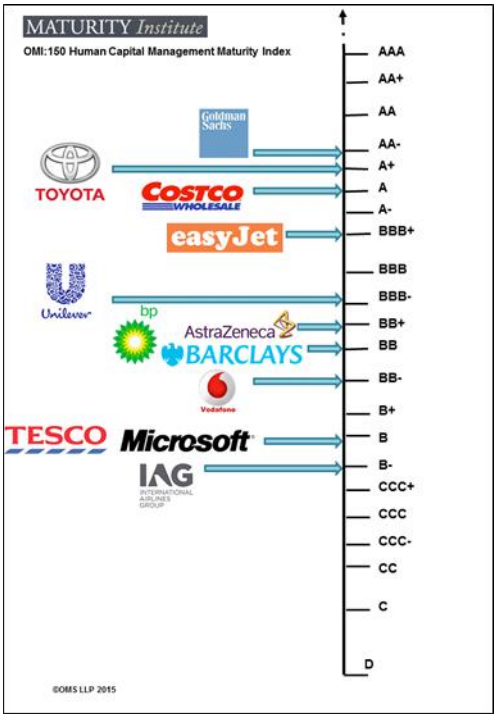
A Guide to OMI – The Global Index of Human Capital Management

"Based on our Organizational Maturity Ratings (OMR) for a sample of 60 of the largest (market cap) companies quoted on the London stock exchange today, the average score for their capability in human capital management is 51.5%. This represents a colossal shortfall in value that is being lost by shareholders, customers, employees and society at large. A much more professional attitude towards human capital management (HCM) has demonstrated the creation of significant increases in company value (Goldman Sachs AA-, Toyota A+, Admiral A+). The top 150 quoted companies currently have a combined market value of over £2 trillion: every 1% improvement is worth £20 billion. Human capital can no longer be treated as an intangible: bringing all companies up to AAA standard has to be society's goal. "

Paul Kearns, Senior Partner, OMS LLP - 30th March 2015.



Why the OMI index?

There have been strenuous efforts made for many years, within management academia, government policy forums and other institutions to produce a reporting format that organizations should follow with regard to their human capital. The UK attempted to do so through its 'Accounting for People' initiative of 2003 and has recently attempted this again through a cohort of organisations under a 'Valuing your Talent' project. In the US, the Society for HR Management (SHRM) attempted to produce HR investor metrics in 2013 and most recently the SASB has suggested industry specific standards, which include aspects of human capital management (HCM).

The Global Organization Maturity Index (OMI) is designed differently. OMI provides comparative data from OMRs on the capability of organizations to generate sustained value from human capital. It is based on the research-tested, whole system framework developed by the Maturity Institute (MI). It views the role of HCM as both crucial and integral to any total value management system and offers a consistent and objective methodology for analysing and measuring corporate effectiveness. This makes it a mutually attractive proposition for business leaders, investors and other stakeholders.

This is why OMS LLP was asked to undertake this particular exercise by Long Finance who wanted to include meaningful HCM data in their consolidated Good Governance Index (GGI).

Therefore, as part of its Global OMI, OMS produced a specific grouping from the top 150 publicly quoted companies (market cap) in London.

What does an OMR measure?

An OMR measures the effectiveness of the whole organization because the human capital dimension cannot be separated from it. In essence, it measures whether the organization has a coherent management philosophy and working methodology for creating maximum value from its entire asset and resource base. This level of coherence can only be achieved by means of a well-conceived strategy that ensures its simple societal purpose (making the best quality goods/services at the lowest cost) satisfies the mutual interests of shareholders, customers, employees and society at large on a continually improving basis. Any strategy that fails to do this is deemed to be sub-optimal.

An OMR adopts two clear and distinct perspectives towards the question of value: -

- **Market value**: both step change, through innovation, and incremental improvements measured by way of specific reference to baseline improvements in MI's four key product/service variables of Output (O), Costs (C), Revenue (R) and Quality (Q).

- **Operational Risk**: the probability of significant business risk attributable to ineffective HCM.

A company could already be achieving very high financial returns based on conventional criteria such as EBITDA, ROCE and RONA, for a wide variety of reasons, and yet it might be nowhere near its ceiling of performance. An OMR specifically identifies the extent of this potential value gap. Highly rated firms (BBB and above) should not only achieve significant competitive advantage from their human capital but extraordinary shareholder returns as well.

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Our approach

OMI is produced by listing the Organization Maturity Rating (OMR) for each company, which range from AAA to D. The primary research framework for the OMRs that make up the index is our OM30 Questionnaire supplemented, where necessary and relevant, by our extensive industry experience of particular companies and key personnel.

We contacted the investor relations team in the selected companies to advise them of the rating process taking place and invited them to engage with us by completing the questionnaire. Knowing the history of resistance to new thinking in HCM we were not surprised to find that not a single company chose to do so. We therefore rated our chosen sample of 60 companies and assigned the default 'B' rating to the remainder.

Our initial findings

Maturity predicts real, underlying value The index supports our proposition that human capital management is a key driver of sustained value creation over and above any business model they might currently follow. Costco does not suffer the shrinkage problems of Wal-Mart; Toyota's operating margin is 30 base points above VW. Higher ratings will also be associated with other key aspects of wider value creation as measured by independently recognised authorities on product & service quality and organizational sustainability.

Leadership matters for true HCM For those organizations that understand and have developed systems to leverage human capital value it is evident that current or historic leadership is the source of such strategy. For the most mature firms, leadership articulation of HCM was very obvious and specifically integrated into business strategy as a source of competitive advantage.

Learning & innovation are key differentiators The effective acquisition and use of knowledge, coupled with an embedded motive for never-ending improvement (NEI) are two critical facets for the mature organization; through which human capital generates sustained value.

Human capital issues are often categorised as corporate responsibility rather than mainstream corporate strategy It is perhaps unsurprising that those firms who fail to link human capital to value view people management within a corporate responsibility (CSR) framework and any measures they choose to use with respect to HCM tend to be simplistic D&I, health & safety, and employee engagement scores.

Little understanding of value as a whole system Many organizations still persist in viewing human capital as a cost rather than an investment: the prime reason why most accounting approaches to HCM reporting (e.g. Integrated Reporting, SASB) have floundered. A simple OM30 question enquiring about ROI calculations for HCM quickly reveals where the company sits on this issue. More importantly, recognition of the multi-dimensional, holistic nature of value is rarely manifest. For example, while annual reports often refer to headcount cost reductions (implying they can be read as bottom line savings) they fail to offer any evidence as to the likely negative impacts on quality, revenue and output. Without such evidence, and a mature attitude to the value of people, such pronouncements could prove to be false economies rather than beneficial.

Conventional people management is limited Within many company reports, and in wider corporate literature, the only significant mention of people management arose within the context of attraction (employer branding), retention (engagement) of staff and diversity compliance. These are the limited horizons of HR's professional institutions. The distinction between administrative HR and HCM was clearly seen when SHRM's first international HR standard focused on 'cost of hire'; yet its attempts at 'investor metrics' were withdrawn as many leaders are either unaware of or resistant to looking at people as value.

Human capital risk assessment and mitigation is rudimentary People risk has emerged since the GFC as a more obvious business issue to be assessed and mitigated. However, people risk that is most likely to potentially damage business operations (e.g. serious misconduct) is typically considered as a matter for procedural remedy or training rather than requiring a thorough and comprehensive review of all relevant human capital management systems. Additionally, the most serious risk issues (e.g. a banking culture of encroaching illegality) may even be ignored as "talent" attraction and retention remains the prime remit of HR functional activity.

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HCM reporting is inconsistent and disjointed There is still no common format in annual reporting to cover the subject of HCM. The most common items reported are engagement surveys, diversity/inclusion measures and compliance but with no clear definition or evidence that they produce tangible value.

People metrics produce little insight Companies often measure items that provide no insight to value (e.g. number of employees trained, cost per hire, number of training days, number of hours on community projects, employee participation in company surveys). Such measures appear primarily intended for branding purposes only - to paint a positive picture of the company's approach to people management. Rarely is there any serious, professional attempt made to link these to value outcomes. As such they are of little use in assessing the effectiveness of HCM.

Purpose remains elusive There is no common definition for key terms such as 'purpose', 'vision', 'mission' and 'strategy', which are used in different ways and contexts by different companies. This is a particular issue when considering the organization's over-arching reason for being. The single most important question on OM30 demands a crystal clear purpose with a societal focus; because without this strategic HCM will always be sub-optimal.

There remains significant unrealised value in company human capital Mature HCM regards people as a source for sustained competitive advantage. Any rating below AAA is therefore a signal that opportunity is being missed in terms of company value. The lower the OMR the greater the lost opportunity. The average score for the HCM capability of the sample companies (n60) is 51.5%.

How accountable are leaders? Accountability is another critical question and the search for clear, specific accountabilities at director and senior management level produced mainly evidence of 'responsibilities' without clear accountabilities. Additionally, there was virtually no evidence found for the term 'human governance' being used or the concept even being recognized.

People are not the greatest asset As UK companies in our OMI are the largest and, generally, most well established businesses their strength tends to come from market dominance, technical innovation, scale or simply a very successful business model. Where there is any mention of the importance of 'people' in this equation there is little evidence to add substance to their claims other than within the most mature organizations.

Executive remuneration is a broken system Executive pay continues to be a highly contentious and politically sensitive topic. Despite the copious pages in annual reports, which aim to justify executive pay and rewards, our perspective assesses the foundation principles for reward, how this fits into the corporation's whole system (if at all) and how it links to MI's definition of value. Our conclusion, based on the evidence thus far, is that there is still a long way to go to establish a coherent and tangible connection between Board/Exco remuneration, corporate value, corporate values, and effective business strategy. If nothing else, there are obvious questions to be asked about executive remuneration levels when the average are barely achieving above 50% for their human capital capabilities.

Next steps for OMI

Our ***Global OM Index*** is the world's first index that identifies the extent to which firms are able to generate business value and mitigate risk with respect to their human capital and is already being used for both broader and specific ESG analysis; such as good governance.

Our OMI will continue to grow as we are asked to engage with, and cover, more companies across various jurisdictions. As the index expands it will give specific and comparative rankings of fund-holdings for asset managers and act as an indicator of organizational health for other stakeholders. Independent analysis can also review the impact of human capital management capability on long-term investment value against any preferred measures.

Our aim is for the OMI index to become the key corporate benchmark; encouraging holistic leadership and a more reflective management philosophy that will help all stakeholders to focus on a wider and more sustainable form of value creation linked to the most mature and effective version of human capital management.

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