

The new metrics of corporate performance: **Profit per employee**

Most measurements of performance are geared to the needs of 20th-century manufacturing companies. Times have changed. Metrics must change as well.

Lowell L. Bryan

Let's get right to the point: companies focus far too much on measuring returns on invested capital (ROIC) rather than on measuring the contributions made by their talented people. The vast majority of companies still gauge their performance using systems that measure internal financial results—systems based on metrics that don't take sufficient notice of the real engines of wealth creation today: the knowledge, relationships, reputations, and other intangibles created by talented people and represented by investments in such activities as R&D, marketing, and training.

Increasingly, companies create wealth by converting these “raw” intangibles into the institutional skills, patents, brands, software, customer bases, intellectual capital, and networks that raise profit per employee and ROIC. These intangibles are true capital, in the sense of delivering cash returns, even though the sources of those returns are intangible. Indeed, the most valuable capital that companies possess today is precisely intangible rather than financial.¹ Companies should redesign their financial-performance metrics for this new age.

¹Karl Erik Sveiby, *The New Organizational Wealth: Managing and Measuring Knowledge-Based Assets*, San Francisco: Berrett-Koehler Publishers, 1997.

Article at a glance

Today's approach to measuring financial performance is geared excessively to the capital-intensive operating styles of 20th-century industrial companies. It doesn't sufficiently account for factors such as the contributions of talented employees that, more and more, are the basic source of wealth.

Financial performance—observed through balance sheets, cash flow reports, and income statements—is and always will be the principal metric for evaluating a company and its managers. But greater attention should be paid to the role of intangible capital and the ways of accounting for it.

The superior performance of some of the largest and most successful companies over the past decade demonstrates the value of intangible assets.

Companies can redesign the internal financial-performance approach and set goals for the return on intangibles by paying greater attention to profit per employee and the number of employees rather than putting all of the focus on returns on invested capital.

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Consider a simple approximation of intangible capital: the market value of a company less its invested financial capital. Using book capital as a crude proxy for financial capital, in 2005 the intangible capital of the world's largest 150 companies was \$7.5 trillion, versus \$800 billion in 1985.

Despite the evidence that intangibles are now the true source of corporate wealth, companies tightly control discretionary spending on them. Advertising, R&D, new-product development, training, knowledge creation, software projects, and so forth are almost always expensed on a "What can we afford?" basis. Why?

One reason is that accounting for intangibles is difficult. In particular, each intangible's specific contribution is hard to assess; how, for example, do you value a brand? Intangibles are embedded in the value chain of production, so it generally isn't clear which intangibles are the sources of profits—or what specific balance of intangible and tangible assets should get the credit (or blame) for results.

The bigger problem is that most companies gear the way they measure their financial performance to the needs of an earlier industrial age, when capital enjoyed pride of place in the minds of strategists and investors. Companies fill their annual reports with information about how they use capital but fail to reflect sufficiently on their use of the "thinking-intensive" people who increasingly drive wealth creation in today's digital economy. The development of external financial reports according to generally accepted accounting principles (GAAP) ranks among the principal foundations of our modern global capital marketplace. Financial performance

(seen through balance sheets, cash flow reports, and income statements) no doubt is and will remain the principal metric for evaluating a company and its management. But it's time to recognize that financial performance increasingly comes from returns on talent, not on capital.

GAAP accounting currently treats investments in intangibles conservatively, compared with the way it treats capital investments in tangible assets. Intangible investments are mostly expensed, not capitalized. This conservatism isn't necessarily bad but does inspire top managers to cut discretionary spending on intangibles in order to deliver quick earnings. That approach may raise short-term profits but can also undermine a company's long-term health.

To boost the potential for wealth creation, strategically minded executives must embrace a radical idea: changing financial-performance metrics to focus on returns on talent rather than returns on capital alone. This shift in perspective would have far-reaching implications—for measuring performance, for evaluating executives, even for the way analysts measure corporate value. Only if executives begin to look at performance in this new way will they change internal measurements of performance and thus motivate managers to make better economic decisions, particularly about spending on intangibles.

Measuring financial performance in the digital age

Before exploring the new metrics needed to achieve these goals, let's reflect upon the way some companies have recently created great wealth by using their thinking-intensive people rather than their capital.

In past articles, my colleagues and I have examined how, from 1995 to 2005, the top 30 of the very largest companies in the world (ranked by market capitalization) have seen their profit per employee rise to \$83,000, from \$35,000.² On average, the number of people these companies employ has grown to 198,000, from 92,000, and their ROIC (or book value, in the case of financial institutions) has increased to 23 percent, from 17 percent (Exhibit 1). As a result, the median market cap of this group of companies rose to \$168 billion, from \$34 billion, with total returns to shareholders (TRS) at 17 percent a year. The driver of this dramatic rise in market cap was a fivefold increase in average profits—an increase brought on in turn by a more than 100 percent jump in profit per employee and a doubling in the number of employees. By comparison, these companies' ROIC increased, over this same period, by only a third.

²Lowell L. Bryan and Michele Zanini, "Strategy in an era of global giants," *The McKinsey Quarterly*, 2005 Number 4, pp. 46–59.

EXHIBIT I

Soaring profits

Drivers of growth for 30 largest companies,¹ 1995–2005



¹US and foreign companies by American depository receipts, top 30 by market capitalization in 2005; excludes outliers and companies with negative net incomes.
²Total returns to shareholders.
³Or book value, in the case of financial institutions.

It is hardly a surprise that growth in profits and market caps should be closely correlated and that a fivefold increase in profits should lead to a similar increase in market caps. But these results do suggest that companies need to take a new approach to measuring financial performance—an approach based on maximizing returns on people. Total profit, after all, is the product of profit per employee and the total number of employees, so maximizing both expressions increases total profit, which drives market capitalization.

Concentrating on this formula (as opposed to returns on capital) offers several advantages. For one, unlike ROIC, profit per employee is a good proxy for earnings on intangibles, partly because the number of people a company employs is easy to obtain. Capital, perhaps surprisingly, is subject to the vagaries of accounting definitions and such corporate-finance decisions as debt-to-equity ratios, dividend policies, and liquidity preferences. As we’ve noted, and as any executive will testify, talent—not capital—is usually the scarcer resource.

Clearly, then, a new set of metrics could help companies gauge their performance more effectively. Executives should home in, first, on how much profit per employee a company generates. They should make the number of employees a key factor in strategic thinking. And they should keep a clear eye on ROIC, but more as a way of ensuring that the company earns more than the cost of that capital than as an aspiration in its own right. With these metrics, the company can set its goals for the return on intangibles

(that is, profit per employee) and growth (the number of employees), as well as its return on capital, which is largely a sanity check. Together, these three metrics squarely highlight—and drive—market caps.

Profit per employee

If a company's capital intensity doesn't increase, profit per employee is a pretty good proxy for the return on intangibles. The hallmark of financial performance in today's digital age is an expanded ability to earn "rents" from intangibles.³ Profit per employee is one measure of these rents. ROIC is another. If a company boosts its profit per employee without increasing its capital intensity, management will increase its rents, just as raising ROIC above the cost of capital would. The difference is that viewing profit per employee as the primary metric puts the emphasis on the return on talent. This approach focuses the minds of managers on increasing profit relative to the number of people a company employs. It suggests that the most valuable use of an organization's talent is the creation and use of intangibles. Fortunately, the opportunities to increase profit per employee are unprecedented in a digital economy, where intangible assets are a rich source of value. Opportunities to improve ROIC to an equal extent are hardly as plentiful.

Another advantage of profit per employee is that it requires no adjustment for accounting conventions. Since companies expense their spending on intangibles but not on capital investments (which are usually depreciated over time), profit per employee is a conservative, output-based measure. And since it is based on accounting conventions, companies can easily benchmark it against the comparable results of competitors and other companies.

Profit per employee therefore focuses companies on intangible-intensive value propositions and, in turn, on talented people—those who, with some investment, can produce valuable intangibles.

Number of employees

One way to improve a company's profit per employee is simply to shed low-profit employees. But if they generate profit greater than the cost of the capital used to support their work, shedding them actually reduces the creation of wealth, unless management adds an offsetting number of workers who produce a higher profit per employee.

The Walton family, remember, consistently sits atop the *Forbes* annual wealth list. Why? Because Wal-Mart Stores, the company the family controls,

³ Economists define rent as the profit earned after a company pays for all of the factor costs of production (labor, raw materials, and so forth), including the cost of capital.

not only hires large numbers of employees who generate a relatively low average profit⁴ but also uses a business model that enables it to handle the complexity involved in managing huge numbers of employees, without incurring offsetting diseconomies.

Real wealth creation therefore comes from increasing either a company's profit per employee (without offsetting reductions in the number of employees or offsetting increases in capital intensity) or the number of employees who earn that level of profit—or both. We can observe this dynamic on a simple grid that illustrates the source of the profit earned by a company and a competitor (Exhibit 2). The grid also shows how total employment can serve as a crude proxy for the internal complexity of any organization, particularly when it is compared with companies in similar industries that have a comparable employment mix. From this vantage point, profit per employee becomes a proxy for how well a company manages that complexity.

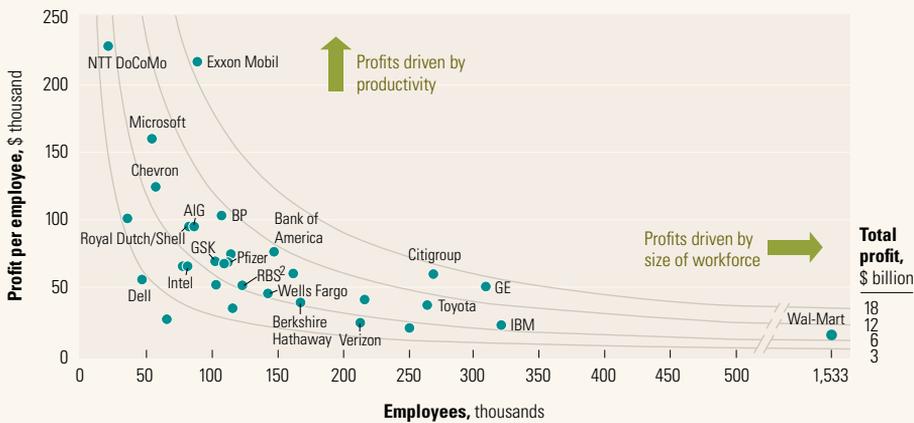
A company can, of course, streamline its organization and use tools such as formal networks, talent marketplaces, and knowledge marketplaces⁵

⁴In 2004 Wal-Mart employed 1.7 million people, who generated an average profit of \$6,200 each.
⁵For more information on talent markets, see Lowell L. Bryan, Claudia I. Joyce, and Leigh M. Weiss, "Making a market in talent," *The McKinsey Quarterly*, 2006 Number 2, pp. 98–109. For more information on knowledge markets, see Lowell L. Bryan, "Making a market in knowledge," *The McKinsey Quarterly*, 2004 Number 3, pp. 100–11.

EXHIBIT 2

Talent as profit driver

Drivers of profit for 30 largest companies,¹ 2002–04 (average)



¹US and foreign companies by American depository receipts, top 30 by market capitalization in 2004; excludes outliers and companies with negative net incomes.

²Royal Bank of Scotland.

to mobilize intangibles throughout the enterprise. To the extent that it does so, its profit per employee should increase, even in the absence of profitable new value propositions, if it removes any unproductive complexity.

Returns on capital

A company can also improve its profit per employee by substituting capital for labor costs. Of course, while capital is relatively inexpensive and readily available, it demands a return and for this reason must be used carefully. But if the company uses total employment to drive its growth aspirations, the amount of capital it requires will be a derivative of the capital its employees need for their work, rather than an independent aspiration.

Executives should therefore look at ROIC mainly as a sanity check. So long as the return exceeds the cost, profit per employee is the better metric because it not only represents the scarcest resource but also reflects profit after the expensing of necessary investments. Capital investment, meanwhile, is depreciated or amortized.

Using the total number of employees as a metric also allows companies to avoid subjective accounting judgments.⁶ Book capital, on the other hand, is—surprisingly—relatively ambiguous, for it is subject to somewhat arbitrary accounting conventions that involve goodwill, depreciation schedules, and the way companies expense stock options, among other things. Calculations of a company's ROIC have their own limitations, particularly for financial institutions, whose assets are mostly financial. Invested capital is not only a meaningless concept for such companies but also requires them to make some heroic assumptions.⁷

Maximizing market capitalization

The goal of these efforts to reorient financial-performance metrics around talent, of course, is to maximize a company's market cap, perhaps the most important single measure of size and economic relevance. The market cap directly affects a company's ability to control its own strategic destiny and is highly correlated with its total net income; of the top 30 companies by net income from 2002 to 2004, all but 5 were in the top 30 by market

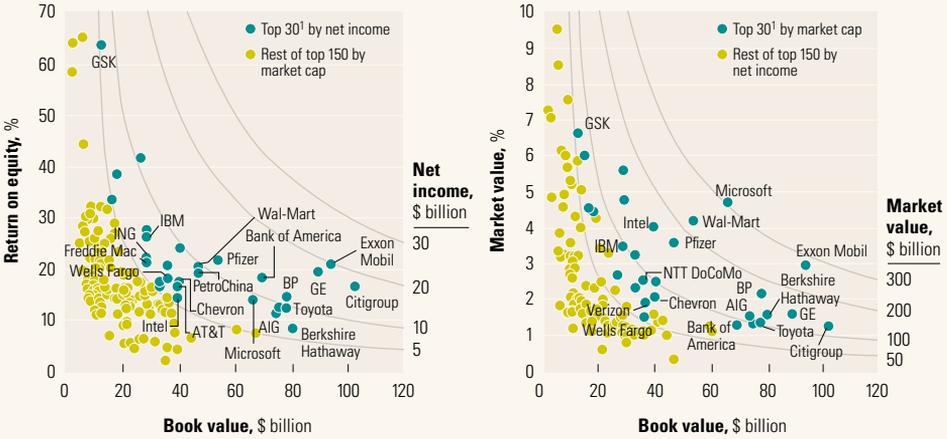
⁶ According to some observers, the many temporary contractual workers that certain large companies use should be counted as employees. I disagree. These workers may depend on the company for work, but they are largely fungible labor and usually don't undertake the intensive intangible work that drives a company's profits. This is exactly why companies choose to rely on contractual labor.

⁷ See Felix Barber and Rainer Strack, "The surprising economics of a 'people business,'" *Harvard Business Review*, June 2005, Volume 83, Number 6, pp. 80–90, in which the authors propose using economic profit per employee to gauge the true performance of "people businesses." Economic profit subtracts the cost of capital from profit per employee. Profit per employee is a more practical metric, as it can be taken directly from accounting statements and allows for straightforward comparisons of performance across companies. (Calculating economic profit per employee often requires internal company data.) A related concept, economic contribution per employee, can be a useful internal metric.

EXHIBIT 3

The return-on-capital lens

Net income and market capitalization shown as returns on invested capital (ROIC), 2002–04 (average)



| Overlap | | | | |
|-------------|--------------------|-----------------|-------------------|------------------------|
| AT&T | AIG | Exxon Mobil | Pfizer | NTT DoCoMo |
| Freddie Mac | Bank of America | GE | Royal Dutch/Shell | Verizon Communications |
| ING | Berkshire Hathaway | GlaxoSmithKline | Toyota Motor | Vodafone |
| PetroChina | BP | IBM | Wal-Mart Stores | |
| | Chevron | Intel | Wells Fargo | |
| | Citigroup | Microsoft | | |

¹US and foreign companies by American depository receipts; 71% of top 30 by income are also in top 30 by market capitalization. Source: Global Vantage; McKinsey analysis

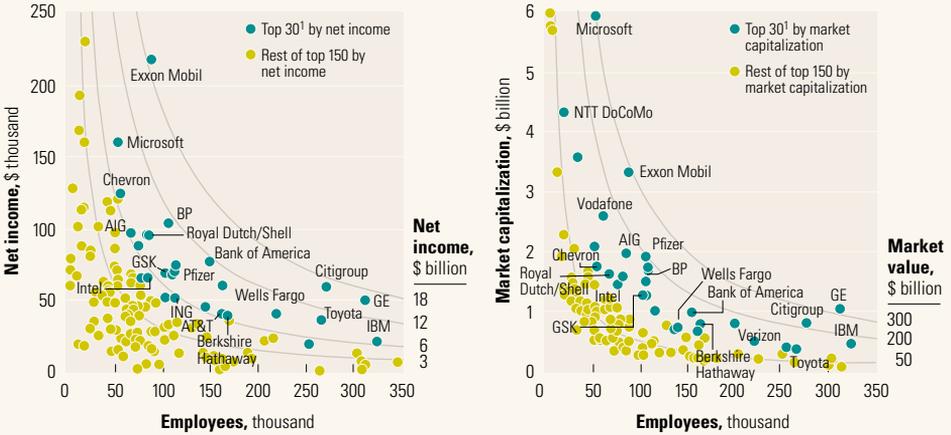
value. A company can expose this correlation by displaying its net income as the return on book equity multiplied by book equity and then comparing that relationship with its total market cap disaggregated (in a strategic-control map) into its market-to-book ratio multiplied by book equity (Exhibit 3). The company can also see this same correlation by disaggregating net income, using profit per employee and the total number of employees. Doing so displays the total market cap as a function of the latter and the market cap per employee (Exhibit 4).

Net income and market cap can therefore be regarded as functions of the return on either capital or talent. The point is that although the two metrics produce similar results, return on talent is a more powerful model in a competitive environment where the intangible assets that talented employees create provide the greater part of new wealth.

EXHIBIT 4

The return-on-talent lens

Income and market capitalization shown as returns on talent, 2002–04 (average)



| Overlap | | | | |
|-------------|--------------------|-----------------|-------------------|------------------------|
| AT&T | AIG | Exxon Mobil | Pfizer | Coca-Cola |
| Freddie Mac | Bank of America | GE | Royal Dutch/Shell | NTT DoCoMo |
| ING | Berkshire Hathaway | GlaxoSmithKline | Toyota Motor | Verizon Communications |
| PetroChina | BP | IBM | Wal-Mart Stores | Vodafone |
| | Chevron | Intel | Wells Fargo | |
| | Citigroup | Microsoft | | |

¹US and foreign companies by American depository receipts. 71% of top 30 by income are also in top 30 by net income. Source: Global Vantage; McKinsey analysis

Today’s annual reports are filled with information about how companies use capital but offer little about the number of employees, the mix of employees, or the different kinds of employees (beyond a simple expense item on compensation and benefits). Yet it is thinking-intensive talent, not capital, that now drives the creation of wealth and thus deserves to be measured more precisely by strategically minded executives. *Q*

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