EVIDENCE-BASED MANAGEMENT AND DEVELOPMENT OF HUMAN CAPITAL
THE AGE OF ANALYTICS
JANUARY 29, 2013

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New York

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“Human capital” defined

“. . . the accumulated stock of skills, experience and knowledge that resides in an organization’s workforce and drives productive labor.”

Source: *Play to Your Strengths*
Human capital strategy, therefore, is a form of asset management . . .

. . . a plan for securing, managing and motivating a workforce to achieve business goals
It is advisable to take an asset management approach because significant economic value is at stake.

By linking plant-level productivity measures to firm-level financial measures, Mercer has shown that a 10 percent gain in persistent productivity translates into at least a 5 percent gain in shareholder value.

A Mercer study of the U.S. manufacturing sector showed that productivity is directly linked to shareholder value – materializing, in effect, as an intangible asset highly valued in capital markets.

We had access to the plant-level measures of productivity under a strict confidentiality agreement with the US Census Bureau. Our results have been screened to ensure that they do not disclose confidential information. For more information, see “The Market Value of a Firm and Plant-Level Productivity,” Douglas W. Dwyer, William M. Mercer, Incorporated, 1997.
Implications of these persistent effects are profound:

- The effects are much more sizable, stable, and enduring than ever realized
- They are dominated by human capital issues
- A powerful human capital strategy provides a sustainable competitive advantage – unlike the effects of capital and technology which appear to be much more easily competed away
GETTING THE “RIGHT FACTS” TO SUPPORT AN ASSET MANAGEMENT APPROACH
Advances in information technology and analytic methods are making it possible for company’s to better understand their workforces and move from “I think” to “I know”
Moving up the analytics value curve requires assessing both what people SAY and what they DO.

**SAY**
What employees and employers say as measured through
- Focus groups
- Leadership and HR interviews
- Employee surveys
- Company policies
- Comparative/pattern databases

**DO**
How employees and employers actually behave as measured through
- Individual employee records
- Employee turnover
- Business performance measures such as customer satisfaction, growth, profit and productivity

Complete, verifiable understanding of the interplay between employer action and employee reaction
Some companies rely solely on what people say -- in this instance using quite sophisticated methods such as conjoint analysis to more reliably elicit employee preferences . . .

These three areas are consistently rated as the top 3 areas of importance by virtually all segments of the population surveyed.

Importance scores were scaled so that the average score is 100.
. . . others rely on what employees actually do, like this company. . .

Results from statistical analysis of drivers of actual turnover

<table>
<thead>
<tr>
<th>More likely</th>
<th>Less likely</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonus participation</td>
<td>Pension vesting within 18 months</td>
</tr>
<tr>
<td>Broader job experience</td>
<td>Time away &gt; 90% taken</td>
</tr>
<tr>
<td>Received technical training</td>
<td>Tuition reimbursement</td>
</tr>
<tr>
<td>Pension vesting within 18 months</td>
<td>Higher pay</td>
</tr>
<tr>
<td>Time away &gt; 90% taken</td>
<td>Add week of vacation</td>
</tr>
<tr>
<td>Tuition reimbursement</td>
<td>Sabbatical</td>
</tr>
<tr>
<td>Higher pay</td>
<td>Unscheduled absence</td>
</tr>
</tbody>
</table>

Likelihood to quit

-30% -20% -10% 0% 10% 20% 30% 40%
Toyota N.A. learned the value of combining both the “Say” and the “Do”—and of balancing statistical and psychological significance.

**Facts from behavioral analysis**
- Performance drives pay growth and promotions
- Training and broad experience drives promotions

**Perceptions from employee survey**
- Pay and promotions not tied to performance
- Training and breadth of experience unrelated to promotions

**Actions**
- Keep performance management system
- Close gaps through communication
Internal Labor Market (ILM) analysis® starts by “mapping” the flows that determine what your workforce is and what it is becoming.
These talent flows can then be segmented by gender, in this case.

Here, women face a ceiling at level 6. Not surprisingly, more women are likely to leave.

Disguised case example
MODELING AND EXPLAINING INTERNAL LABOR MARKET DYNAMICS
ILM Analysis® quantifies the drivers of key workforce outcomes.

What should you know about your internal labor market?

**Know who you are selecting**
This selection instrument not only failed to be predictive of success, it tended to select individuals with a higher propensity to quit.

**Know what you are rewarding**

**Value of performance ratings**
Overall, the value of higher performance ratings is small. In unit 3, a top rating does have higher value. But in unit 2 where 40 percent of the workforce falls, there is little incentive to excel or to improve low performance.

**Know how you are managing performance**

**Redirecting investments to career programs vs. salary increases should reduce turnover by over 20%**.

Disguised case example
This regional bank found that career opportunity and managerial stability – not pay and workload – are what actually mattered for retention.

**Analysis of actual turnover behavior**

<table>
<thead>
<tr>
<th>Turnover drivers</th>
<th>Percentage point reduction in turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>10% market pay adjustment</td>
<td>0%</td>
</tr>
<tr>
<td>1-point rise in unemployment</td>
<td>0%</td>
</tr>
<tr>
<td>Hire 20% more from employee referrals</td>
<td>2.5%</td>
</tr>
<tr>
<td>10% base pay growth</td>
<td>5%</td>
</tr>
<tr>
<td>1-year decrease in current position</td>
<td>7.5%</td>
</tr>
<tr>
<td>Increase jobs performed (from 1 to 2)</td>
<td>10%</td>
</tr>
<tr>
<td>10% reduction in layoffs</td>
<td></td>
</tr>
<tr>
<td>Supervisor did not leave within last year</td>
<td></td>
</tr>
<tr>
<td>If incentives received</td>
<td></td>
</tr>
<tr>
<td>If promoted within last year</td>
<td></td>
</tr>
</tbody>
</table>

Previous surveys of perceptions suggested that pay and workload were most critical to employee commitment (in this organization). Our analysis of actual behavior showed that career development and management stability most affected retention.
Know how careers unfold . . . and if there are potential ways to accelerate effective development

An example of opportunity pathways in an energy company

Based on actual job transitions. The time shown are the approximate average time for the job transitions to have occurred.
Know if channeling and/or self selection is limiting your leadership pipeline... and impeding realization of your Diversity goals.

Disguised case example
Know if and to what extent ILM dynamic play out differently across regions

**Percentage difference in a high results rating probability**

<table>
<thead>
<tr>
<th>Role</th>
<th>US</th>
<th>Global</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sr. Executive (vs. Professional)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Executive (vs. Professional)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Sr. Director (vs. Professional)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Director (vs. Professional)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Sr. Manager (vs. Professional)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Sr. Professional (vs. Professional)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Support (vs. Professional)</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

**Percentage difference in pay growth**

<table>
<thead>
<tr>
<th>Role</th>
<th>US</th>
<th>Global</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sr. Executive (vs. Professional)</td>
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<tr>
<td>Executive (vs. Professional)</td>
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<tr>
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<td>-</td>
</tr>
<tr>
<td>Sr. Professional (vs. Professional)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Support (vs. Professional)</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

**Masked Example of a U.S.-based Global Company**

Notes: The statistical model upon which these results are based accounts for individual attributes, organizational factors, and external influences and includes all active, on-leave or temporary employees.
INTERNAL LABOR MARKET (ILM) ANALYSIS®:
CASE EXAMPLES
ILM analysis® allowed this large energy company to assess the impact of developmental and education experiences, so as to improve the return on their considerable investments in human capital.

<table>
<thead>
<tr>
<th></th>
<th>Promotion</th>
<th>Turnover: Voluntary</th>
<th>Turnover: Retirement</th>
<th>Rating</th>
<th>Pay Level</th>
<th>Pay Growth</th>
<th>Total Pay</th>
</tr>
</thead>
<tbody>
<tr>
<td>Masters Vs. Bachelors</td>
<td>11%</td>
<td>No Influence</td>
<td>No Influence</td>
<td>3%</td>
<td>5%</td>
<td>No Influence</td>
<td>2%</td>
</tr>
<tr>
<td>Doctorate Vs Bachelors</td>
<td>55%</td>
<td>No Influence</td>
<td>-83%</td>
<td>No Influence</td>
<td>10%</td>
<td>No Influence</td>
<td>3%</td>
</tr>
<tr>
<td>Ever did Overseas Assignment</td>
<td>49%</td>
<td>41%</td>
<td>Not Applicable</td>
<td>6%</td>
<td>-4%</td>
<td>0.1%</td>
<td>28%</td>
</tr>
<tr>
<td>Ever did Prog. X (Certification Program)</td>
<td>47%</td>
<td>-89%</td>
<td>Not Applicable</td>
<td>No Influence</td>
<td>-4%</td>
<td>-0.1%</td>
<td>No Influence</td>
</tr>
<tr>
<td>Ever did Prog. Y (Degree Program)</td>
<td>65%</td>
<td>No Influence</td>
<td>Not Applicable</td>
<td>2%</td>
<td>-13%</td>
<td>-0.2%</td>
<td>-4%</td>
</tr>
</tbody>
</table>

Here, overseas assignments were a ticket out the door, even though it was also a ticket to advancement.

Note: The models on which these results are based control for individual attributes, organizational factors, and external influences.
It helped this financial services company understand how their move to forced ranking and greater reliance on variable pay was playing out… as for instance in driving out high performers

### Percentage change in probability of voluntary turnover next year

<table>
<thead>
<tr>
<th></th>
<th>-60%</th>
<th>-50%</th>
<th>-40%</th>
<th>-30%</th>
<th>-20%</th>
<th>-10%</th>
<th>0%</th>
<th>10%</th>
<th>20%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Base pay rate</strong>*</td>
<td>N/S</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Base pay growth</strong>*</td>
<td></td>
<td>-3%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total pay growth</strong>*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Received a bonus</strong></td>
<td>-48%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Large performance bonus</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>12%</td>
</tr>
<tr>
<td><strong>LTI amount</strong>*</td>
<td>N/S</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This is a result of statistical modeling to identify drivers of turnover. Other factors were controlled for such as the tenure of employees, their job, department, location, recency of promotion, etc.
A CAUTIONARY TALE:
MOBILITY RUN AMOK AT PRODUCTCO
Case Study: Global Consumer Company

Strategic Situation

• Strong brand recognition, but market share is under pressure
• Profitability and growth strongly contingent on product quality and reputation for customer service

Assessment of “Current State”

• Excessive mobility within leadership group undermining technical depth and accountability
  – A culture that valued generalists over specialists.
  – An entrenched pattern of building from within over hiring from outside
  – A “tournament” structure that produced strong incentives for high performers to move laterally
  – A system of talent identification and performance management that generated a form of internal “free agency” for high potential employees

Results

• Potential cost reductions for overcoming excessive mobility and resulting lack of specialization/accountability resulted in quality improvements valued in excess of one billion dollars.
A “best practice” approach to leadership development that failed to take account of context created a serious business risk.

**Business Results**
- Flawed product launches
- Poor customer satisfaction
- Reduced quality
- Slowed brand building

**Talent/Capability Results**
Rapid and multiple lateral (primarily within-function) moves, which have positive and negative impacts

**Business Strategy**
- Strong global brands
- Customer satisfaction & loyalty
- Total value to customer
- Corporate citizenship
- “Leaders at all levels”

**Talent Processes & Practices**
Talent management processes and practices facilitate accelerated movement, particularly of high potential talent, along the functional generalist leadership path

**Reward Systems**
The history, culture, and hierarchical structure make promotion the centerpiece of the reward system. People who leverage the talent strategy and make rapid and multiple lateral moves increase their likelihood of being promoted and valued.

**Implicit Talent Strategy**
- All high potential talent should be developed along a functional generalist leadership path
- Functional generalist leaders are developed through multiple in-function job experiences and some cross-functional assignments
- Talent should be primarily developed from within
The company had a “tournament” to the top – being won by by those who “game” the system
Employees who changed jobs frequently got rewarded more than those who did not.

<table>
<thead>
<tr>
<th>Received over past 2 years</th>
<th>Likelihood over next 2 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Neither promotion or lateral</td>
<td>83%</td>
</tr>
<tr>
<td>Lateral but no promotion</td>
<td>56%</td>
</tr>
<tr>
<td>Technical promotion</td>
<td>62%</td>
</tr>
<tr>
<td>General promotion</td>
<td>50%</td>
</tr>
</tbody>
</table>

Promotion likelihoods are based on statistical models that control for key individual and workgroup attributes such as gender, age, tenure, job title, location, etc.
What does this company’s experience tell us?

- Like most human capital practices, the efficacy of mobility as a mechanism to develop leaders depends on the specific context in which it is introduced
  - Strategic context, e.g.,
    - Relative importance of quality
    - Value of cross-business or cross-geography synergies
  - Operational context, e.g.,
    - Duration of production cycles
    - Need for technical depth
  - Organizational context e.g.,
    - Buy vs. build orientation
    - Performance management system
    - Reward system

Mobility can have damaging unintended consequences if not well aligned with the broader human capital “system”
LINKING WORKFORCE OUTCOMES TO CUSTOMER VALUE AND BUSINESS RESULTS:
BUSINESS IMPACT MODELING®
Business Impact Modeling® *quantifies* direct links between human capital management and business results

An HR practice’s effect on productivity is determined by examining the relationship between the practice and productivity across work groups and over time.
Business Impact Modeling® shows how workforce attributes and management practices affect financial performance and customer value.

### Financial performance

Training also improved product sales by roughly $3.7 million annually.

<table>
<thead>
<tr>
<th>Courses taken per branch</th>
<th>Checking accounts</th>
<th>New accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1</td>
<td>0.8</td>
<td>2</td>
</tr>
<tr>
<td>2</td>
<td>1.5</td>
<td>4</td>
</tr>
<tr>
<td>3</td>
<td>2.3</td>
<td>6</td>
</tr>
<tr>
<td>4</td>
<td>3.0</td>
<td>8</td>
</tr>
<tr>
<td>5</td>
<td>3.8</td>
<td>10</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Courses taken per branch</th>
<th>Savings accounts</th>
<th>New accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1</td>
<td>+0.4</td>
<td>2</td>
</tr>
<tr>
<td>2</td>
<td>+0.8</td>
<td>4</td>
</tr>
<tr>
<td>3</td>
<td>+1.2</td>
<td>6</td>
</tr>
<tr>
<td>4</td>
<td>+1.6</td>
<td>8</td>
</tr>
<tr>
<td>5</td>
<td>+2.0</td>
<td>10</td>
</tr>
</tbody>
</table>

### Customer value

**Employee attitudes and perceptions**
- Attachment: .19**
- Perceived effectiveness of marketing strategy: .24**
- Work-life balance: .25**
- Satisfaction with supervisor: .21**
- Openness of work climate: .20**

### Customer value

**Grow firm-specific human capital (+1 year of service)**
- $15M from increased revenue
- $25M from new customers and increased revenue

**Greater market share**
- 2 percentage points of market share
- Revenue gain $40M

**General human capital has no such impact**
It can also help identify drivers of productivity at the organization and individual levels.

**Productivity – organization level**

- **Breadth of relationship**
  - Delivering one additional service to customers
- **Stability of relationships**
  - Increase in dedicated staff serving customers (from 15% to 30%)
  - A 33% reduction in the turnover of the most seasoned people
  - A 33% reduction in voluntary turnover
- **Key personal attributes**
  - An increase from 5 to 7 years in the average tenure
  - An 8% increase in the average performance rating of employees
- **Diversity**
  - A 33% increase in the diversity of tenure of team members
  - An increase % in the percentage of non-whites (from 10 to 15%)

**Productivity – individual level**

- **Tenure 3-5 yrs vs. tenure < 2 yrs**
- **BA vs. no college**
- **Two or more years industry experience**
- **Supervisory spans 10% less**
- **Ever rehired**
- **Time in position over 24 months**
- **Overtime over 300 hrs**
- **Higher than normal absence**
- **Recruiting source: Agency**

**Disguised case example**
BRINGING IT ALL TOGETHER:
FINANCECO’S PATH TO ENHANCING CUSTOMER VALUE
FinanceCo: knowing your employees as well as you know your customers

**Business Challenge**
Top-tier US financial services firm pursuing “customer-centric” strategy to drive growth
Focused on building additional sales to existing customers and expanding market share

**Critical Perceptions / Actions**
Company devoted significant resources to understand customer needs and expectations
Leadership understood that workforce management is a key factor affecting customer experience, but little research had been done on the employee side

**Analysis / Change**
Analysis: Rewards favored newcomers over incumbents (with customer knowledge)
Program changes: Realigning pay for performance, changing hiring mix, broad banding

**Business Results**
Annual potential revenue gain: $60 million
Overall, human capital factors explained a large fraction of the variance in performance across branches and regions.

Performance variance driven by people factors

Business performance metric:

<table>
<thead>
<tr>
<th>Metric</th>
<th>% of explained variance accounted for by...</th>
</tr>
</thead>
<tbody>
<tr>
<td>AGI per FTE</td>
<td>... all human capital factors (demographic, organizational and compensation factors)</td>
</tr>
<tr>
<td>Pretax income per FTE</td>
<td>... demographic factors only</td>
</tr>
<tr>
<td>Total customer retention</td>
<td></td>
</tr>
<tr>
<td>Retention of key customers</td>
<td></td>
</tr>
<tr>
<td>Market share</td>
<td></td>
</tr>
<tr>
<td>Average revenue per customer household</td>
<td></td>
</tr>
</tbody>
</table>
Business Impact Modeling® revealed significant value in firm-specific experience and rewarding performance

- **Financial**
  - Increase shareholder value (TSR)
  - Achieve profitable growth
  - Grow margins / Net income

- **Customer**
  - Market share
  - Product breadth
  - Improved product value/cost
  - Talent attraction
  - Rewarding performance & innovation
  - Acquisition integration

- **Operational and Process**
  - Grow firm-specific human capital
  - Talent development/retention

- **Learning and Innovation**
  - Grow firm-specific human capital (additional year of tenure)
  - Increase incentive elig by 10%

- **Gain in net income**
  - 6.9%

- **Gains in net income**
  - 4%

- **Marked share**
  - 2 pct points
  - 0.8%

- **Rewarding performance and innovation**
  - 0.6 pct points

- **Disguised case example**

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January 28, 2013
However, Internal Labor Market (ILM)® analysis showed that, other things equal, firm-specific experience was not rewarded.

The hire year-tenure groups shown have at least 94 employees active at year-end.
... due largely to FinanceCo’s growing tendency to “buy” rather than “build” talent
... which led to increasing turnover of seasoned high performers, placing the company at risk

<table>
<thead>
<tr>
<th>Performance rating in prior year</th>
<th>% of voluntary turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>86</td>
</tr>
<tr>
<td>Med-High</td>
<td>298</td>
</tr>
<tr>
<td>Med-Low</td>
<td>83</td>
</tr>
<tr>
<td>Low</td>
<td>6</td>
</tr>
</tbody>
</table>

Based on employees active at year-end and prior year-end. Limited to full-time regular, part-time regular and prime time employees.
To the surprise of leadership, the modeling also showed that increasing differentiation in pay would hurt performance.

**Impact of increasing pay differentiation on performance**

- **Market share (primary accounts)**
- **Market share (all accounts)**
- **Net Income per FTE**

Base pay level variance: +10%

*Disguised case example*
To address these and other misalignments, FinanceCo developed a workforce strategy focused on several key areas, including:

- Valuing incumbents (e.g., strengthening the “return to tenure”)
  - Ensure that seasoned, high-performers and high-potential employees have and recognize clear opportunities for career growth
  - Strengthen and highlight career milestones in career development and pay structure
  - Place greater emphasis in recruitment on broader employment package and career opportunities rather than pay

- Deepening incentive compensation
  - Extend pay for performance opportunities to customer-facing jobs at lower levels

- Expanding training and development
  - Invest more in training to broaden capabilities of existing workforce

- Capitalizing on an effective team culture
  - Preserve strong team orientation with differentiation focused more on career rewards rather than pay
In order to monitor the success of its workforce strategy, FinanceCo is developing a scorecard based on these key metrics.

**The Human Capital Scorecard**

<table>
<thead>
<tr>
<th>Metric</th>
<th>ASSETS</th>
<th>DIFFERENTIATION</th>
<th>DEPLOYMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metric</td>
<td>Direction / Magnitude of Desired Change</td>
<td>Metric</td>
<td>Direction / Magnitude of Desired Change</td>
</tr>
<tr>
<td>Ratio of hires to promotees in middle and upper levels</td>
<td><img src="image" alt="Meter" /></td>
<td>Skew of performance rating distribution, for each segment and level</td>
<td><img src="image" alt="Meter" /></td>
</tr>
<tr>
<td>Difference in retention rates between top and average performers</td>
<td><img src="image" alt="Meter" /></td>
<td>Payout differentiation by performance level (e.g., range of payouts)</td>
<td><img src="image" alt="Meter" /></td>
</tr>
<tr>
<td>“Return to tenure” – average pay increase associated with one additional year</td>
<td><img src="image" alt="Meter" /></td>
<td>Average time in last career level for high performers</td>
<td><img src="image" alt="Meter" /></td>
</tr>
<tr>
<td>Average base pay premiums for new hires</td>
<td><img src="image" alt="Meter" /></td>
<td></td>
<td></td>
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<td>Difference in retention rates between more and less tenured employees</td>
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*Disguised case example*
The results were impressive

• Introduced greater talent segmentation, allowing for smarter investment in talent
• Jump started multiple cross-business solutions, using cross-business teams
• Made significant payouts under cross-business incentives
• Improved employee satisfaction
• Improved selection and retention of senior staff
• Achieved substantial reductions in turnover and payroll costs
SUMMARY AND CONCLUSIONS
Key messages

- Above all, master your ILM – so you can shape how it operates to deliver the workforce you need today and in the future
  - HR’s “strategic” role is to help secure, motivate and manage the workforce required to achieve business goals
  - This role is facilitated by measuring and understanding the dynamic process that “produces” your organization’s workforce

- Capitalize on what no one else can know about your business
  - Modern electronic information systems combined with new measurement methods permit organizations to continuously review the running record of their own performance to determine what works and what doesn’t
  - In the process, you can increase the return on your substantial investments in these systems as well as on your enormous investments in human capital

Applying this new discipline will improve the decision process around human capital and support more reliable workforce planning