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HR on Top

by Edward E. Lawler III

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Breakthrough Thoughts

HR on Top

Outsourcing routine activities can turn human resources administrators into business strategists.

by Edward E. Lawler III

When a company is striving to ferret out costs and promote innovative management, all parts of the enterprise should be fair game. Yet in many companies, the human resources department has avoided change and is still run much the way it was 10, or even 25, years ago when it was known by the impersonal name of "personnel." In a typical large U.S. company, about one out of every 90 employees works in HR, a ratio that hasn't changed in decades. Spending on HR administration, which usually runs more than $1,200 per employee annually, has increased steadily, albeit slowly, over the past 10 years.

Illustration by Lars Leetaru

In the past decade, the Center for Effective Organizations at the University of Southern California's Marshall School of Business has conducted three studies (1995, 1998, and 2001) examining trends in the HR organizations of large corporations. In 1995, our survey of HR executives showed that the HR department spent 80 percent of its time managing such administrative services as payroll, benefits, relocation, record keeping, and the auditing and development of HR processes. When we resurveyed these companies in 2001, their executives' responses were the same.

Some HR executives do feel they actively advise line executives on managing their human capital — helping them to obtain, develop, and distribute staff in order to successfully execute business strategies. But their perceptions aren't necessarily shared. Seventy-nine percent of the HR managers participating in a 1998 survey described themselves as "business partners." Yet only 53 percent of the line managers responding to the same survey characterized HR managers this way.

There are many reasons the HR department has been slow to change, not the least of which is the widespread belief that human resources is simply a fact of organizational life that has little or no effect on business performance. The time has come, however, to see beyond this limited view. Technology is driving a revolution in the way HR administration can be managed, giving HR executives new data-collection and analysis

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tools with which they can more easily demonstrate the importance of effective human capital management — to strategy and the bottom line. Furthermore, large administrative cost savings can also be realized by outsourcing activities that don't contribute to shareholder value. Companies that hone HR's contributions in both the human capital strategy and administrative realms can build a significant competitive advantage.

Drivers of Change

Sophisticated new information technology applications and systems, and the emergence of technology-savvy business process outsourcers specializing in human resources administration, are the most significant drivers of change in HR.

Outsourcing of HR administration is not new, of course. For years, companies have outsourced specific services (typically payroll, benefits, relocations, and the management of HR information systems) to cut costs and improve service. But more and more, to reduce HR administrative costs even further, large companies want full-service human resources outsourcers, or HROs, that can deliver and manage multiple HR processes.

With paperwork for health insurance, compensation planning, flexible benefits, and legal compliance — to name just a few tasks HR handles — becoming even more burdensome and costly, demand for HRO services has grown rapidly. In 2003, HR services topped Gartner Inc.'s list of the business processes most commonly outsourced by large corporations; Gartner is projecting that in 2004 worldwide human resources outsourcing revenues will reach $51 billion.

The 1999 decision by the global energy company BP to outsource HR administration to the startup Exult Inc. was a bold move that has triggered growth in the number of full-service HROs. Others building positions as full-service HROs include companies well known in IT outsourcing, such as Accenture, and established HR consultants, such as Hewitt Associates Inc. and Fidelity Investments. The "soup-to-nuts" HROs handle HR process design and provide a full range of HR administrative services — payroll and benefits management, compensation, planning, recruiting, training of administrators, and management relocations. By offering integrated services, these HROs eliminate the difficulties involved in coordinating and managing multiple vendors. Similar to IT outsourcers, the HROs have a level of expertise and a scale of operations that allow them to achieve efficiencies and service levels their customers cannot match.

Full-service HROs rely heavily on Web-based "eHR" software applications and systems with self-service HR tools that allow employees to get routine information and submit forms through a company intranet. Self-service tools for managers are used for compensation management, employee transfers, and a growing list of activities that formerly required paperwork and discussion with the HR department.

Self-service is convenient for employees and relieves HR staff from time-consuming paper processing and interactions with employees. A few companies are also beginning to use self-service tools for career development and job searches. Using these tools, employees have excellent opportunities to research and apply for new jobs within their company, sign up for training, and get current information about their company's business performance. At BP, 50,000 employees have online access to job information, career guidance, and resources for skills development.

Outsourcing nonstrategic HR operations and giving employees self-service tools frees HR professionals to focus on acting as business advisors in organizational design, building management capabilities, assessing the costs and benefits of HR initiatives, and counseling on business strategy formulation and implementation. New HR information systems enable senior and midlevel HR professionals to perform powerful strategic analysis. For example, the latest systems can track and analyze data to link competency development, staffing requirements, and the funds needed to support a new product launch. Using specific competency data, for instance, HR can identify skill strengths and gaps, recruiting needs, and potential organizational changes, as well as control compensation and benefits costs.

Another new IT resource, employee relationship management (ERM) tools, makes it easier to capture and analyze data from multiple sources. The result: insights into the costs and causes of employee turnover, better measures of the return on investment of specific programs such as incentive plans and training offerings, and the ability to track individual employees' skills development and preferences. Like the better-known customer relationship management systems, ERM tools use advanced data-mining techniques.

HR outsourcing at Prudential, BP, and International Paper has reduced administrative costs by 15 percent.

Outsourcing Strategies

Outsourcing all HR administration is highly attractive to large companies. My research at BP, Prudential, International Paper, and Bank of America confirms that the outsourcing of HR administration and the use of self-service eHR systems have reduced the companies' HR administrative costs by more than 15 percent, while improving the quality of HR services. Furthermore, my research shows that companies that engage with a full-service outsourcer facilitate the integration of HR systems and increase the probability that their internal HR group will be liberated from administration so that it has the chance to be a strategic partner to business units.

But handing HR administration to an HRO and implementing self-service are radical actions that warrant close scrutiny. Ultimately, the outsourcing strategy needs to fit both the role top management wants HR to play and the readiness of the organization to adapt to significant changes.

Before entering into any discussions with an HRO, a company needs to know its HR administrative costs and quality. If a company is unsure whether outsourcing HR administration can save money, it probably hasn't carefully tracked its HR costs or service levels, because there usually is significant room for process improvements and labor cost reductions that can be achieved by outsourcing. An activity-based costing model is one tool that can help determine what is being spent on HR programs and services.

Wholesale outsourcing of HR administration is far more disruptive than outsourcing one task at a time. The HR department that emerges will look and feel very different than it did before. The size of the internal HR staff will be reduced rapidly and dramatically. Managers will have to get along without someone in-house to answer their HR administration questions and do their paperwork.

Organizations can count on resistance to and fear of change from their HR departments and the people they serve. For many longtime HR administrators, working in an HR department that isn't immersed in administration is not only undesirable, it's frightening. Many HR administrators truly enjoy helping managers and employees solve their day-to-day problems and take pride in their expertise. They worry about losing personal contact with their "customers." One way companies can respond to these employees is to transfer their jobs to the outsourcer. The HRO gets the internal knowledge and talent of its client's best administrators, which makes it easier for the HRO to build its service capabilities quickly. This is the approach IBM used when it outsourced much of its HR administration to Fidelity in 2002. Almost

1,000 IBM HR employees ultimately were transferred to Fidelity.

There is also the issue of whether HR staffs have the business skills to meet new expectations. My research, supported by recent research at the University of Michigan on HR competencies, indicates many HR professionals don't have the right skills and experience to take on more strategic responsibilities. Because they often have spent their entire careers in HR — or even in one specialty such as training, compensation, or recruiting — they don't have sufficient knowledge of the business or experience in assessing organizational effectiveness or leading change.

Adjusting to a self-service system of eHR can be difficult for many employees. Everyone needs time to get used to the electronic tools. Remember how people initially reacted to e-mail? Some took to it immediately; some were reluctant converts; and some still, to this day, prefer not to use it. At one company I studied, managers could do a number of administrative tasks (e.g., give raises, post jobs) on the company's eHR system, but they still preferred to deal directly with their HR contact. The company finally broke this habit by eliminating the human resources administrators so that line managers had to use the new self-service system.

Finally, it's impossible to overemphasize the importance of selecting the right vendor and managing the relationship from the outset as a close partnership. When the outsourcer steps in to run the process, many operational details can easily fall through the cracks and cause friction at a crucial time when the two parties are trying to build trust. An HRO, for example, can't instantly liberate HR managers from their administrative work, especially if imperfect data has to be corrected by hand to keep systems running smoothly, which is common in large companies.

Hiring outside experts in such areas as change management, organizational design, and business strategy is often necessary, but these decisions need to be evaluated separately from administration because they require a deeper understanding of an organization's market, its operating environment, and its business strategy. The HR pyramid shows which functions have the potential to create a strong competitive advantage. (See Exhibit 1.) Not surprisingly, many of the transactional HR processes that every company must perform have a low strategic value.

Exhibit 1: **The HR Pyramid: From Administration to Human Capital Advantage**

Organizational Effectiveness

One way to reframe the role of HR is to apply new terminology, perhaps replacing "human resources" with "organizational effectiveness," and appointing a "chief organizational effectiveness officer" with responsibilities for ensuring the organization has the right human capabilities and core competencies to meet its business goals.

With or without the change in language, the appointment of a respected senior executive who reports to the CEO and who can provide leadership in the areas of human capital management, organization design, and effectiveness is critical to setting a new tone and validating a new role for HR.

Two U.S. retail companies — The Home Depot Inc., in the home-improvement business, and Washington Mutual Inc., in financial services — have HR executives who were handpicked by the CEO for the top human resources job and given responsibilities far outside the traditional boundaries of HR. These executives are involved in all areas of business decision making — whether it is a long-term strategic initiative, such as buying and integrating companies; or changes in the market and brand positioning; or ongoing operational concerns such as managing supplier relationships, communications, and customer service.

"We in HR exist for only one reason: to increase the organization's capability," Daryl David, executive vice president of HR at Washington Mutual, told *Chief Executive* magazine last December. Mr. David, reporting to the chairman and CEO

Kerry Killinger, has played a pivotal role in Washington Mutual's growth by acquisition. Since 2000, the firm has completed seven acquisitions, expanding from a midsized regional financial-services company with 25,000 employees to a national player with more than 50,000 employees as of 2003. Mr. David and his team get involved in due diligence for each acquisition, in post-acquisition integration, and in planning for future organizational changes. In 2000, Linda Clark-Santos, a Ph.D. in educational administration and former senior HR executive at Starbucks, filled Washington Mutual's newly created position of senior vice president for talent recruitment and organizational capability, reporting to Mr. David.

Dennis N. Donovan, executive vice president of human resources at Home Depot, was one of the first senior executives hired by Robert Nardelli when he became CEO in December 2000. Mr. Nardelli recruited his former General Electric colleague because he knew Mr. Donovan could immediately dive into leading major strategy and change initiatives and tackle the challenges associated with rapid growth.

Mr. Nardelli set a corporate goal of growing the business from $48 billion to $100 billion. A key component in achieving that goal was opening new stores — at an average rate of 200 per year (or one every 43 hours). In 2002 alone, the company hired more than 180,000 people, and expanded in Canada and Mexico. Within a few months of his arrival, Mr. Donovan and his HR team came up with 300 different projects to initiate over a three-year period, many of them aimed at strengthening management and leadership skills in order to increase operating efficiency and customer service at the store level. For example, using information collected from a survey of 276,000 Home Depot employees, Mr. Donovan was able to link the turnover of store managers directly to store financial performance, and identify the store manager job as a pivotal position in achieving corporate goals. He also showed how rapid growth had drained Home Depot's store management pipeline and created service problems in some stores.

In response, the HR department introduced a learning forum for store and district managers, and within five months put 1,800 managers, many of whom were learning to develop strategy and create operating plans for the first time, through a week of intensive leadership training. Now there is an HR manager in every Home Depot store who works with store managers to facilitate staff education using e-learning kiosks. Home Depot also created the Leadership Institute with programs for developing functional staff and high-potential store managers.

High-Powered HR

The reinvention of the HR department is inevitable; the only question is how fast it will happen.

Fortune 100 companies are currently leading in outsourcing HR administration because they often have an IT infrastructure to support such an action. Small and medium-sized companies potentially have plenty to gain from HR outsourcing as well, so there is every reason to believe that more and more vendors will target them.

To thrive amid these changes, HR professionals must develop the skills to become strategic business partners. In some instances, the HR department that emerges following a major outsourcing could be a very small group whose only job is to manage the relationship with the outsourcer. This is likely to happen if the company's senior management takes the view that value creation at the top of the HR pyramid is too important to be left in the hands of an internal HR department. In this case, senior executives from other parts of the company may take on the strategic HR role themselves.

Some involvement in HR strategy on the part of executives is needed, but it shouldn't be a substitute for having HR staff who understand the business and can be strategic partners. Line executives who are not experts in managing human resources and organizational effectiveness just don't have the knowledge needed to link strategy and HR. Consultants can help, but they typically must be paired with respected insiders who have deep knowledge of their companies' strategic and operational needs.

Modern organizations need a high-powered staff group that focuses on how human capital should be managed, developed, and teamed in order to implement an organization's business strategy. Whether its work is called *HR* or *organizational effectiveness* isn't important. What is important is that the group exists, and is staffed with talented executives. +

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