

A New Way to Measure and Improve Profits?

One aspect of an article I read a couple of weeks ago¹ puts some rational basis to my long held belief that People are the most important asset in any company – particularly growing ones. The authors ask and answer the question - what gives us the best Return on Investment (ROI) in this knowledge based economy - traditional, “tangible” capital based assets or “intangibles” such as knowledge, relationships and the reputations of talented people (which companies can turn into institutional knowledge and skill, brands, software, patents etc.)?

Between 1995 and 2005, the market value of the 30 most successful companies in the world rose by almost 500%. This was driven by a similar increase – 500% - in average profits. (This makes sense - increase your profits and you increase the value of your company.) What caught my interest, however, was that during those 10 years, the companies’ average profit per employee grew by more than 200% even as the number of employees doubled while the return on capital increased by only 33.3%.

So could maximising returns on people (maximum profit per employee x optimum number of employees) be a new way to measure performance? After all, total profit = profit per employee x the total number of employees. The authors argue that focusing on this formula offers several advantages over focusing on return on capital. Profit per employee is a good proxy for earnings on intangibles, total employees is easier to define than capital (which is subject to interpretation using accounting and finance definitions). And this formula focuses us on the fact that (despite what has happened over the last few weeks) talented people, not capital, are usually the scarce resource.

If profit per employee is part of an acceptable measure of performance then proactively managing it is an effective way of improving performance.

Arguably there are more opportunities to increase profits relative to the number of people employed in this digital age than ever before. Other advantages are that profit per employee is easy to calculate; payroll is expensed rather than depreciated making it a conservative output-based measure of results and the calculation of net income is based on accounting rules, making for relatively objective comparisons between companies.

One way to increase profit per employee is to reduce the number of low profit employees (an incentive to move more quickly on poor performers).

Which raises the question of how you know which employees are contributing and which aren’t. The answer is to link department goals to the company’s goals and then link individuals’ goals to those of the department.

The responsibility – and power – for changing financial results lies in the hands of frontline managers. So, if we treat each department as a contribution centre, rather than a profit centre, then department managers are responsible only for the costs they can control, not the portion of overhead that is “allocated” to profit

¹ “Financial Performance Measurement for the 21st Century” by Lowell Bryan and Claudia Joyce of McKinsey Consulting. It appears in the Fall 2008 issue of the Rotman School of Management’s magazine.



centres. In this way, managers – and individual employees – can be focused on improving the activities of their department, and increasing their team’s motivation by producing results that are also good for the company.

But optimizing the number of employees doesn’t necessarily mean keeping their numbers low. The authors point out that Wal-Mart has relatively low profits per employee and a relatively large number of employees. Their business model is an example of how increasing the number of employees rather than the profits per employee can also increase the value of the business. Highly automated systems and processes in logistics and at the point of sale has allowed Wal-Mart to cut their supply chain and inventory costs and allows them to quickly respond to emerging sales trends. Those, combined with low labour costs, support the size of their staff.

The current standard used to determine how successful a company has been is its financial statements - Balance Sheet, P and L and cash flow. But these documents are prepared using Generally-Accepted Accounting Principles (GAAP) which treats investments in intangibles as expenses. The danger there is that when we need to increase profits in the short term – and I’ll bet we’ve all had to do that at one time or another - expenses are the first area we cut. So, we achieve our short term goal – but actually shoot ourselves in the foot in the longer term.

So I’m all for any measure that puts human capital (people) where it belongs – front and centre in business owners’ minds – while promoting long term growth. In our [5 P Solution](#) we talk about the importance of People and offer [6 Tips for Finding and Keeping Good People](#) So let’s change the metrics we use to measure successful performance so that they include returns on talented people as well as returns on capital investments.

As usual, any misinterpretation of what Lowell Bryan and Claudia Joyce are actually saying is entirely mine. To take issue with anything I’ve said or to share your thoughts or experiences, send me an email at jimstewart@profitpath.ca or call me at 416-258-9610.

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