Measuring the ROI of Competency Management

Human Capital Institute

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By Ross Jones
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EXECUTIVE SUMMARY

Competency-based human capital management practices can prove to be of substantial value in real financial terms. In order to realize the return-on-investment (ROI) of such practices, a company must know how to measure competency and how it directly affects the bottom line.

Kirk Hallowell, a senior consultant at Talent Genesis, Inc., has studied the ROI of competency-based human capital management practices and understands the key business metrics that are utilized when a company is considering a capital investment.

"Let's say that your VP of IT or your VP of Operations wants to go before the senior executive team and ask for money for capital investment," which can be anything from technology innovation to expansion of a distribution center. The senior leader will need to know exactly what he has to take to the leadership team to make that business case.

A business case has many different parts, but "at a minimum, it's going to have to have a clear link to corporate strategy, a market or competitive analysis, a project plan with a firm timeline, and most importantly, it's going to have financials." Financials include risk analysis and ROI analysis, which are based on sound metrics and established financial practices.

An effective human capital management system takes the ROI of competencies into consideration and can offer a sound financial figure of how much competency is worth to a corporation.

DOES HR MEET THE SAME STANDARDS?

Solid business practices dictate that making an investment of any kind should be preceded by research and followed up with analysis, including an analysis of the return on the investment. But are human resource departments required to follow this standard when considering their investments in a performance management system?

According to Hallowell, "the average cost, including direct and indirect cost, for a performance management system is about $2,000.00 per employee per year." But only about 2% of organizations actually evaluate the effectiveness of those systems.

WHY COMPETENCIES AND ROI?

The standard formula used to calculate ROI can be found below:

$$\frac{\text{BENEFITS} - \text{COST}}{\text{COST}} \times 100 = \%\ \text{ROI}$$

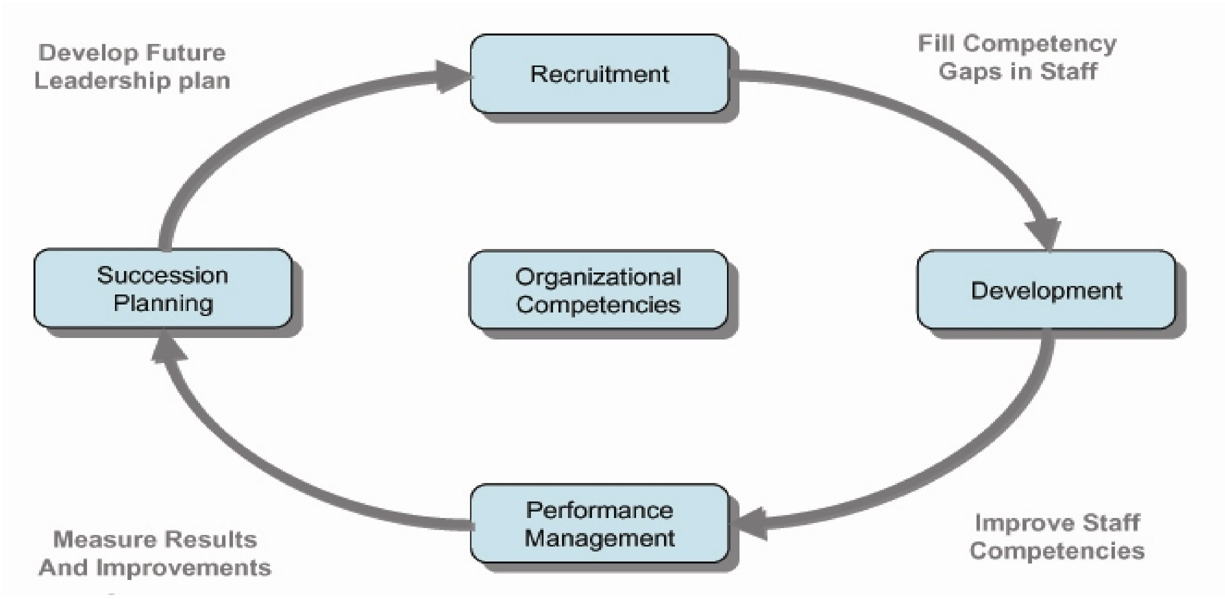
However, when we compute ROI "in the real world there are lots of variables in direct and indirect cost, so it is a far more complex computation."

He believes that companies need to think about ROI as a way of doing business, "a strategy and approach to human capital investment." This means that the ROI plan should include a basis in financial strategy, a clear process for implementation, and the use of key metrics for evaluation. These practices should be used to gather the necessary data needed to drive a process for continuous improvement in the performance management system.

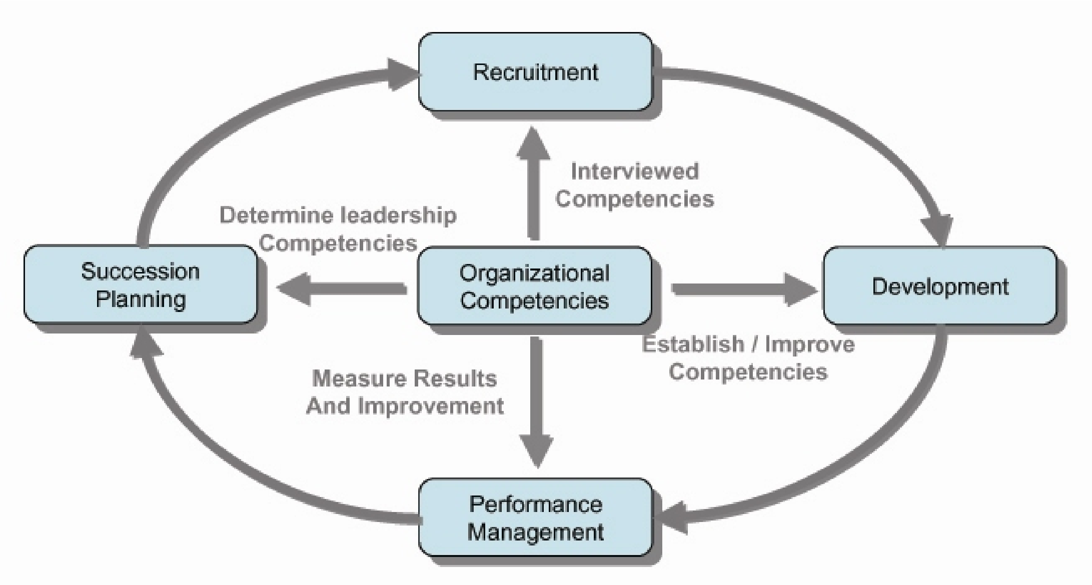
MAPPING COMPETENCIES TO HCM

Hallowell explains why competencies should be the basis of the ROI analysis of a human capital management (HCM) system. By definition, validated competencies predict performance. "If you have a set of attitudes, skills, and knowledge that don't predict performance, they are, by definition, not a validated competency."

Validation research is extremely well established, with over 35 years of it documented. "That's why competency structures are a standard part of human capital management practice." In addition, competencies are able to provide focus and structure across human capital management systems. As shown in the figure below, competencies can make key connections between all the phases of a human capital management system, from recruitment to succession planning.



Many HCM processes can be affected by competencies. If competency measures are used effectively, it generates accurate tools and measures needed to drive a successful system, as illustrated in the figure below.



A CASE STUDY: DARREN

The following case study illustrates how much a "mis-hire" can cost a company and the employee in real financial terms.

Darren is a software engineer with 12 years of experience. He earned a Master's degree in Software Engineering and was formerly employed by a large IT firm as a project/quality manager. His job was outsourced, and he was then hired as a project manager for a smaller, entrepreneurial company to oversee a $2 million software project.

In his previous job, Darren was adept at finding bugs in codes and eliminating them before production, a quality that served him well at the IT firm. However, this competency proved to be not as valuable in his new position, where his team worked very quickly and worried about eliminating bugs after production. Consequently, Darren was fired from his new position just 12 months later.

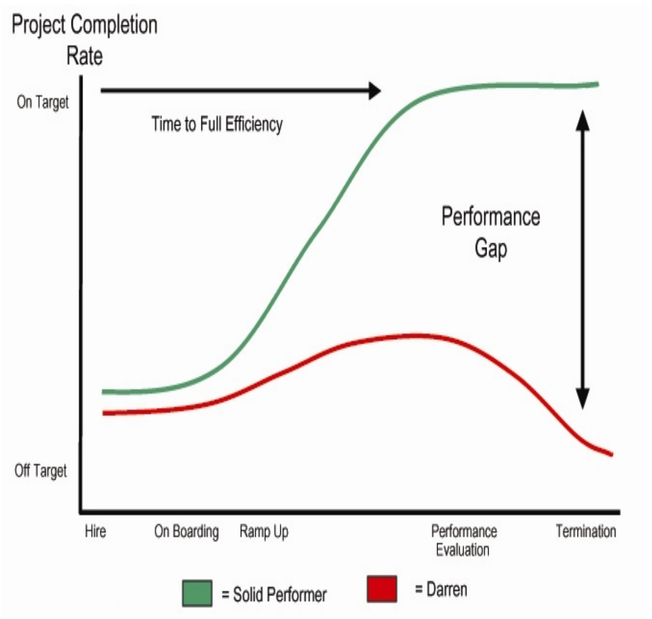
Hallowell points out that what organizations need from a good manager "is someone who can come into the organization, onboard quickly, ramp up, understand the project, get used to the culture, establish social networks necessary to get work done and hit somewhere in that process an on-target completion rate for that project."

The Hire to Performance Chain is made up of several different stages, and within those stages, an organization needs to be able to figure out the time and cost involved with human capital. The stages include:

- Posting of the position
- Recruiting candidates
- Selection of candidates
- Bringing the new hire on board (On-Boarding)
- Bringing the new hire up to speed (Ramp Up)
- Reaching the performance goal

THE PERFORMANCE GAP

In Darren's case, the time to hire was 45 days and the cost to hire was $9,000.00, which included a $5,000.00 moving expense. But in order to determine the cost from On Boarding to Performance Goal, the organization must consider Darren's performance gap (compared with a solid performer), as illustrated in the following figure.



The gap in performance can come from not being able to correctly identify the necessary competencies needed for a position or a project at the outset. While a resume may show adequate threshold competencies such as technical skills, planning, conceptual thinking, analytical skills, and the like, other competencies may be missing. Hallowell refers to the following as "differentiating competencies": communication skills, creativity, adaptability, conflict management, and influence. In Darren's case, the differentiating competencies that were required for a good project manager "weren't compensated for in the onboarding process." And there are other competencies, termed "cultural" that Hallowell says are often overlooked but need to be considered, such as speed of work, relationships, and enjoyment of work. "Once Darren got behind on his project and entered into the conflict process, he did not exhibit those kinds of competencies."

While Darren appeared to be a qualified candidate on paper, he lacked competency in the skills and attitudes that meant the difference between success and failure in this new organization. This difference resulted in failure for both him and the organization. Hallowell suggests that the total amount of time and cost spent in the hiring of Darren is $588,750.00 and 15 months, as illustrated in breakdown shown in the following figure. The ROI for this hire is computed to be -404%.

For the Company:

Direct Cost:	
Cost to Hire	9,000.00
12 month Salary + Benefits	97,000.00
Severance package (3 months)	24,250.00
	$145,500.00
Benefit:	
Projected Cost for Project at 12 Months:	
$2,000,000 @ 30% Gross Margin	
90-day overrun	(350,000.00)
Turnover Cost @ 125% Salary	(93,750.00)
	($ 443,750.00)

$$\text{ROI} = \frac{(\$443,750) - \$145,000}{\$145,500} = -404\%$$

Human Cost: Work overload, morale, productivity, separation

For Darren:

Cost to hire:	
Lost salary and benefits to hire (1 month)	$ 6,600.00
Insurance premium and deductible	$ 1,750.00
Job search costs	$ 1,500.00
	$ 9,850.00
Repeated costs from termination:	
Lost salary and benefits (per month)	$ 8,800.00
Indirect cost:	
One-year employment on resume	?
Questionable references	?

Human Cost: Personal and family stress, loss of self esteem, career block

With the utilization of integrated and aligned competency-based practices, from posting (using a competency-based job analysis) to selection (implementing behavioral interviewing) to ramp up (using mentoring, training, and coaching), interventions could have take place earlier to stem the cost associated with this "mis-hire."

Larry Clark, the Assistant Vice President of Executive Development for New York Life Insurance Company, examines ways to determine which competencies should be measured and the ROI for developing the right competencies. "Competencies are like apple pie and motherhood. Who would be against them? All of them are good things to do. How do I know which ones make a difference in the world I work in?"

THE STUDY OF CHOOSING THE CORRECT COMPETENCIES

In order to find out which competencies are most important, New York Life completed a study using 43 executives who completed the VOICES 360 feedback process on 67 competencies. Those competency ratings were correlated to the measures of First Year Commission.

The executives were asked which competencies they thought were most important and were given several competencies grouped into three categories: business, leadership, and personal. Most of them responded with competencies that were "all about leadership and personal behavior," according to Clark. But New York Life felt that what really drove performance in their organization was business-related.

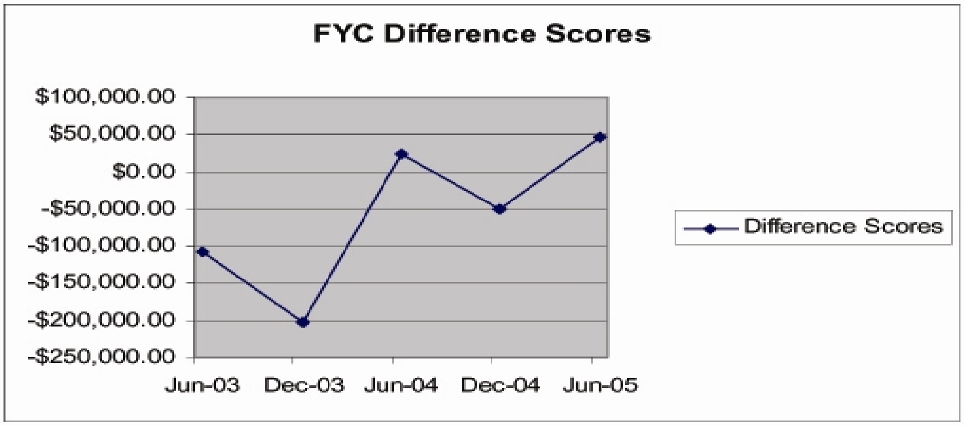
When people are asked what they feel is important, their responses are essentially referring to the culture of the organization. If one doesn't link those opinions to actual performance measures, though, research shows that they will only match about half of the important competencies right. The competencies that people *think* are important differ from those that actually *are* important. "You ought to ask about all of the competencies in your 360 degree instrument, not just the subset that people think is important."

TEACHING COMPETENCIES

New York Life created a "Management Leadership Series" (MLS) to study the effects of competency training and the ROI of the program. The MLS consisted of a four-session program that spanned a period of two years. Each session lasted 2½ days and was held off-site. The primary focus of the series was on the 13 competencies that made the most difference within the New York Life organization.

"In order to determine ROI, you have to figure out the cost." All possible costs need to be taken into account in order to accurately figure the return on the investment. In the case of this study, the total cost to conduct the training was $760,000. This included the cost for the presenters and the conference center, the travel costs involved, and two weeks salary for each of the participants.

There were measurable financial benefits (illustrated by First Year Commissions - FYC) over the two-year timeframe between those who participated and non-participants, as shown in the graph below:



Difference in Mean FYC: Participants vs. Non Participants

Clark explains that the net increase in FYC for the 27 program participants equaled $4,154,000 during the two-year time span, which translates to an ROI of 547%. In terms of dollars, Clark states that for every dollar spent on the MLS program, New York Life enjoyed a $5.47 gain in return.

"If you look across a lot of the research literature, you'll find that this 500 plus percent return on training programs is fairly typical," states Clark. The key to a high ROI is to discover which competencies make a difference and how much. Then an organization needs to determine if employees can be trained on those competencies, and if so, what kind of return they can expect from the training.

CHALLENGES AND STRATEGIES

Hallowell admits that there are some challenges in implementing human capital performance models, which can include:

- Lack of communication between departments, what Hallowell calls a "siloed mentally in the HCM process"
- Resistance to loss of ownership and control
- Focus – sometimes it's difficult to think strategically when concerned with day-to-day challenges
- Buy-in and accountability for competency structure – Are the departments using and accepting the structure?
- Lack of an integrated HRIS system - It "makes it hard to put hiring and performance data together in a cost-effective way."

But Hallowell also offers suggestions and strategies for implementing a human capital performance model, including: a change in leadership from the start, taking small iterative steps instead of large-scale integration, establishing interaction and partnership between finance and HR, implementing an effective HRIS system, and implementing an appropriate competency structure.

KEY QUESTIONS

There are some key questions that organizations need to explore and answer in order to successfully implement competency structures and measure ROI:

- What is our current level of competency alignment and integration across human capital management functions?
- What strategies and tools do we have in place to measure the impact of competencies?
- What key human capital management performance metrics will drive focus and action?
- Is there a cross functional project of limited scope to begin the alignment and metrics process?

Regarding the identification of key metrics that might be used, Clark says: "If you have a performance management system that has generic drivers of your performance, such as timeliness, quality, and customer satisfaction, you might be able to link your competencies to them." But Hallowell makes a point that "the challenge is when you get into higher levels of leadership, where direct impact on financial return is not as clear."

Two other points to consider are quality promotion and quality of separation. Hallowell suggests that one determines the competencies that can help an individual move into a management role. Additionally, one should uncover the types of competencies lost when someone does a voluntary separation for some reason. "Do we know that reason, and do we track what kind of competencies we're losing at that point? Because that's a loss of human capital."

CONCLUSION

Identifying the appropriate competencies and capitalizing on their development are the keys to success in many organizations. It is important to implement competency-based human capital management practices and analyze the ROI of those practices in order to determine the true financial value of employees or what it takes to replace them.

Organizations must recognize that there are costs associated with hiring the wrong person for the job, as well as benefits associated with providing a sound training strategy based on appropriate competencies. It is essential to be able to identify which competencies are fundamental to the bottom line.

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PRESENTER
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Kirk Hallowell is a Senior Consultant for Talentgenesis, Inc., an innovative human resource consulting firm delivering high impact, cost effective consulting and training solutions. Kirk specializes in the design, implementation and evaluation of competency-based talent development systems. He has worked with over 20 organizations across the United States to integrate competency models into leadership development, selection, and talent development processes including Prudential Financial, BP, International Truck, Textron and OSF Healthcare

PANELISTS
Lawrence Clark
Dr. Clark is an Assistant Vice President - Executive Development at New York Life Insurance Company. In that capacity, he provides expert consulting services to New York Life, its subsidiaries, and its senior executives. At New York Life he has been a member of two Core Competency Teams, a member of the Sourcing Committee, and a member of the SAP - HRD

implementation team. In addition he has major responsible for the design of the Leadership Effectiveness Program, Developing Excellence in Leadership, and the program for Vice Presidents. Prior to joining New York Life, Larry was Vice President of W. Warner Burke Associates, Inc., a Pelham, N.Y. based consulting firm. He has conducted research in the areas of managerial competencies, organizational climate, and management training. He is interested in applying organizational and social psychology techniques to problems that confront major organizations.

MODERATOR
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As Director of Talent Development and Leadership Communities at The Human Capital Institute, Joy brings twenty-five years of experience in multiple facets of organizational development, human resources and business management with an emphasis in customer satisfaction, service quality, process improvement, and applying the Malcolm Baldrige Criteria for Performance Excellence. As founder and President of Performance Partners in Health Care, a company dedicated to building better patient experiences, she has authored several curriculums in leadership and staff development, and co-authored with Harold Bursztajn, MD Senior Clinical Faculty member, Harvard Medical School, *Building a Treatment Alliance with Patients and Families.*

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The Human Capital Institute is a catalyst for innovative new thinking in talent acquisition, development and deployment. Through research and collaboration, our programs collect original, creative ideas from a field of top executives and the brightest thought leaders in strategic HR and talent management. Those ideas are then transformed into measurable, real-world strategies that help our members attract and retain the best talent, build a diverse, inclusive workplace, and leverage individual and team performance throughout the enterprise.

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