People Management Practices and Financial Success: A Ten-Year Study

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Many long-term research investigations begin innocently enough. And that was the case with my work on the link between people management practices and company financial success.

In the early 1980s I served on the advisory board of directors for Commerce Clearing House. The board was comprised entirely of human resources executives and company legal executives. At each board meeting we would go around the room and update each other on what was going on at our respective companies. Through this group, you got a good capsule summary of the latest trends in human resources and people management.

I noticed a simple trend. Those companies on our board that were doing progressive innovative work with people management also had good financial results. Those on our board who were doing only basic administration work had mediocre financial results. I speculated that this trend might be true for companies in general and not just an artifact of our board.

Research in this area was non existent. While it "made sense" that the effective management of people would correlate with company financial success, there were no facts or data to back this up. You could offer up only anecdotal evidence to support the idea. Given the lack of research, I decided to conduct a study.

The First Studies

At this time I headed up the Research Committee of the Society for Human Resource Management. It was under this group that the first study linking people management practices and financial success was undertaken. That was back in 1984.

I brainstormed a list of thirty people management practices that I thought might correlate with company financial success. For example, I thought that companies with participative management styles would be more financially successful than those with autocratic management styles. This was due to the fact that quality and customer service initiatives seemed to depend on at least a moderately participative management style.

While it made sense that the effective management of people would correlate with financial success, no data existed to back this up.

I turned this idea into a survey item that could be answered by employees. Not a job satisfaction question, but one that asks employees to describe, on a predetermined scale, how participative the company's management style was.

In this way I could quantify the results and correlate them with financial success. A similar process was used for the other survey questions.

Next I lined up thirty companies and their employees to fill out the surveys. In this way each company received a score on each of the people management practices being surveyed. The score on each item was the average survey response for all employees at that company. Unknown to the companies, I gathered financial data on each of them through public sources. This data included growth in sales, growth in profits, profit margins, and other hard financial results.

The first pilot was surprisingly successful. Twenty-two of the experimental items correlated with financial success. The composite of all items had a very strong correlation with the financial criteria. Some of the items washed out. For example, I thought that a rich employee benefits package might retain employees and in this way correlate with company financial success. In reality there was no correlation at all.

Given the success of the first pilot I quickly did a second with another set of companies. The items which predicted company financial success were retained for this next pilot. Results of the second pilot re-validated the original set of items. We also discovered several new items that correlated with company financial success.

Activity picked up rapidly after the second pilot. Altogether, we surveyed over 150 of the largest 500 companies between 1985-87. That list today includes over 330 organizations, roughly half of them in the *Fortune* 500 group. Altogether we have discovered eighty different people management practices that correlate with a composite index of financial success. Though it becomes increasingly difficult to discover new items that correlate with financial success (many new items correlate with existing items), we are constantly searching for more.

Financial Results

Table 1 shows the long-term financial results of our work. Over 200 organizations are represented in this table. We first calculated an overall score for each company on all people management practices. This is called the "PMP score." The PMP score was calculated by merely summing together the scores on each practice, all of which are measured on a five-point scale.

Next we split our sample in half based upon the overall PMP score. Those companies that scored in the upper half were called the "High PMP" group and those that scored in the lower half were called the "Low PMP" group. In essence, the higher-scoring companies are better at managing the people-side of the business. This is not our opinion but the actual scores of their employees on the survey items.

With each group of companies we then calculated the financial numbers reflecting their performance over the past ten years. As can be seen in Table 1, the relationships were very powerful. In all cases the High PMP group had much better financial data than the Low PMP group. These results were statistically significant in all cases. This shows a very powerful association between how a company manages people and financial success.

Financial Factor	**Companies with High PMP Scores**	**Companies with Low PMP Scores**
Sales growth	**16.1%**	**7.4%**
Profit growth	**18.2%**	**4.4%**
Profit margin	**6.4%**	**3.3%**
Growth in earnings per share	**10.7%**	**4.7%**
Total return (stock appreciation + dividends)	**19.0%**	**8.8%**

Table 1. People Management Practices and Financial Results. Figures in cells are based on ten years worth of data, but are annualized averages.

It is interesting to play "what-if " with the numbers in Table 1. Say, for example, that the Low PMP group was to change their people management practices to be like the High PNW group. The question might be: how much additional profit would this add for these companies each year? The high PMP companies grow their profits by 18.2% per year. In current dollars, this means they should average an additional $88 million in profits next year. The low PMP companies, by contrast, grow profits by only 4.4% per year. Next year this should translate to $21 million per company in additional profits.

The companies in our database would add $6.7 billion in additional profits if they could improve people management practices.

That difference of $67 million per company is astounding. It must be remembered that this benefit is incurred <u>each year</u>, not just for one year. Collectively the companies in our database would add $6.7 billion in profits each year if they could improve people management practices. For all companies in the U.S., the difference would be many times this amount.

The trends shown in Table 1 appear even if we look at just one year's worth of financial data. However, the differences between the two groups are not as strong. This no doubt reflects the vagaries that enter in when looking at any given year of financial data. You see more powerful relationships between PMP scores and financial success as the timeframe becomes longer. When looking at three-year or longer trends, the anomalies tend to wash out. What you find is that the companies who manage the people-side effectively attain better financial results.

Correlation Versus Causality

For the first few years of our research, critics would say, "You always imply that better people-management practices cause better financial results. It could be the other way around." What they were saying was that causality might be in the opposite direction--companies which make a lot of money might change their people management practices rather than the other way around.

While I could not prove them wrong I always felt that the direction of causality was that effective management causes better financials. Why? The following reasons apply:

1. Only six of the eighty practices we assess cost money to put in place. Another six actually save money (are cheaper) than not doing them. The net cost of all eighty is zero. Therefore, you cannot argue that companies that make a lot of money will spend it on people management practices since these practices, as we measure them, are not cost items.

2. If you were making a ton of money, why would you change your people management practices? Why would you, for example, make your management style more participative if you were making a ton of money being autocrats? There would be no logical reason to do this. Companies, in all likelihood, would continue behaving in the same way. Making lots of money would not cause them to change the way they manage people.

3. By talking to the execs at many of these organizations I got to know the history of the company, its culture, style, and values. Clearly, the leading companies did not change their people management practices once they started making a great deal of money. Their companies managed people well for a long time. They refined and improved how they managed people but did not dramatically change their practices as a consequence of making more profit.

Though logic suggested that people management practices caused financial results, my critics had a point. I could not prove with facts and data that this was the case. To do so would require that companies be measured on at least two points in time. Then you could determine causality.

Prediction Over Time

It takes three consecutive years of financial data for us to be confident of a company's financial performance. To assess changes in people management practices requires at least two measurements of the PMP score, with three years separating each measurement. We now have this data and more. We can assess causality rather than speculate on what is causing what.

Changes in people management practices bring about changes in financial performance.

Here is how we studied causality. Three years of company financial data was gathered prior to determining, the company PMP score. After the first assessment of PMP was completed, another three years of financial data was collected. Then the second assessment of people management practices occurred, three years after the first assessment. Finally another three years of financial data was collected for the time period following the second assessment.

From this we created deltas to examine change. One delta was the change in people management practices between the two assessments. Another two deltas were the changes in financials fi7om time one to time two and from time two to time three. We then treated people management practices as a predictor and examined what happened to financials. Next we did another analysis treating the financials as predictors and saw what happened to PNT scores. The statistical technique we used is called "crosslagged correlations."

When treating financials as predictors, the resulting correlation with people management practices is .14 (total of 52 companies). This is not statistically significant. When treating people management practices as predictors, the correlation with financial results is .86, which is statistically significant. This means that changes in financials do not cause companies to alter their people management practices. Rather, changes in people management practices bring about changes in financial performance. This result, based on 52 companies, when coupled with the correlational trend with over 330 organizations, makes a very strong argument for people management practices causing financial results.

Recently, I was going over these financial trends at a large utility company. One of the senior execs said:

"Of course people management practices should cause financial results. How could you run a good engineering department or a good accounting department without hiring the right people, training them, rewarding them effectively, etc. And these are the exact things you are measuring in the PMP score."

I told the executive that I agreed with him. I then asked, "How often is it when you try to improve financial performance that you look at factors like your management style, the effectiveness of training in building competencies, reward practices, etc.?" The room went silent and the exec replied, "That's why you are here."

Table 2 shows changes in profits for the 52 companies assessed multiple times. We classified companies into one of three categories based upon what had happened to their overall PMP score between the three years. More companies improved their score than stayed the same or declined. We then looked at how many additional dollars in profits each group had at the end of the financial period. This was three years after the second PMP assessment.

Companies that improved PMP added $294 million in profits per company, a gain of 60% over three years. The companies that did not change PMP showed an additional $78 million in profits per company, a gain of 16%. For the eight companies with declining PMP scores, they had $16 million less in profits than earlier, a decline of about 3% over the three years.

Change in PMP Score	Number of Companies	Change in Profit Growth ($ millions)	Ave. Change Per Company ($ millions)
Increase	**36**	**+10,584**	**+294**
No Change	**8**	**+624**	**+78**
Decrease	**8**	**-128**	**-16**

Table 2. Changes in Company Profits as a Result of Changing People Management Practices. Profit growth measured over 3 years.

This difference of over $200 million in profits per company over three years is very significant. Many a CEO has had a career made or broken over far smaller changes in profit, though it must be remembered that these are very large corporations.

The predictive data, like the correlational data, is quite clear. Companies that manage the people-side of the business more effectively increase their profits more rapidly. And the same is true for the other financial results such as the growth in sales and profit margins.

Table 3 shows changes in total return to investors over the same three years for these 52 companies. Total return here includes both gains in the value of the stock plus dividends, assuming the dividends are reinvested. Stockholders would clearly value by purchasing the stocks of the companies that have the best people management practices.

Change in PMP Score	Number of Companies	Change in Total Return (over 3 years)	Value of $1000 on Stock after 3 Years
Increase	**36**	**69%**	**$1690**
No Change	**8**	**45%**	**$1450**
Decrease	**8**	**20%**	**$1200**

Table 3. Changes in Total Return to Investors as a Result of Changing People Management Practices.

If someone invested in the stocks of companies that improved their people management practices, they would have gained 69% over three years (23% per year compounded). This is more than three times what they would have gained from investing in the stocks of companies that decreased in people management practices. Altogether, investors would have an additional $490 in total return for each $1000 invested. CEOs whose bonuses are based upon stock appreciation should take note. Not only would their shares be worth more, but they would likely see larger bonuses as well.

Survival

Many people commonly think that companies, once they are large, will be around forever. Actually, there are no guarantees. Forbes magazine pointed out in a recent special issue that only two companies in the 100 group today were in that same group in the year 1900 (they were AT&T and U.S. Steel). As the next table shows, things can change rapidly in just ten years.

1987 Group	Percent in Existence
Top 20 List	80%
Bottom 20 List	30%

Companies profiled here are those who made our Top 20 and Bottom 20 list in 1987. These lists were calculated by simply ranking companies based upon their overall PMP scores at the time. We then calculated how many of these companies exist at all today as separate entities. A total of 80% of the Top 20 group is still around while only 30% of the Bottom 20 have survived.

A total of 80% of the 20 group is still around while only 30% of the Bottom 20 survived

Many of these companies that no longer exist went through mergers or were acquired by others "to increase shareholder value." But many of those in the Bottom 20 had severe financial difficulties and this was the reason for their being acquired. None of those in the Top 20 which no longer exist had severe financial problems. This still shows the powerful and pervasive link between people management and success. Even with something as basic as survival.

Special Quality Study

We have done hundreds of studies with financial data and will continue these in the future. We examine different time periods, industry trends, company size trends and many other factors. Occasionally, we do specialized, one-time studies with our database. One of these was done with quality and customer satisfaction data.

We were able to get quality and customer satisfaction data on only a portion of the companies in our database (approximately 100 of 330). For the most part this data does not exist or is not publicly available. However, in some industries (e.g., the automobile industry) there is detailed information on the quality of company products and customer satisfaction with the products.

What we did was take the company overall rating on quality/customer satisfaction and standardize it against an industry norm. This means that each industry would have a mean (average) quality or customer satisfaction score of 100. A score of 110, for example, would translate to the exact same amount above the mean in each industry. This enabled us to combine company scores across industries.

We correlated each of the 80 people management practices with this composite quality/customer satisfaction score. We found that 60 or the 80 items had a significant correlation with success at quality or customer satisfaction. The item which correlated highest with quality was whether the company had a participative management style. Not surprisingly, this item has correlated highest over the years with our various financial criteria.

Bear in mind, our items were not developed to predict quality or customer satisfaction. They were developed to predict financial success. Yet it was interesting to discover the relation to quality. This is, of course, somewhat expected since success at quality plays a part in a company's overall financial success.

Our Current Work

We continue to search for additional predictors of financial success that pertain to people management. The predictive power of what we have is so strong that it is hard to improve upon. Yet we keep looking.

We maintain a qualitative database of company best practices in people management.

The eighty people management practices that we have found to predict company financial success fall into the following categories:

Management style
Company culture and goals
Organization structure
Communications practices

Quality and customer satisfaction
Recognition and reward practices
Employee development practices
Employee accommodation practices
Selection/promotion practices
Job design

Each of the eighty practices is measured on a five-point scale. This makes it possible for us to measure “soft stuff” with a great deal of precision. The scales enable us to roll together scores for an entire company and then do research with these scores. We have created national norms, industry norms, and leading company norms by grouping the 330 companies in our database into different demographic groups.

Best Practices Database

In addition to a quantitative database of company information, we collect a qualitative database. This tells us what the company is doing and how its scores got to be so high. We gather this information by doing a direct on-site examination of the company's people management practices. For example, we take a look at the exact recognition and reward programs and policies that exist.

In addition, we run focus group meetings with randomly chosen employees at a company. If the company is doing something exceptional in some aspect of people management, employees will tell us this in the focus group meetings. Likewise, if the company's activities are poor or missing, we would know this. The focus groups help us understand what the company does and what employees want.

The qualitative database enables us to provide companies with very specific recommendations on how to change their practices. For example, say that a given company has ineffective technical training for its employees and we know this through their survey scores. We can then look up the practice leaders in this exact area. We share with the company needing help who the leaders are and what they are doing that makes their technical training so effective.

We actively manage the best practices database, and share out the information in it with participating companies. This ensures that each company knows precisely how to change whatever needs changing. This database is constantly being updated, as is the quantitative database of norms.

Assessment Process

Companies that participate in the assessment of people management practices participate in the following activities:

1. Employee surveys (either sampling or the entire workforce).

2. Direct examination of people management programs and policies.

3. Focus groups of randomly chosen employees.

The information is then compiled into a composite for each company. Normative data of the company's choice is compiled. We write up a report detailing the company's strengths and areas to improve. Focus group comments are written up to highlight what employees had to say about the areas which need improvement. We then give the company a step by step plan for making improvements. This plan includes the benchmarks of what the leading companies are doing.

The typical company acts on the recommendations and makes improvements. Most complete the assessment process again from one to two years after the first assessment. In this way progress can be objectively evaluated. We try to get repeat data on every company that goes through the assessment process so we can track the data over time. Unfortunately, it takes years to study the relationship between people management practices and financial success, and there is no way to speed up the clock.

The Challenge Ahead

In working with people management practices for over ten years, we have had many observations. Overall, we have been very encouraged about the receptivity of organizations to making improvements in people management practices. The strongest selling point for them has been the tight link to financial results. We are, in effect, enabling companies to increase profits by

tapping, into areas that they had never thought of before. Most companies never think of better people management as a way to increase profitability. They tap into a new gold mine.

There are ways for the situation to be better. Our suggestions here are different for line managers and for human resource managers. We will consider each individually.

For line managers, many do not think about people management practices at all. Their focus is more on "things" rather than people. They think of goals, bottom-line financials, new products, new services, major initiatives, and the like. Employees are merely the means to an end. They get you the goal or financial results.

There are no losers in the game of people management.

What we try to say to such line managers is that people management, if done well, is the bottom line. You cannot attain your goals without people and if you focus on the process of how you manage people, you are more likely to attain the goal. Effective people management practices are end results. Managing employees effectively relates to every goal, every initiative, and every mundane activity that goes on in the workplace. It should receive a lot of attention.

This has been an educational process for some line managers. They were schooled on numbers, goals, engineering concepts, science, etc., not the “soft stuff” such as how you manage people. We have enlightened many with our hard data but this educational process has a long way to go. It is new and different for many line managers.

For human resources professionals, who most often hire us and coordinate our consulting work, the situation is different. In some cases they are not focused on the line business or hard numbers such as financial results. We have to tell them that they should pay attention to this and become more astute at it. Some can think only of people issues, and lack a more business oriented perspective.

In addition, many human resources managers focus on running their silos, be it compensation, benefits, training, employment or other HR functions. No one in the HR group, including the VP, is looking at broad people management issues such as management style, organizational structure, bureaucracy, etc. For these HR managers, the feeling is. "I'll help the CEO if he asks for it." Yet they do not take the time to broaden their horizons and think of larger people management issues in a consulting capacity. So the gold mine goes untapped.

For these HR managers, we have to educate them on broadening out, becoming a catalyst and champion for needed people management changes. We also have to tell them to think like a business person and focus on bottom line impact. In some cases, they might have to outsource some of the traditional HR administrative work to focus on these broader issues. For many, this is exactly what they are doing.

We are optimistic about the changes we see occurring. We think that both line managers and HR managers will develop perspectives beyond their traditional ones. They will see employees, and people management not as an area to give lip service to, but a critical component of company financial success. Both line managers and HR managers will partner together to assess the company's practices and make improvements where needed. That will benefit management, employees, the company, and stockholders. There are no losers in the game of people management.