



ECONOMIC CASE FOR QUALITY

People Equity: The Hidden Driver Of Quality

by **JT Kostman and William A. Schiemann**

Two companies decide to increase their focus on quality. They are in the same industry, have access to the same resources and employ exactly the same quality principles and techniques. Yet while the efforts of one prove a complete waste of time, money and effort, the other goes on to set new standards in quality—and ultimately comes to dominate its market. Why?

In 50 Words Or Less

- A survey of ASQ members and *QP* readers shows organizations that manage people and processes better dramatically outperform the competition.
- Organizations with employees aligned to business strategy, the ability to deliver customer value and strong engagement are most successful in applying quality principles and techniques.



This was the question we started with when *Quality Progress* and Metrus Group, a research and consulting firm specializing in strategic measurement and performance excellence, invited ASQ members and customers and *QP* readers to participate in a survey assessing the impact and

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effectiveness of quality principles, practices and techniques. The purpose of our research was to discover:

- Whether some quality processes and techniques are inherently more effective than others.
- What role, if any, leadership and culture play in the quest for quality.
- Most important, what factors most significantly contribute to the success of quality initiatives and to superior financial performance.

The survey questionnaire was sent to more than 50,000 ASQ members and customers and *QP* readers. The 2,041 who responded represented more than 30 industries, from aerospace to utilities. Participating organizations ranged in size from very small to very large, with an average organization having about 16,000 employees. The industry representation and job titles of respondents are shown in Tables 1 and 2.

Calculating the Cost of Turnover

The cost of employee turnover can be staggering. According to the U.S. Department of Labor, the average employee earns \$36,210 annually.¹ At a replacement cost of 41% of annual salary, this amounts to \$14,846 for replacing just one frontline manufacturing employee.

For the manufacturing firms responding to our survey, which averaged 11,526 employees each, reducing turnover from 17.8% to 6.8% would net an annual savings of \$18.8 million annually—and that is if turnover was restricted exclusively to frontline employees. If a proportional number of middle managers also had to be replaced, those costs would soar to an astounding \$40 million annually.

REFERENCE

1. "Occupational Employment Statistics," Bureau of Labor Statistics, www.bls.gov/oes/current/oesrci.htm.

TABLE 1 Industry Representation

Ten most represented industries	Number of respondents
Manufacturing and industrial products	540
Transportation and automotive	115
Professional services/consulting	113
Aerospace	94
Healthcare	83
Pharmaceuticals	82
Government	66
Telecommunications	54
Education and training	50
Computer	46

TABLE 2 Position in Organization

Respondents' position in organization	Number of respondents
President/CEO	46
Senior executive/manager	385
Middle manager	566
Frontline manager/supervisor	262
Individual contributor	462
Other	281

We asked a series of questions covering the following areas:

- Which quality principles and techniques respondents were using.
- How effective they considered each of those principles and techniques.
- To what extent their leadership and workforce were committed to quality.
- How they managed the people in their organizations.

In addition to asking respondents what they were doing, we also asked them how well they were doing: whether their organizations ranked in the top, middle or bottom one-third of their industries in the application of quality principles and how they

ranked on financial performance. They were also asked about their management of costs and employee turnover.¹

Effectiveness of Quality Techniques

Respondents told us the most commonly used quality principles and techniques include continuous improvement, customer satisfaction/loyalty measurements and project management. The quality principles and techniques judged most effective included ISO 9000, ISO 14000 and voice of the customer. Nearly all of the most commonly used techniques were also considered highly effective, as shown in Table 3.²

We also asked participants which organizational performance areas they were measuring and which they considered most valuable in guiding their business decision making. Not surprisingly, financial performance was reported both the most commonly used and most valuable organizational performance area measured.

Nearly all our respondents (94%) said their organization measures financial performance, and 98% of those who employ this measurement consider it valuable in guiding the organization's business decision making. Interestingly, some of the less commonly measured areas, such as adaptability, proved highly valuable as well (see Table 4).

What Separates the Best From the Rest?

The survey findings make it clear the success of quality initiatives is unrelated to specific techniques or measures.

According to respondents, the organizations that receive the highest marks for successful implementation of quality initiatives are those that have the support of top leadership, possess a quality culture and do a good job of managing their people effectively.

Organizations spanned the continuum in each of these three areas. While some had the full support of senior leadership, others seemed to be fighting a constant uphill battle. Similarly, only 30% of respondents

TABLE 3 Quality Principles and Techniques Used

Most common	Percentage using	Most effective	Percentage using
Continuous improvement	93%	Continuous improvement	93%
Project management	91%	Customer satisfaction/loyalty	91%
Customer satisfaction/loyalty	91%	Project management	91%
Root cause analysis	89%	Root cause analysis	89%
Performance metrics	88%	Performance metrics	88%
Voice of the customer	84%	Voice of the customer	84%
Trend analysis	83%	Trend analysis	83%
Cause and effect analysis	82%	Process mapping	82%
Process mapping	82%	ISO 9000 (or related sector specific standards)	71%
Cost of quality/poor quality	81%	ISO 14000	35%

TABLE 4 Organizational Performance Areas Measured

Organizational performance areas	Percentage of respondents measuring	Consider valuable in guiding business decision making
Financial performance	94%	98%
Customer satisfaction/loyalty	85%	97%
Quality products or services	85%	94%
Operational efficiency	80%	92%
Quality of customer service	75%	90%
Supplier performance	72%	86%
Environment/community impact	54%	88%
Innovation	50%	83%
Adaptability	31%	89%

said their organization had created a quality culture in which all or nearly all employees had quality responsibilities.

When we compared organizations with top leadership support and quality culture with others, we found dramatic differences in the likelihood of their success in implementing quality initiatives.

The message is simple: If an organization is serious about quality, its efforts cannot be confined to a

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few people with formal quality responsibilities. For quality initiatives to succeed, they have to become a part of the organizational DNA.

As dramatic as the differences were in the success of organizations that had senior leadership support and in which quality had been inculcated into the corporate culture, the biggest differences we saw by far were in the effectiveness with which organizations managed employees—their people equity.

The Power of People Equity

Over the past few years there has been considerable research showing the relationship between employee engagement and organizational performance. Engaged employees—those more highly connected and committed to their organization—dramatically outperform their peers on numerous measures, including their attention to quality and service.

The findings from this survey confirm employee engagement does indeed contribute to the successful implementation of quality initiatives but is only one part of a bigger picture. Those organizations that also focused on developing the capabilities of individual employees and creating a higher degree of alignment with organizational strategies and priorities dramatically outperformed the competition. These three factors in combination—alignment, capabilities and engagement (ACE)—gave organizations a distinct advantage.

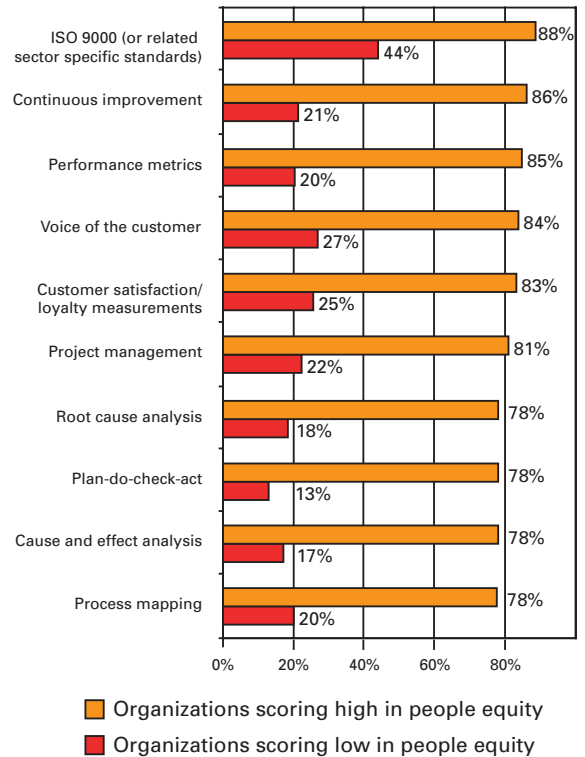
While just slightly more than half the respondents reported their organization does an effective job managing its people equity, those that did so

Conference Presentation

William Schiemann and JT Kostman will include discussion of the findings in this article during a general session, “People Equity Model for Managing Three Key Factors—Alignment, Capabilities and Engagement,” on May 17 at ASQ’s World Conference on Quality and Improvement in Seattle.

FIGURE 1 Success Indicators

Likelihood of success in the application of quality principles and techniques



dramatically outperformed others in both the application of quality principles and ability to achieve superior financial performance.

Organizations scoring in the upper 25% on people equity (as measured by ACE) were considerably more effective in implementing any and all quality principles and techniques, as shown in Figure 1.

These organizations with high people equity were considerably more likely to be industry leaders in both the application of quality initiatives and financial performance. They showed a 72% probability of being industry leaders in quality and a 68% probability of leading their industries in financial performance. Figures 2 and 3 show this correlation.

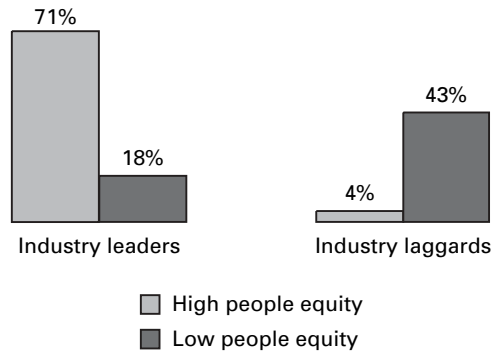
Organizations that met all three of the most critical criteria—top leadership support, development of a quality culture and a high level of people equity—dramatically outperformed others with respect to:

- Successful application of quality initiatives.

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FIGURE 2 Quality Performance



- Likelihood of employees incorporating quality principles and tools into decision making.
- Managing resources and business processes in a cost effective manner.
- Eliminating activities inconsistent with the organization's strategic direction.
- Increasing the likelihood of customer referrals.
- Identifying, analyzing and closing performance gaps.
- Developing better reputations in their communities.

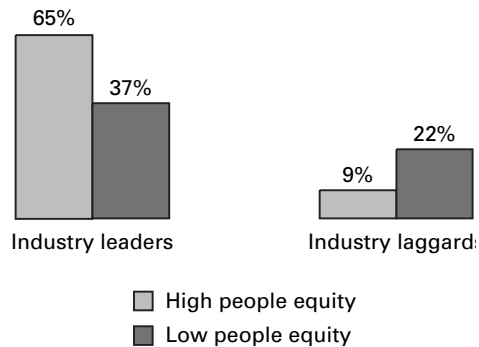
Controlling Turnover

In addition to the considerable influence more effective management of people equity had on each of these areas, it also proved to significantly impact the rate of employee turnover.

The costs of employee turnover are potentially staggering. The Corporate Leadership Council approximates the cost of replacing a frontline manufacturing employee to be 41% of annual salary and the cost of replacing a middle manager to be approximately 240% of annual salary.³ Figures similar to these have been reported by the U.S. Department of Labor and a host of research studies.⁴ These often unexamined costs have proven the difference between financial viability and ruin for more than one organization.

A recent front-page story in the *Wall Street Journal* discussed Domino's Pizza's focus on turnover reduction as being a key to its long-term strategy.⁵ Consistent with the numbers in the preceding paragraph, Domino's CEO David Brandon approximates the cost of replacing an hourly store worker to be approximately \$2,500 and the cost of replacing a store manager to be about \$20,000.

FIGURE 3 Financial Performance



Brandon credits Domino's reduction of employee turnover from 158% to 107% over the past six years as having been a major factor in the organization's success. With so much at stake, it is obvious why even small reductions in the amount of undesirable turnover can have a tremendous financial impact.

Rates of employee turnover ranged widely among our survey respondents' organizations: from near zero to 200%. The average rate of turnover across all organizations was 11.8%. Manufacturers—the largest group represented by survey participants—reported similar turnover rates, ranging from 1% to 200%, with an average rate of turnover of 12.7%.

When we examined the factors that contributed to turnover, we found organizations that did a better job of managing people equity or ACE of their workforce were considerably more effective at managing employee turnover. Organizations scoring in the upper 25% on people equity had an average turnover rate of only 7.7%, compared with the bottom 25% people equity organizations, which had an average turnover rate of 16.7%.

People Plus Process— A Winning Combination

We measured four areas using a return on people equity calculation⁶ to come up with a quality index for organizations represented in the survey:

- The extent to which employees incorporated quality principles and tools into their daily decision making.
- The effectiveness with which organizations' employees were trained and provided quality related skills.
- The effectiveness with which the organization

recognized and rewarded people for applying quality principles.

- The extent to which top leadership embraced quality principles.

Organizations that scored high on both people equity and the quality index outperformed others on all significant measures: employee retention, quality results and financial performance (see Table 5). They had turnover rates of only 7.6% and had a 73% likelihood of being among the top one-third in their industry in the application of quality principles and a 60% probability of being in the top one-third in their industry in financial performance.

By comparison, organizations that were low in both the quality index and people equity averaged a 17.6% turnover rate and showed only a 12% probability of being in the top one-third in the application of quality principles and 32% probability of being in the top one-third with respect to financial performance.

Keys to Success

Organizations that become industry leaders in both quality and financial performance not only use best in class tools and processes but have also learned to move beyond them to address the people side of the equation.

Gaining top leadership support, developing quality minded cultures and more effectively managing the hidden driver of quality—people equity—are the critical differences between success and failure when it comes to implementing quality initiatives.

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TABLE 5 Important Measurements

		Quality index	
		High	Low
People equity	High	Turnover: 7.6%	Turnover: 6.8%
		Quality: 73%	Quality: 31%
		Financial: 60%	Financial: 39%
	Low	Turnover: 9.8%	Turnover: 17.6%
Quality: 57%	Quality: 12%		
Financial: 43%	Financial: 32%		

Notes:

Turnover: rate of employee turnover.

Quality: likelihood of being in the top one-third in quality performance.

Financial: likelihood of being in the top one-third in financial performance.

REFERENCES AND NOTES

1. Previous research by Metrus Group has shown these self-ratings to be accurate representations of actual organizational standing.
2. More detailed survey findings, including a complete rank-order list of quality principles and techniques by frequency of use and effectiveness, is available by contacting the Metrus Group at info@metrus.com.
3. Corporate Leadership Council, www.corporateleadershipcouncil.com.
4. "Cost of Turnover Worksheet," Department of Labor, www.dol.gov/cfcti/turnover.htm.
5. Erin White, "To Keep Employees, Domino's Decides It's Not All About Pay," *Wall Street Journal*, Feb. 17, 2005.
6. You can calculate the return on people equity (ROPE) in your own organization by going to the Metrus Group, www.metrus.com/roi. The ROPE calculator is being made available to *Quality Progress* readers at no cost through July 2005.

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