

What Price Talent?

Introducing a new metric
to understand the return
on investment in talent



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Finding True North

The staggering volumes of data underpinning business analytics represent a new strategic *tabula rasa* for executives. Recent research attributes this challenge not just to one of the emergence of 'big data' or even to its analysis, but to one of understanding how executives can best use analytics to improve business performance.¹

Firms are not short of data. Executives are, however, experiencing continuing challenges relating the magnitude of data they possess to meaningful insights concerning the performance of their business. This lack of progress was initially attributed to the infancy of analytics.² Questions concerning the strategic utility of the field to unlock value creation still remain, even for those organisations whose calculative capabilities now reach the dizzy heights of Thomas Davenport's "analytical competitors".³

Analytical insights are constantly emerging and being further refined. In a world where not just the volume of data counts but differentiating which data matter and why, both analysts and the executives whose decision-making they inform, require an objective yardstick or point of 'True North' against which they can gauge the contribution of analytics to overarching questions. Such questions are applicable to any firm, be they on existing strategy, current initiatives, future intentions, or mapping performance of the business against competitors.⁴

It is from this starting point that this research aimed to establish a satisfactory analytical yardstick with which executives can evaluate the specific contribution of their talent to the performance of their business. All functional analytics require a clear line of sight through to financial performance. The research focused on the human resources function due to its being a particular analytical honey pot, primarily because the function acts as a point of convergence for large volumes of data relating to employees. Despite such abundance of data, and not for the want of trying, an analytical pathway through which executives can plot data-driven insight into the *financial* contribution to business performance made by their employees is less clear.⁵

Becoming an analytical player

Analytics has become an integral part of the executive's skill-set. Drawing on the results of a major survey with responses from executives working within and without the human resources function (HR), the analysis revealed that the performance of senior HR executives, when viewed by fellow leaders across the business, appears to be enhanced substantially by success in four key aspects of their activities, as illustrated in Figure 1.

Figure 1. The four value differentiators

HR Executive Differentiator	Description
Networkers	HR executives are well networked with executives outside and especially within their companies. They are highly personable and possess deep business acumen.
Strategists	HR executives have advanced skills and experience in the formulation and implementation of strategy and of working with their executive peers.
Analysts	HR executives have advanced analytical abilities, understanding various metrics and data used to measure and establish business traction.
Executors	The credibility of HR executives requires that they lead and provide optimal services from their function to the rest of the organisation.

Business analytics has an important role to play here. Not just in terms of the analytical capabilities of individual executives themselves, but also in their capacity to interpret insights offered by analytics and to make operational interventions accordingly. This subsequently opens up an opportunity to make evidence-based contributions to wider ongoing conversations with colleagues across the business.

Analytics influences success in all of these discussions, often representing one of the key currencies of evaluation – be they related to financial, operational or strategic data – with which individual executives provide evidence to demonstrate they are executing on strategy.⁶

Talking analytically

If HR executives are to successfully interact with senior leaders across the rest of the business they require a certain level of business and analytic acumen to be taken seriously.⁷ Different firms collect different data in line with different business models, operating conditions, levels of emphasis, and analytical maturity.⁸ Ultimately, all data – big or small – have to demonstrate some form of traction against overarching business objectives.

Senior executives talk less about the results of functional analytics, such as how many training days they may have completed, or the cost per employee of human resources. They talk more instead about how their analytics contribute to their understanding of their activity's constantly evolving role in appropriating more value.⁹ One investment bank executive interviewed for this research neatly encapsulated the point: "HR needs to talk to me in *Excel* not *PowerPoint!*"

A solution to this challenge has been surprisingly elusive. Emerging from this 'analytical turn' has been an endless stream of new ideas, formulas and paradigms in which 'gurus' or 'fads' thrive with varying degrees of success.¹⁰

The problem is one of a clear line of sight. On one side of the equation there is confusion as to which attributes of people should be measured: many opt not to measure people at all but the systems and processes used by the human resources function to manage them. Related analytics consequently remain anchored to the initial level of administrative data as opposed to more penetrative insights relating to the capacity of employees' *talent* to drive financial value.

On the other side of the equation, where greater consensus on what to measure might be expected, a whole raft of different performance proxies are used. These range from different financial or behavioural metrics through survey data on the perceived performance of people, the HR function, or both. Consequently, the analytics deployed here, although translated into *Excel*, and purporting to refer to the *financial* performance of the business, in the final analysis, largely rest on *subjective* or *behavioural* data.

And then there is the problem of analytically uniting both sides of the equation. Research until now has sought to establish the link between investments in particular aspects of talent management to establish which practices matter most.¹¹

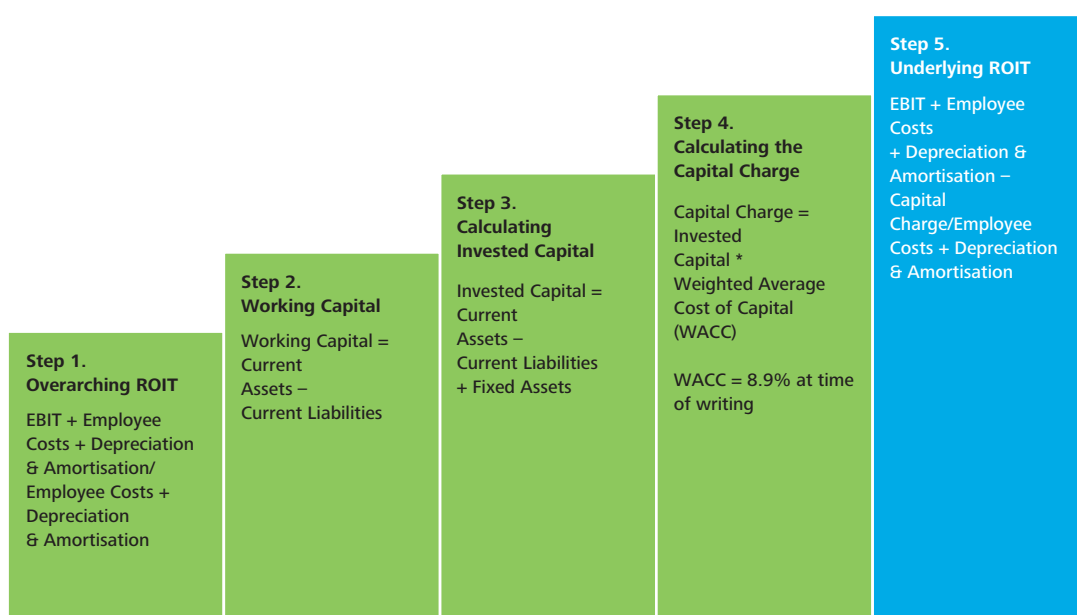
Establishing this link has been problematic. Just how problematic is demonstrated by the collective observation by leading scholars in the field that the best analytics on the table reveals investment in people can account for less than just five per cent of the variation in the financial performance between companies.¹²

To professional practitioners in research and consulting, this seems to be counter-intuitive. Are the returns from "our most important asset," really so meagre? Given that the cost of people in a typical firm lies in the range between 40-80 per cent of the operating costs, might a savvy chief executive be tempted to focus more on the factors driving the other 95 per cent of value enhancement?

Towards an analytical solution for talent

An answer revolves around the original exam question set by this research. If an estimate is sought of the level at which human resources interventions cause increased financial returns, challenges are immediately faced about the veracity of the initial claims. If, as an alternative, a solution is sought for the rate of financial return from a direct investment in talent using easily obtainable financial fundamentals, it may, initially, be difficult to understand what causes returns to rise and fall, but there is at least a clear financial line drawn in the sand from where analytical discussions in the boardroom relating to talent can begin, as shown in Figure 2.

Figure 2. Five steps to calculating your gross and net return on invested talent



As with other metrics, return on invested talent (or ROIT) is not a silver bullet. ROIT represents a lens through which the complexities of the financial impact of talent can be analytically viewed retrospectively and converted into the more financially nuanced perspective of the boardroom and wider investment communities.

This does not mean that the value proposition of people can simply be reduced to numbers. Getting the right balance between the analytical and artistic craft of executing decisions is where both the greatest opportunities – and challenges – in releasing talent’s latent value lie. With the ROIT metric on one side of the equation, a common currency with which to gauge progress against various analytics emerging from various combinations of big data on the other side of the equation is now available.

Moreover, the firm’s executives, its shareholders and other interested parties now have an objective line in the sand against which to measure the *financial* impact of employee-related interventions. Conversations about how much to invest in talent – or how much to scale back investment in talent – can now take place against the backdrop of an analytically informed evidence base. Whatever the strategic intent, or economic sector of the business, there are four key questions executives in all firms should be able to answer using the ROIT equation and wider analytics in the talent space.

1. What is the rate of return from our investment in talent?

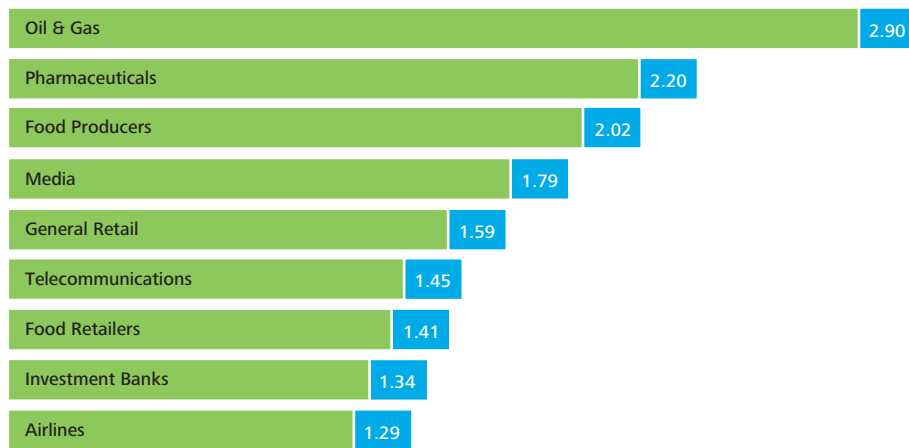
An analytical 'true north' needs to be established, against which talent's capacity to create value can be gauged. Tackling this issue head-on enables the initial contribution made by ROIT to the understanding of talent to be unpacked.

The basic unit of this approach emulates the same logic as Return on Invested Capital (ROIC), which reflects the relationship between capital and earnings. For the purposes of this research, invested capital is replaced with cost of talent, then the price of equipment provided is added, providing for amortisation and depreciation, and the result is then divided by the same.

The result gives a dollar value for returns before tax; for example a ROIT of 1.32 indicates a return of \$1.32 for each \$1 spent on employees. This is referred to as the *Gross Return on Invested Talent* (or ROIT-G). A ROIT value of greater than one translates into a profit after employee and associated costs (arrived at by simply subtracting 1 from the return), while a value less than one indicates a loss. Although ROIT is unit-less, a dollar amount allows ROIT and a range of other financial metrics from organisations around the world to be more easily compared.

Interestingly, on an industry basis, ROIT-G varies considerably, as shown in Figure 3. In a study of 300 European leading firms by market value, it was found that the oil and gas sector has the highest rates of return from talent, with pharmaceuticals in second place and food producers in third. The least effective rates of return from employees were secured by airlines, with investment bankers second from bottom.

Figure 3. Examples of ROIT-G by sector



Source: Deloitte Analytics

It is important to underline what is not being said here. Many factors can impact on ROIT, which may or may not be directly related to talent. For example, rising commodity prices in recent years have had what analysts describe as a more “material” impact on oil and gas prices than any underlying changes in the underlying capacity of the sector’s talent base. As one CEO said, “I can promise you, there is nothing that one individual employee at a company can do to make any difference to the revenues. The consultants can provide you with ‘all you can eat metrics’ but ultimately people are interchangeable: one good person can soon be replaced by another.”

Consequently, as with any fundamental metric, ROIT needs to be examined in combination with a wider range of financial and non-financial data before reaching conclusions over a company’s capacity to secure differential returns from its talent.

Above all, the leadership team requires laser-like clarity as to the primary ways in which the contribution of available talent interlocks with the operational requirements of the business it is in. How and where does talent add greatest value to the business? What is the balance between high value-adding skills and highly skilled people? One unlocks higher margins; the other risks driving them down through higher people costs. This critical balancing act of aligning a firm’s strategy with its talent, revenues, assets and margins has undone many executives and can soon dilute the value of talent’s capacity to drive value.

It might well be an organisation’s most important asset but some types of talent are more important than others. Not all talent can contribute high margins. It is vital to recognise that what might be described in cold analytical terms as internal loss-making talent entities may, when seen through a wider analytical lens, be providing critical services vital to the enablement of the release of financial value elsewhere within the business. Talent pipelines run on longer time-scales than economic cycles or short-term strategic targets. It is a fine line, taking the C-suite across the analytical line to the judgemental art of insight into a firm’s strategy.¹³

In short, ROIT provides executives with a language and metric to compare the rate of return from talent against other assets of the business, and gives them the financial and analytical tools to have meaningful discussions with other colleagues about the complex relationship between the allocation and sequencing of investment, employment strategy and corporate performance and the different value constellations of talent created by the firm.

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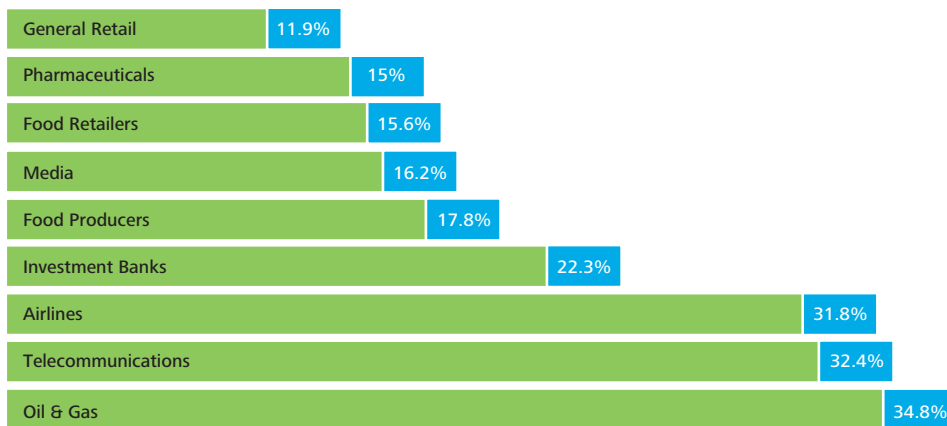
2. How does the return from our talent compare to the competition?

Many leadership teams and equity analysts tackle this question with more basic metrics including *Revenues per Employee* or *Profits per Employee*. The former offers insight in to the relationship between talent and top line generation, the latter with the bottom line. There are three problems here. First, both are subject to fluctuations by shifts in the numerator as well as by what some call 'denominator management' which equates to workforce reduction. Second, neither factors in the actual direct or associated costs of talent itself. Third, both do not include the impact of the company's own internal cost of capital, thereby distorting – often inflating – the perceived returns from investments in talent.

To accommodate this latter problem, a second and more granulated version of the ROIT equation can also be calculated by taking into account the cost of capital, which has risen in significance following the financial crisis. The weighted average cost of capital can be subtracted from the numerator in the ROIT equation to give a reduced value, which is referred to as the *Net Return on Invested Talent* (or ROIT-N). As before, one can be subtracted from this figure to arrive at the rate of profit generated by talent after factoring in its costs.

Again, the impact across sectors varies considerably depending on the capital intensity of the particular industry, as illustrated in Figure 4. By this measure oil and gas takes the heaviest hit, with telecommunications the second most intense consumer of capital. The sectors least impacted by capital charges are cash rich retail and pharmaceuticals, taking far lower impairments.

Figure 4. Capital charge hits



Source: Deloitte

The upshot of this is that the initial chasm in the return on invested talent between oil and gas and general retailers narrows sharply with the cost of capital factored in, proving first impressions about the rate of return secured from talent can be deceptive unless underlying organisational financial dynamics are taken in to account.

Such variations also underline the dangers executives face when drawing simplistic comparisons between the rates of return obtained from their workforces with those obtained by other firms, even within the same industrial sector. This is no better exemplified than in the airlines industry where clearly different business models are in play, as illustrated in Figure 5.

Figure 5. Comparing ROIT and typical financial metrics across two different business models

Airline	Revenue/FTE	Profit/FTE	ROIT-G	ROIT-N
Legacy	400,000	13,000	1.11	0.86
Low Cost	450,000	61,000	1.75	0.83

Source: Deloitte

At face value, both types of airline clearly secure different margins from their workforce from broadly similar employee-to-revenue bases. This is principally a function of their relative size: legacy airlines tend to secure similar operating income but have a workforce and accompanying cost base typically four times the size of low cost airlines. Consequently, the older airlines' ROIT-G lags behind the rate of return obtained by low cost airlines by some margin. By stripping away the underlying costs of capital, effectively factoring into the equation the financial management of both types of company, the underlying performance of talent in a typical legacy airline can be seen to at least match the rate of return from employees in their low cost competitors.

The older legacy airlines across the globe may have many deeply entrenched and long-standing ailments, which curtail their capacity to keep pace with their younger and more nimble low cost competitors. The rate of return obtained from their employees, however, does not appear to be the primary problem. It is perhaps not coincidental that different legacy airlines have recently been pursuing new and alternative strategies of consolidation through mergers, alliances and acquisitions to compete with lower cost models in a bid to lift their scale and revenue streams as opposed to merely trying to eat away at their own people cost bases. There is a different way of turning a dividend and demonstrates why investors have not deserted legacy airlines just yet.

The challenge for executives, then, lies in how they can glean insights into more efficient capital management from wider sets of big data. For example, through more detailed understanding of customers' future requirements, inventory can be better managed, which in turn translates through to more efficient working capital, which in turn leads to a reduced capital charge. Joining data traditionally owned by the finance and operating functions with employee data enables a shift not just from *PowerPoint* to *Excel* but also in the emphasis of people management from the minimisation of cost to the maximisation of return on investment.

The research has revealed that when examined over time, some companies and industries possess 'genotype-like' qualities in their ROIT, representing significant spurs or challenges to productivity improvement.

3. Can we improve the rate of return from our talent?

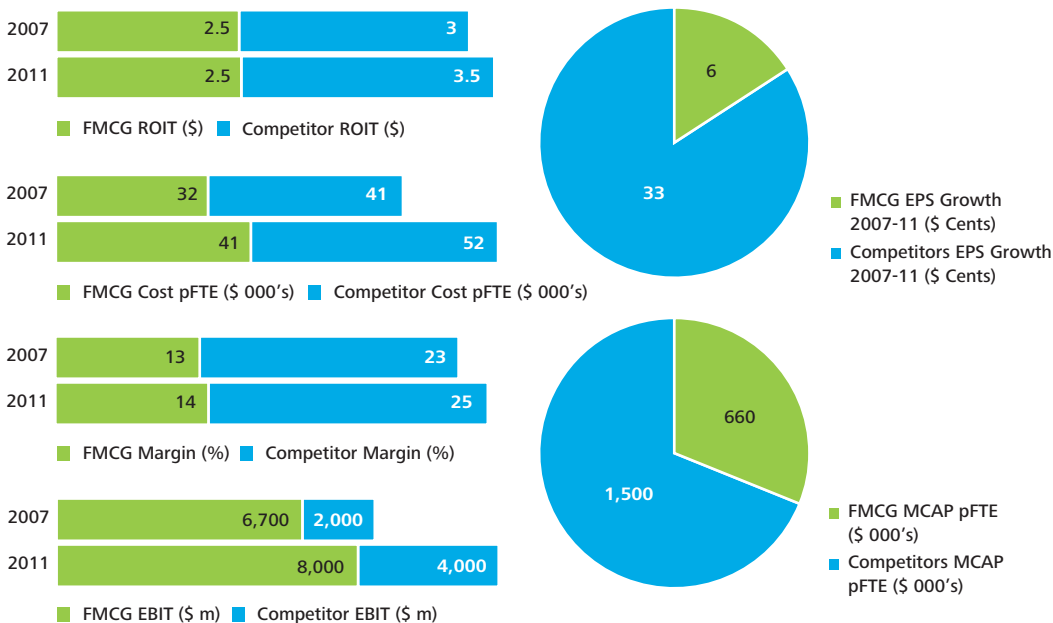
Leadership teams continuously seek productivity gains from their workforces. Any investment in talent is universally upheld as a sound investment. Imagine a scenario, however, in which you could track the returns from talent but over time analysis revealed that there comes a certain point where, no matter how much investment you pump in, or how many innovative talent strategies you import from elsewhere and all dutifully captured by your analytics, the productivity dial simply refuses to budge. What if the upshot of this analysis was that your people had a certain 'metabolic rate,' which, once reached, was unresponsive to investments beyond a certain level to improve it?

The research has revealed that when examined over time, some companies and industries possess 'genotype-like' qualities in their ROIT, representing significant spurs or challenges to productivity improvement. For example, in investment banking, salaries and bonuses are uniquely fixed at a certain proportion of revenues. Legacy airlines live up to their names carrying through older working directives over pay and conditions that limit their ability to make changes to existing business models and strategy. Other workforces, particularly those of larger and older companies, simply appear impervious to productivity initiatives, not for reasons always of their own making. Skills shortages, inflated salaries for scarce labour or other wider market dynamics can all be seen as contributory factors in determining the 'metabolic rate' of people.

Establishing metabolic rate is important because different aspects of investment drive returns from human capital across businesses and industries in different ways. It is precisely at this level of talent strategy and intervention where the C-suite needs to become analytically informed.

For example, in 2007 the CEO of a large and established fast-moving consumer goods company (FMCG) compared the ROIT of his workforce with that of a younger and smaller competitor, and concluded he needed to raise the metabolic rate of his people by up to 25 percent to match the rival, as illustrated in Figure 6.

Figure 6. A tale of two FMCGs



Source: Deloitte

Over the next five years the revenues of the long-established FMCG increased by more than 12 percent and profits rose more than 22 percent. However, ROIT remained stubbornly anchored around the \$2.50 range. Meanwhile, the competitor's ROIT increased by ten percent, and earnings growth outperformed.

When aligned with wider analytics, ROIT reveals some of the underlying dynamics at work in the performance of talent at an individual firm and crucially enables comparative analysis with competitor firms, often revealing significant differences in obtained margins, which, in turn, are influenced by deliberately different talent strategies on the one hand, or wider market dynamics on the other.

On a conventional viewing of people costs, one would conclude that the competitor's costs measured on a full-time-employee (FTE) basis were less productive than those of the larger FMCG firm. In addition, the people costs of both companies have increased at similar rates during the last five years.

Digging a little deeper, however, reveals an emerging relationship between higher rates of growth in ROIT and the underlying performance of the competitor firm's business, whether measured in returns to shareholders or the relative value that the stock market places on the heads of employees from each of the firms. The conclusion: the market rewards – directly or indirectly, it is difficult to know for sure – those CEOs who improve the metabolic rate of their workforce.

Such an outcome may not be the result of talent-specific strategy, however. The younger competitor firm had a clear strategy of hiring higher value-generating staff, albeit at more expensive rates but they also enjoyed correspondingly higher-value returns from their investment in their talent – a clear case of getting from talent what you pay for.

Critically, the competitor firm established the signals emerging from its wider analytics on consumer behaviour. Far from buying cheaper products in the face of the downturn, buyer behaviour was focusing on fewer, what were perceived to be more reliable albeit more expensive products. A micro 'war for talent' ensued between competitor firms, with many key employees moving to the smaller firms hoping for a less conservative strategy and faster moving product investment, innovation and go-to-market strategies. Older, larger and more established firms lost ground. Younger, more nimble and fluid firms continued their inexorable rise in revenues and share price.

This suggests the C-suite requires a clear view on the art of the possible in securing enhanced returns from talent. Competition for limited available capital resources, all competed for by different executives, each with different functional imperatives and targets to meet, is intense. The balancing act for chief executives and their teams turns on aligning these different functional imperatives and underlying talent strategies to enable the development of the appropriate organisational capabilities essential to meeting the delivery of the value propositions presented to customers identified by wider analytics and underpinned by existing and evolving strategy.

Here, the temptation is to invest specifically in talent in a bid to differentiate the value proposition of a firm's distinctive capabilities. Such a course of action may not necessarily be the most economically productive. Examining the reality between ROIT-G and ROIT-N alongside other performance metrics, and against which other investment imperatives are set, keeps executives honest insofar as they can make evidence-based estimations – in advance – on the balance between talent-based and wider capital expenditure-based investments in line with strategic intent.

A possible corollary of such deliberation might be the conclusion that lifting the metabolic rate of the workforce is possible by not investing in talent but in other complementary assets which later unlock corresponding and compounding rates of return from talent. Investment in wider analytics and product development aligned with wider consumer behaviour paid – quite literally – higher dividends for the competitor firm than specific talent-related programs. Indeed, recruitment, retention and employee satisfaction levels all increased in response to a change in market segmentation.

The subtle point here, then, is that ROIT is not an absolute measure or 'leading indicator' of corporate performance. The bottom line simply incorporates too many diverse factors unrelated to workforce productivity. What ROIT can do, when combined with wider analytics, is help executives establish how realistic it is to expect to improve the return on investment in their workforce and measure progress against those targets. One employee may indeed not be able to make a difference; but ROIT can enable the C-suite to model the difference a workforce can make in line with wider changes across the rest of the business. How big a difference represents the next challenge.

4. Is talent's value aligned with our strategic intent?

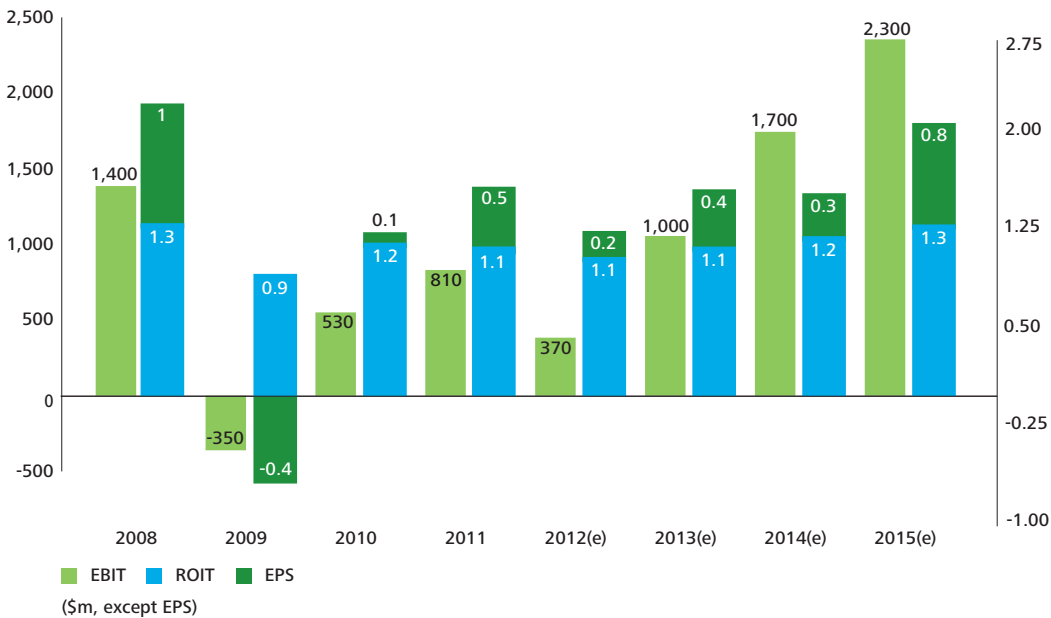
A constant problem for company leaders revolves around the setting of expectations of the future performance of their talent. Any announcements of future strategic intent attract both scrutiny and challenge from the investment community over the veracity of claims relating to projections of future performance. The ROIT equation can help both executives in making better projections as to anticipated future rates of return from their people, and aid investors in their evaluations of the feasibility of such claims.

One company, which we will refer to as *Wilcox* – in reality, a fusion of several companies – announced new targets executives hope to deliver by 2015 on the back of recently consolidating their position in the market. Achieved through a combination of enhanced customer service quality and greater consolidation and synergies through mergers and acquisitions, the revenue base has already doubled with significant efficiencies in operating costs. However, *Wilcox* experienced its toughest challenges in the workforce space, with employees concerned at changes to working conditions and unhappy with requests for higher levels of productivity.

Instead of managing employee costs through workforce reduction *Wilcox* chiselled out additional margins through changes to its strategy and accompanying business model, and on the back of recent impressive performance, the company's executives have subsequently set an ambitious \$0.8 earnings per share target for 2015, compared with an actual return of \$0.1 in 2010.

The challenge to consider here for all companies is one of having the requisite resources in place to provide competitive advantage and meet targets. Based on historical financial data and analysts' projections, the ROIT equation allows us to plot traction against wider strategic, operating and financial goals, the projected metabolic rate of a company's workforce factoring in past and projected performance.

Figure 7. Setting the future metabolic rate of Wilcox's talent



Source: Deloitte

Should a company's projected ROIT figures diverge significantly from historical ROIT numbers, it would give cause for concern. In *Wilcox*'s case the opposite was true.

This can be shown with reference to the ROIT 'high-water mark' of \$1.30, posted in 2008 when *Wilcox* hit a record operating margin and shareholder return, similar to the levels targeted for 2015, as shown in Figure 7.

With revenues effectively doubled, and the recent combination of operations across entities, there appears to be an optimal metabolic rate of performance for *Wilcox* people located around a Gross ROIT of \$1.30. This is an impressive figure in light of the fact that ROIT generally falls as workforce size increases. Nor is the basis for this projection all about talent, either.

If these projections are to be delivered a number of complementary efficiencies need to be delivered across other functions. Improvements in the rate of return from talent are to be enabled by other interventions revealed again by wider analytics – most notably in this case, the outsourcing of certain back office functions in technology and finance – which in turn are to drive working capital improvements as well as productivity in staff. A turnaround plan is also now in place to ensure newly acquired entities of the business rise to the rates of return obtained from the parent. A new operating model has also been designed on the basis of wider analytics revealing customer preferences and activity. The ROIT metric affords executives a clear line of sight through to progress with employees against operating and wider performance targets.

Of course, *Wilcox* executives need not feel they cannot improve ROIT beyond the \$1.30 level. But talent pipelines operate on longer time-scales than economic cycles and material changes in the gearing obtained from ROIT remain a significant challenge, particularly for the global behemoths. Nevertheless, organisations can break through their metabolic ceilings through a variety of strategies, such as new product innovation or mergers and acquisitions, but most involve long-term investment programmes as opposed to overnight transformations. Executives who claim major future metabolic improvements in the short term will receive short shrift without very solid evidence from accompanying analytics to underpin their projections.

Where the numbers finish, executive craft begins

In summary, corporate leaders must be able to make evidence-based strategic choices to drive the performance of their business. ROIT can help them do so, adding additional layers to the accountability, discipline and transparency to wider analytics complimenting the people value proposition.

But where the numbers finish the executive craft begins. Those responsible for driving the performance of talent carry the burden of weighing the contribution made by their firm's human capital against the wider dynamics revealed by analytics and acting accordingly. The ROIT equation, delivering an accountable, evidence-based metric, represents but a single, albeit significant step in rising to this challenge.

In summary, corporate leaders must be able to make evidence-based strategic choices to drive the performance of their business.

Notes

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About the research

After a short pilot exercise, a survey comprising 16 main questions was published online during which time a total of 263 responses were obtained. Of these, 159 were completed. Two in every three were senior HR executives, with 50 per cent of the sample being HR directors and an additional 13 per cent holding C-suite positions. Others described themselves as HR managers (14%), business partners (9%), experts (3%) or professionals (6%). The remaining balance (5%) comprised directors and C-suite executives from other functions outside HR. Survey respondents worked for companies in both the FTSE 100 and FTSE 250. Nearly three in every four (73%) respondents worked in private sector companies. The financial aspects of the research drew on data examining the fundamentals of over 300 firms in the EuroFirst and the firms comprising the S&P 500. The research also drew on a total of over 20 interviews conducted by Anthony Hesketh as part of his Golden Triangle research with CEOs, CFOs and senior HR executives in the UK, Europe, Asia and the US.

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