4).

Put Figure 4 about here

Focusing only on HR efficiency is largely a zero sum game between HR professionals and line managers. The strategic relationship in Figure 4, however, defines a common interest in value creation through HR's role in strategy implementation. The firm's HR Architecture and line managers are both focused, and held accountable, for their contribution to the same strategy drivers. HR deliverables become the foundation of the enterprise strategy map .

The HR Architecture now has several important features that differentiates it from the traditional HR focus. These include:

- The motivation, competencies and structure of the HR Function are guided by a "top down" analysis of its strategic contribution.
- The measure of HR's strategic value lies in its contribution to goals identified by line managers through the development of a strategy map
- Both HR professionals and line managers will be able to measure HR's contribution to financial performance beyond simply its effect on cost control.

The Measurement Transition

Nevertheless, because what gets measured gets managed, organizations need to be sure that they measure HR performance in a way that reflects the organizational logic of HR's contribution to firm performance. Once an organization begins to manage HR like a strategic asset, the measures of HR's performance must reflect that transition. Unfortunately, organizations too often fail to make the systemic changes that structural link HR to the strategy implementation process, and simply attempt to raise the profile of "people" performance measures. Figure 5 illustrates the transition in measurement systems required of most organizations.

Put Figure 5 about here

Level 1 measurement systems reflect the traditional HR focus on transactional and administrative efficiency. For these firms HR "performance" is often based on comparisons to external benchmarks. As more organizations have recognized the limits of these traditional HR measures there is an increasing effort to give "people" measures a more strategic significance as reflected in Level 2 in Figure 5. The problem with this approach is that, at best, there is a tenuous relationship between success on these "people" measures and subsequent business success. Neither line managers or HR professionals can identify the direct relevance of these measures for the business problems facing the firm. There is no clear line of sight from achieving these "people" goals and implementing the firm's strategy. As a result, line managers give little more than lip-service to "people" goals and the performance of HR professionals is still judged largely by efficiency metrics. Operating at Level 2 is frustrating for both line managers and HR professionals.

Level 3 measurement systems avoid the problems in Level 2 because the choice of measures is based on a systematic analysis of how intangibles, particular HR, can influence the successful implementation of strategy. HR measures are now tied directly to the development of a strategy map that outlines the causal logic of HR's impact on firm performance. Both HR professionals and line managers understand the rationale for, and indeed have a common interest in, success on the HR measures. At this level, HR measures actually serve to guide management decisions that drive strategy, rather than simply reduce overhead.

Consider the example of a pipeline company that traditionally emphasized reactive maintenance policies for its pipeline workers. Following the development of a strategy map it was clear that pipeline reliability was an important driver of customer satisfaction, and ultimately financial performance. To increase pipeline reliability the firm reoriented its maintenance efforts toward preventive maintenance. This in turn required new employee behaviors emphasizing diagnosis and prediction of failures, life cycle cost analysis and knowledge-sharing. At Level 3 there is a clear line of sight between key strategic behaviors and financial success.

Finally, Level 4 is the most sophisticated measurement system because, it not only measures levels, it also measures relationships. This allows the organization to actually calculate the impact of HR in terms that are relevant to line managers. For several years, Sears has been a leader in estimating the impact of intangibles on financial performance. This allows the decisions of Sears' managers to be guided by such specific relationships as "a 5-point improvement in employee attitudes will drive a 1.3-point improvement in customer satisfaction, which in turn will drive a .5% improvement in revenue growth."[12] More recently GTE (now Verizon) has been measuring HR performance by its contribution to business and strategic goals (see inset), to the benefit of both HR professionals and line managers.

Insert GTE Experience text box here

The HR Scorecard as the Solution

In order to successfully make the transition to managing and measuring HR as a strategic asset requires an entirely new perspective on the role of HR in the organization. There needs to be a new understanding on the part of both line managers and HR professionals about what it takes for HR to make a strategic contribution. In fact there needs to be a new appreciation for what HR represents. In our book, *The HR Scorecard: Linking People, Strategy and* Performance, we develop a 7-step model (see inset box) to guide organizations through this transition to the top of the pyramid in Figure 5.

Inset *Seven Steps to Making HR a Strategic Asset*

The result is an HR Scorecard that will enable an organization to both measure HR's strategic impact, as well as manage HR as a strategic asset.

Put Figure 6 about here

Making People Your Most Important Asset

It really is true that, for most organizations, people are their most important asset. But translating that observation into practice means breaking with organizational systems premised on the assumption that people are largely a cost to be minimized. Senior line managers in organizations that require speed, flexibility and innovation understand that strategy is everybody's job. Getting from here to there is the challenge. We believe that a new perspective on HR, one that thinks of the HR Architecture in terms of an organizational asset, is the foundation for meeting that challenge. It means that HR is more than a function, and has the potential to be more than a cost center. This new perspective on HR requires changes in the relationship between line management and HR professionals, and a new shared responsibility and accountability for strategic performance drivers. The potential benefits, however, are enormous. As a combination of organizational systems, routines and changes in the firm's culture, the result is a new source of competitive advantage that is not easily imitated.

Figure 1
HR's Strategic Architecture

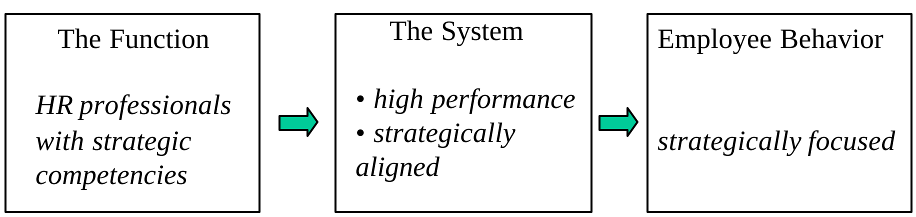


Figure 2
Strategy Execution Improves As Employee Strategic Focus Increases

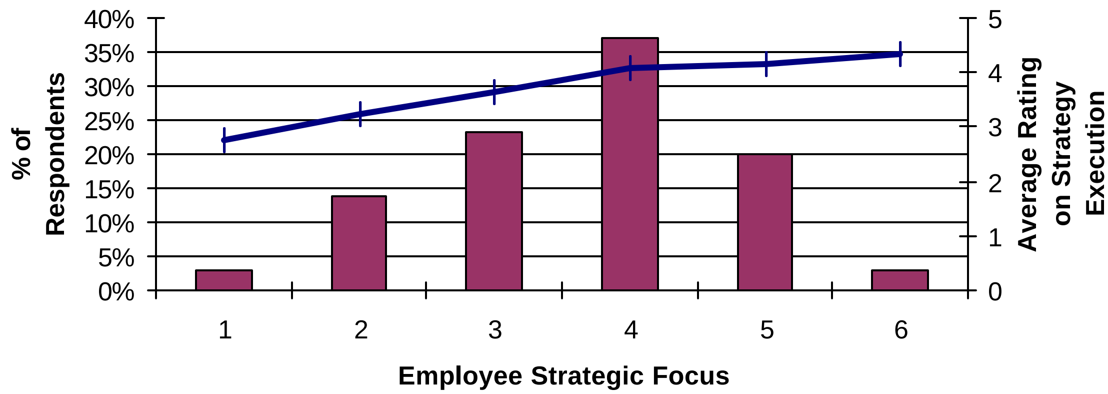
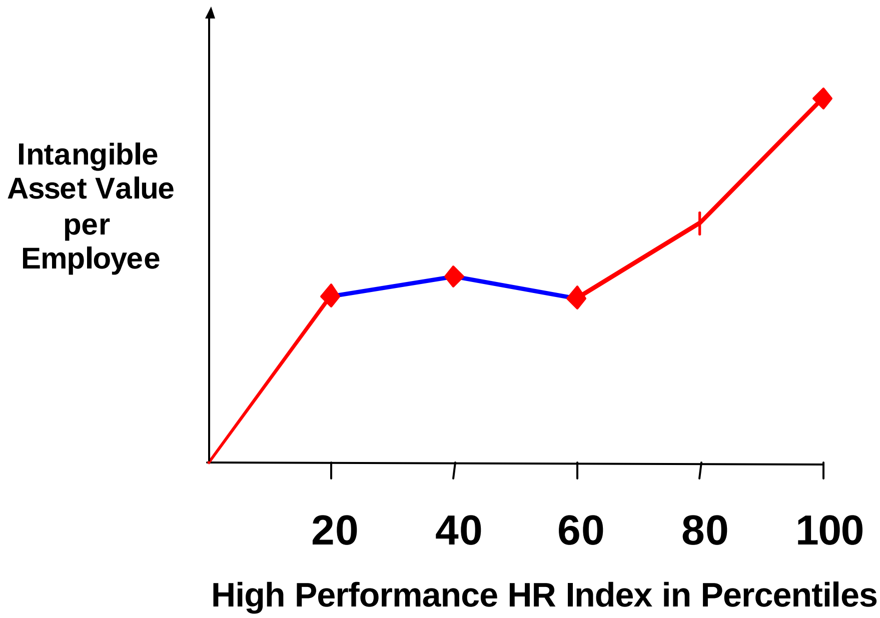
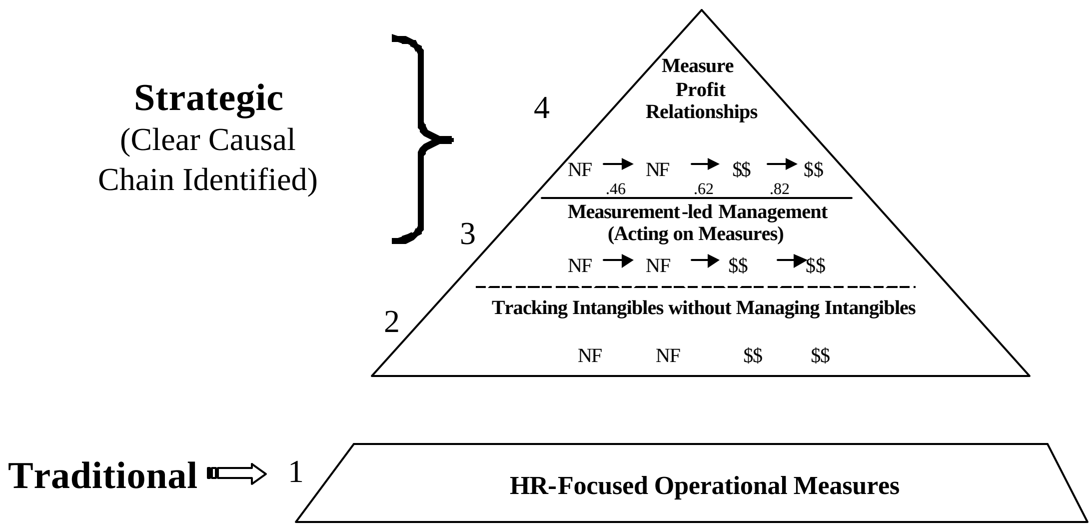


Figure 3
The Strategic Impact of HR



Source: Huselid and Becker (1995)

Figure 5
Increasing Focus on Strategic Performance Measurement
Supports Management of HR as Strategic Asset



$$ = Financial Measures
NF= Non-financial Measures

Estimating Causal Linkages at GTE

GTE (now Verizon) provides a very interesting illustration of how an organization can estimate linkages between HR Deliverables and performance drivers in a strategy map. Their Network Services unit (approximately 60,000 employees) "hypothesized" that market share was driven by customer valuation of their service, which in turn was driven by customer service quality, brand advertising and inflation. The driver (the leading indicator) for customer service was a set of strategic employee behaviors focusing on broadly on employee engagement. GTE HR created what they called the Employee Engagement Index based on a subset of 7 questions from the GTE employee survey as a measure of these strategic behaviors.

The analysis supported their hypothesis and demonstrated the wisdom of their "balanced" approach to performance measurement and management. For example, GTE found that a 1 percent increase in the EEI resulted in nearly a ½ percent increase in customer satisfaction with service. In other words, GTE has examined a key section of their "strategy map" and explicitly tested their hypothesis that employee behaviors are indirect leading indicators of key strategic measures (market share). The measured the strategic impact of one element in the HR Architecture.

GTE was able to do this because they had a clear story in mind of how employee behaviors actual drive strategy in their organization. Second, they recognized the need to collect and merge information from multiple source and multiple time periods. Third, GTE HR had access to the technical expertise necessary to make these statistical estimates.

Source: Brian E. Becker, Mark A. Huselid, Dave Ulrich, *The HR Scorecard: Linking People, Strategy and Performance*, (Boston: Harvard Business School Press), 2001, pg. 122.

Seven Steps to Making HR a Strategic Asset
(excerpted from *The HR Scorecard: Linking People, Strategy and Performance*)

Step 1: Clearly Define Business Strategy. Our focus on implementation assumes that a consensus strategy exists and that it can be clearly described and communicated to the entire organization.

Step 2: Build a Business Case for Why and How HR Matters for Strategy Implementation. HR will only become a strategic asset when both line managers and HR professionals assume a shared responsibility for implementing strategy. For this to happen, both parties need to have a common understanding that HR's strategic value is linked to the extent to which it directly contributes to better strategy execution.

Step 3: *Build a Strategy Map Describing the Causal Flow of Strategy Implementation*. A strategy map takes what tends to be an externally focused vision in Step 1 and links it to an internal roadmap that "show(s) how an organization plans to convert various assets into desired outcomes."[1] It is an essential part of managing HR as a strategic asset because it provides the basis of aligning the HR Architecture with the firm's strategic drivers. It provides the organizational logic that transforms HR from a transaction and operationally oriented function to an organizational asset with strategic impact.

Step 4. Link HR Architecture to Strategy Map. This may be the most important step in transforming HR to a strategic asset. The term HR Deliverable is just a short-hand term for the outcomes of the HR Architecture that directly drive successful strategy implementation. The question is where in the HR Architecture to locate the HR Deliverables? Should we focus on employee performance and behaviors, or the drivers of those behaviors? We believe those HR Deliverables should focus on employee performance behaviors because they *most directly influence* the strategic goals of line managers.

Step 5: Design HR System in Alignment with HR Deliverables The strategic behaviors in the organization (HR Deliverables) are driven by competencies, motivation, work structure, strategic focus, etc. Therefore, the HR system (recruiting, selection, compensation, rewards, career development, etc,) must be focused on those behavioral drivers. The result is an HR system that is both externally aligned with the requirements of the strategy map, and internally aligned among the various elements of the system.

Step 6: Design HR Strategic Measurement System (The HR Scorecard) Steps 1-5 lay the foundation for managing HR as a strategic asset. Next the organization will need a measurement system that will not only guide that management process, but also validate HR's contribution to firm performance. We use the term HR Scorecard because it is designed to extend the concepts of the *Balanced Scorecard* to an organizational asset, in this case the HR Architecture. In other words, based on Steps 1-4 above, there is a very clear logic that links the strategic results for the HR Architecture with the ultimate financial success of the organization.

Step 7: Implement Management by Measurement. Managing HR as a strategic asset will be a significant change initiative for most organizations. It will require a new perspective on HR, as well as acceptance this new role, by both line managers and HR professionals. Senior line managers need to understand that if the organization is going to reap the benefits making people "our most important asset", implementation of the HR Scorecard needs to be approached as a major change initiative. Ultimately the success of this initiative will turn on whether the people in the organization who are charged with implementing the firm's strategy, understand the logic of the strategy's execution, and their role in that logic.

[1] Robert S.Kaplan and David P. Norton, "Having Trouble with Your Strategy? Then Map It", *Harvard Business Review,* September-October 2000, p. 169

Figure 4
HR Architecture Intersects with Enterprise Strategy Map

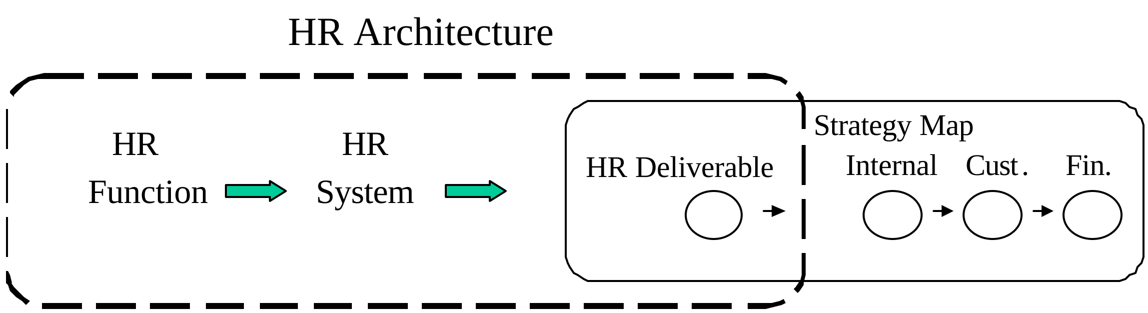
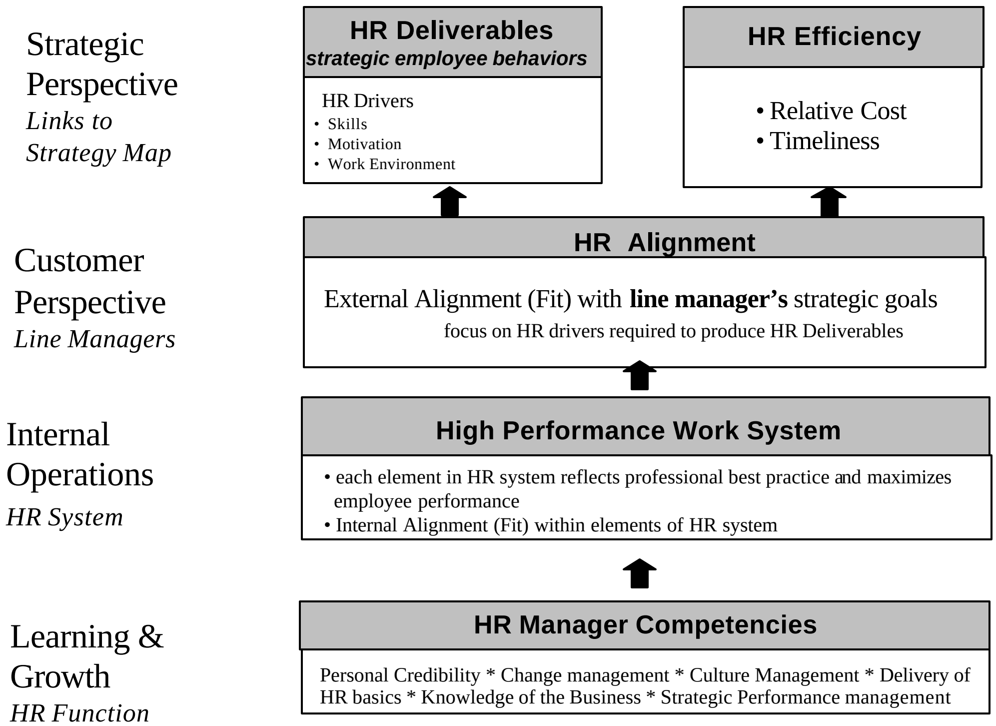


Figure 6
HR Scorecard



[1] Baruch Lev's ideas are summarized in Jonathan R. Laing, "The New Math", *Barron's* , Nov. 20, 2000, pp. 31-36.

[2] Thomas Stewart, "Real Assets, Unreal Reporting," *Fortune*, 6, July 1998, 207.

[3] Ram Charan, "Why CEO's Fail", *Fortune*, June 21, 1999, pp. 69-78.

[4] By firm performance we mean market value/book value. These estimates are based on statistical models that control for the effects of industry, growth, risk, R&D, and size (employment).

[5] Raphael Amit and Paul J.H. Shoemaker, "Strategic Assets and Organizational Rents", *Strategic Management Journal*, 14 (1993): 33-46.

[6] H. Itami, *Mobilizing Invisible Assets*, Boston: Harvard University Press, 1987.

[7] Explain control variables

[8] Robert S.Kaplan and David P. Norton, "Having Trouble with Your Strategy? Then Map It", *Harvard Business Review,* September-October 2000, pp. 167-178.

[9] See for example Robert S. Kaplan and David P. Norton, *The Balanced Scorecard: Translating Strategy into Action,* (Boston: Harvard Business School Press), 1996.

[10] Robert Kaplan and David Norton, *The Balanced Scorecard*, pp. 144-145

[11] Dave Ulrich, *Human Resource Champions,* (Boston: Harvard Business School Press), 1997.

[12] Anthony J. Rucci, Steven P. Kirn, and Richard T. Quinn, "The Employee-Customer-Profit Chain at Sears," *Harvard Business Review* 76, no.1(1998): 91.