Barrett Values Centre

January 2009

Cultural Capital: A Fundamental Driver of Financial Performance

Executive Summary

Do you see your organization's culture as a significant part of your business' performance equation? Do you see it as a driver of your financial performance?

If your answer is not a resounding "Yes," then you may want to read on.

To better understand the relationship between culture and performance, you have to recognize that "who you are" and "what you stand for" represents your cultural capital, and cultural capital has become the new frontier of competitive advantage.

Whether you recognize it or not, your organizational culture is an important factor of your performance. Therefore, monitoring and measuring your culture is vitally important to your organization's success.

This study of more than 160 organizations, carried out by Hewitt Associates and Barrett Values Centre as part of the 2008 Best Employer study in Australia/New Zealand, shows that:

> *Cultural alignment and cultural entropy significantly influence employee engagement, and employee engagement significantly influences organizational and financial performance.*

The findings of this study confirm and support other research results, indicating that a "strong culture" – as defined by the degree to which employees agree that the organization is living its desired values – has a significant impact on financial performance.

As a result of these studies, and our experience of working with organizational cultures over the past ten years, we know that managing your culture requires a two prong approach:

a) Improving cultural alignment through measures that improve the level of staff engagement, and

b) Addressing and eliminating energy draining systems, processes and behaviours that contributes to cultural entropy.

Culture and Financial Performance

During the past 150 years we have seen a significant shift in how organizations leverage their competitive advantage.

In the Agricultural Age, organizations focused on manpower. The more manpower you could muster, the more land you could till, and the more income you could make delivering your crops to the market place. In the Industrial Age, productivity and quality became the principal arenas of competitive advantage. Companies worked on improving their margins and delivering the quality that customers were seeking. In the Information Age, the focus shifted to intellectual capital, and organizations competed for the best and brightest. We moved into a knowledge economy. Now, as we move into the Cultural Age, not only are organizations having to focus on quality, productivity, and talent management, they are recognizing that who they are and what they stand for – their vision and values – are a significant differentiator in attracting and keeping talented people and fostering high levels of staff engagement. In other words, cultural capital has become the new frontier of competitive advantage.

As we passed through these different ages, organizations developed methods for measuring and managing their competitive advantage by focusing on the most important drivers of performance. They focused on measuring because whenever you attempt to measure something, what you focus on tends to improve. Consequently, during the Industrial Age, organizations measured productivity and quality. During the Information Age, they measured intellectual capital. And, now during the Cultural age, they are measuring cultural capital.

Until the creation of the Barrett Values Centre's Cultural Transformation Tools, cultural capital was difficult to measure. The Cultural Transformation Tools and the Barrett Model provide a breakthrough technology for measuring and managing organizational cultures, and more importantly, a way of managing performance. Cultural performance, it turns out, is a lead indicator of organizational performance.

The link between culture and performance has been investigated and proven by a number of researchers. In 2001, Eric Flamholtz from the University of

California at Los Angeles[1] conducted a study to explore the affect corporate culture has on the bottom line. As part of his research, Flamholtz discovered a strong positive correlation between cultural agreement (a proxy for values or cultural alignment) and the company's EBIT (earnings before interest and taxes).

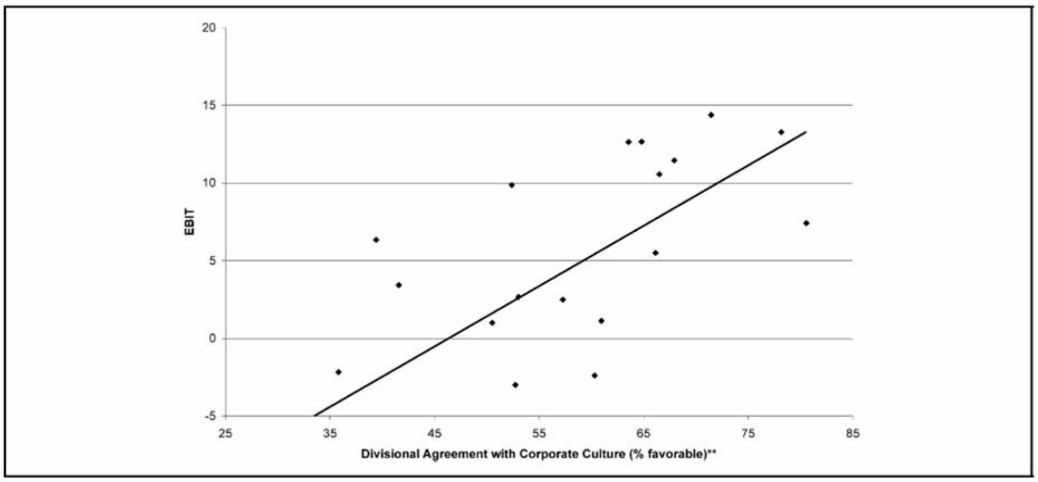

Figure 3 Divisional Cultural Agreement vs EBIT
****This is the "Percentage Favorable Response" to value statements by divisional personnel, defined as the sum of responses "To a very great extent" and "To a great extent", using a Likert scale**

He concludes, "Organizational culture does have an impact on financial performance. It provides additional evidence of the significant role of corporate culture not only in overall organizational effectiveness, but also in the so-called 'bottom line.'"

More recently, the Barrett Values Centre researched the financial performance of the top twenty publicly traded Best Companies to Work For as listed by Fortune Magazine over the past 10 years. The results showed that investing in that group produced an average annualized return of 16.74% compared to 2.83% for the S&P 500. This huge financial performance difference underlines the importance of the employee experience in contributing to the success of a company.

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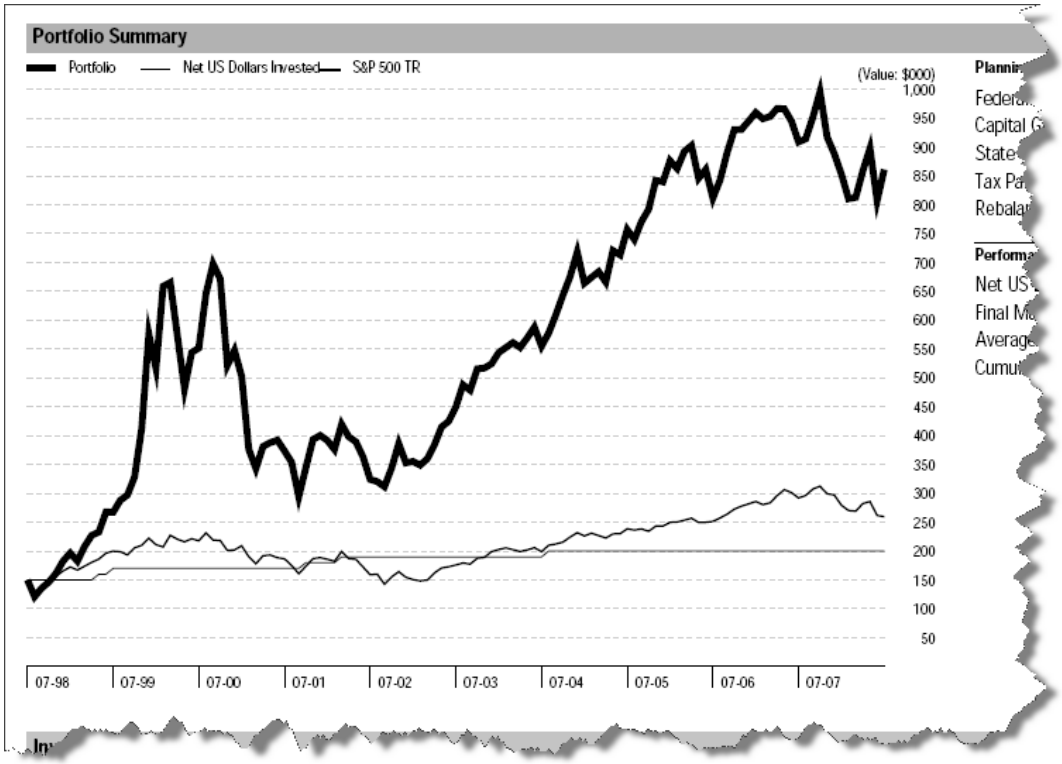
[1] Flamholtz, Eric. "Corporate Culture and the Bottom Line." *European Management Journal* Vol. 19, No. 3 (2001): 268-275.



Share Price of Top Twenty Publicly Traded Best Companies to Work For in the USA

The Best Employer Study in Australia and New Zealand also confirms this conclusion. The Current Culture values that were present in the best employers, and not in the worst, were all values that reflected a positive employee experience – employee recognition, teamwork, coaching/mentoring, and balance (home/work).

The importance of cultural performance is also demonstrated through the measure of employee engagement. Employee engagement is defined at the extent to which people will act and intervene to improve business results. Furthermore, it is directly correlated to the financial success of an organization. In this study, we worked with Hewitt Associates to blend their employee engagement survey with the Barrett Values Centre's values assessment.

Hewitt Associates' employee engagement survey measures employee's perceptions about the organization they work for in three ways:

Say – how likely an employee is going to say something positive about the organization,

Stay – how likely is the employee going to remain working there, and

Strive – how likely will the employee intervene to make the organization successful.

The Best Employers Survey

Hewitt Associates have been using their employee engagement survey as part of their Best Employers Survey for more than a decade. They have found that the Best Employer organizations, be they in the private or public sector, are “best in class” in terms of performance. Here are some of the key characteristics of Best Employers:

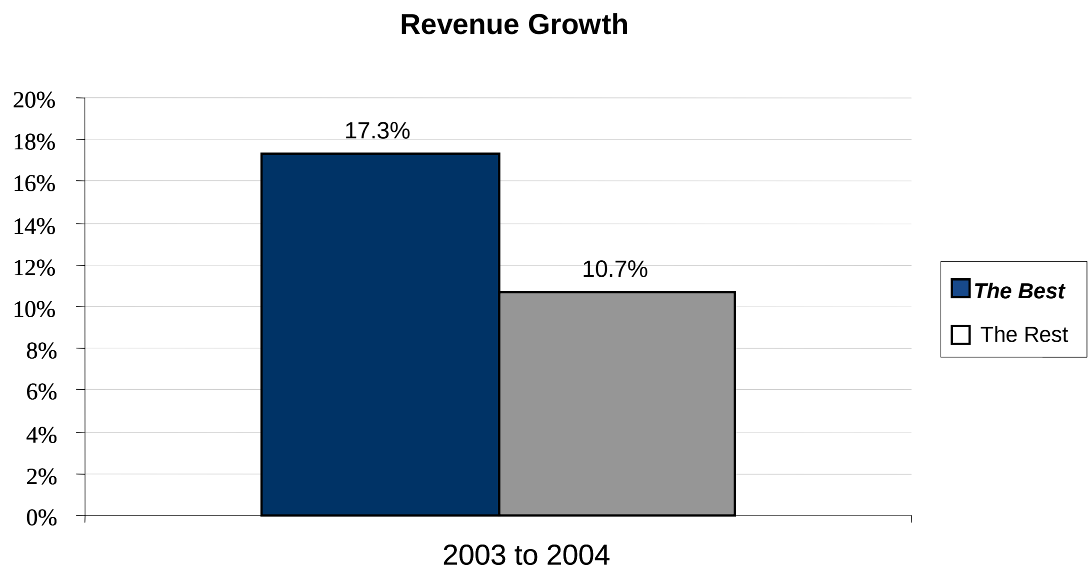
1. Best Employers attract and retain employees, resulting in significantly lower levels of employee turnover.

Region	Level of Employee Turnover
Asia	40% lower
Australia	45% lower
Canada	54% lower
Europe	30% lower
U.S.	50% lower

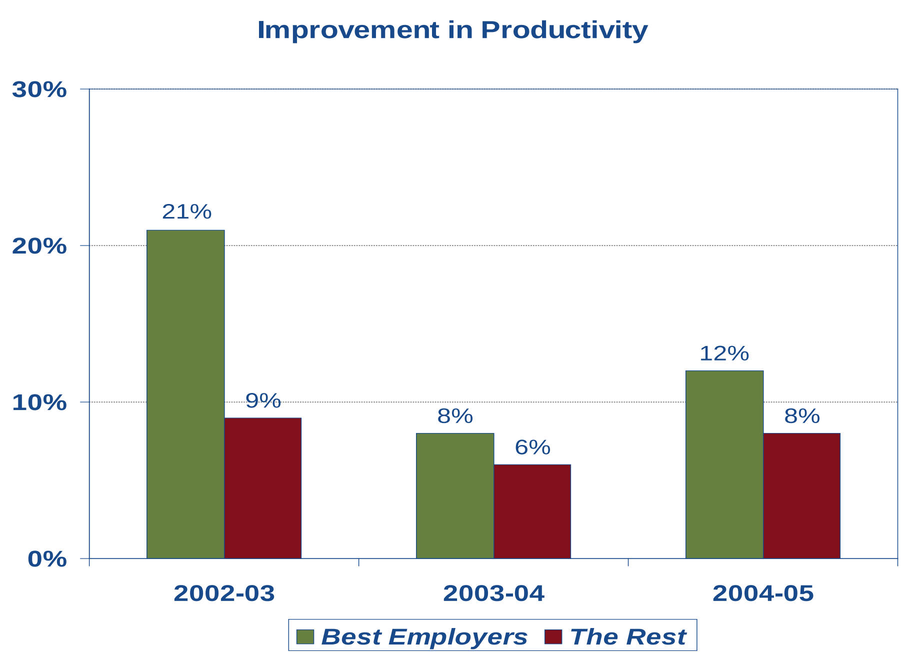
Best Employers have significantly lower levels of turnover and larger pools of talent to chose from. In fact, Best Employers have nearly double the number of applications per position than other organizations.

Scott McNealy of Sun Microsystems estimates that being a Best Employer is worth $75 million annually to his company in recruiting, retention, and productivity gains.

2. Best Employers have faster revenue growth. Among the data collected in the Best Employer surveys is each company’s financial information for the last three years. Using these numbers, it is consistently found that the Best Employers exceed the rest in revenue growth, year after year.

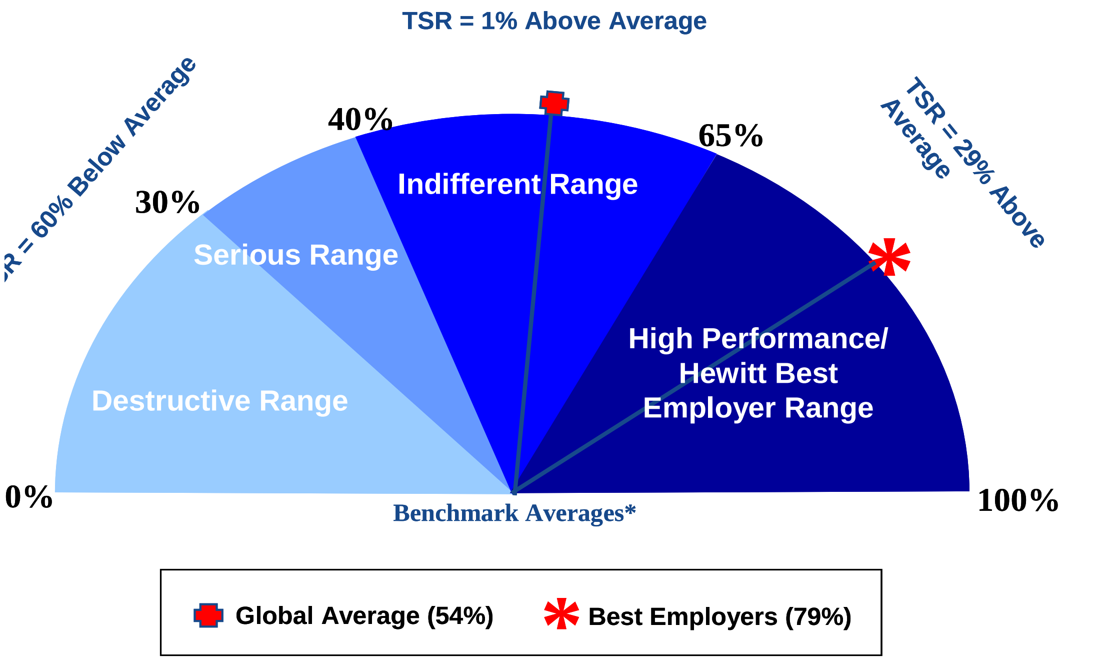


3. Best Employers have higher levels of productivity. Revenue per employee is consistently higher in the Best Employers. Breaking down the revenue per full-time employee shows that companies considered the Best are able to achieve higher levels of employee productivity.



Cultural Alignment and Entropy

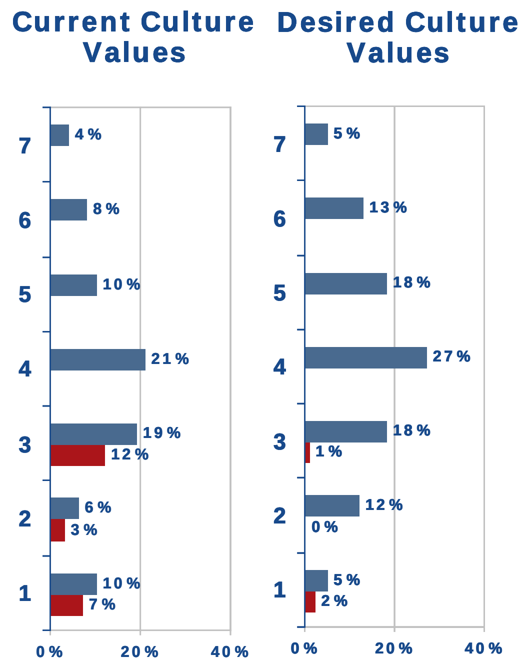
Hewitt Associates employee engagement scale provides ranges that define different levels of organizational performance. As shown in the following diagram, Best Employers have levels of employee engagement in the range 65% to 100%. Best Employers average around 80% employee engagement. The worst employers have levels of employee engagement in the range 0% to 40%.



By using employee engagement as a measure for organizational performance, we have been able to compare the results of the Barrett Values Centre surveys, in particular the degree of cultural misalignment and the level of cultural entropy, with Hewitt Associates employee engagement scores.

CULTURAL MISALIGNMENT

Cultural misalignment is calculated by taking the total of the percentage differences between votes for positive values in the Current Culture and Desired Culture at each of the seven levels of organizational consciousness. This number represents employee's perception of the gap that exists between the Current and Desired Culture. An example of this calculation is shown in the following diagram.



Level 7 : 5-4

Level 6: 13-8

Level 5: 18-10

Level 4: 27-21

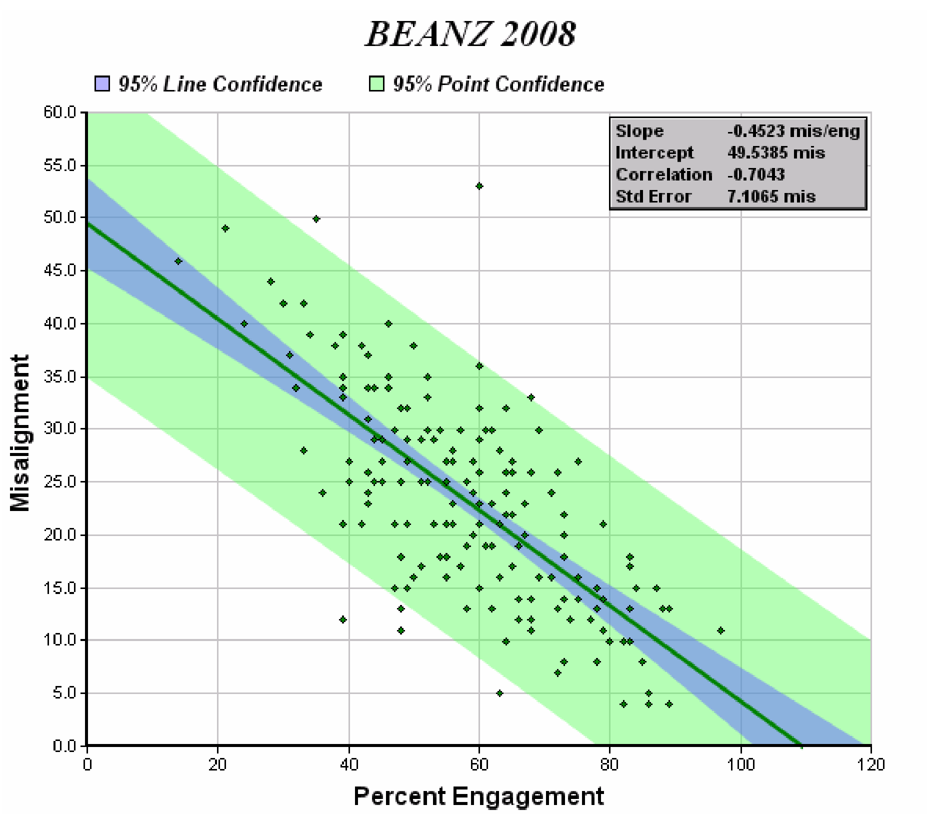
Level 3: 19-18

Level 2: 12-6

Level 1: 10-5

Misalignment = 32

We found a high correlation between the Barrett Values Centre cultural misalignment score and Hewitt Associates' employee engagement score as shown in the following diagram.



If employee engagement is taken as a measure for performance then the strong correlation between employee engagement and cultural misalignment corroborates the findings of the UCLA study mentioned above.

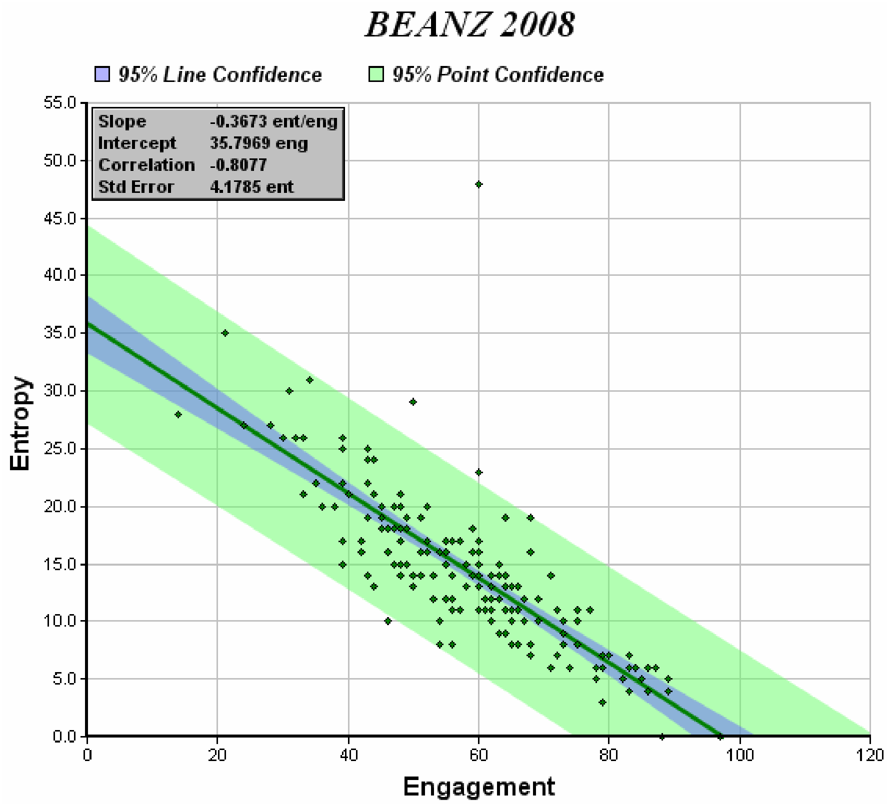
What is even more interesting is that the combination of the Hewitt and Barrett data allows us to probe deeper than the UCLA and other studies into the link between culture and performance by focusing on specific values and, in particular, the difference between the number of votes for values in the Current Culture and Desired Culture (value jumps) for the best and worst employers.

Based on the Best Employer survey for Australia and New Zealand (BEANZ) we found that the value jump for "employee fulfilment" in the Best Employers was 51%, whereas for the Worst Employers it was 622%, indicating that this value is a significant differentiator between high and low performance. Similarly we see that employee recognition, coaching/mentoring, leadership development, and balance (home/work) are significant differentiators between high and low performing companies.

Value	Best Employers	Worst Employers
Employee fulfilment	51%	622%
Employee recognition	(1)%	298%
Coaching/mentoring	16%	164%
Leadership development	44%	109%
Balance (home/work)	3%	70%

CULTRUAL ENTROPY

A strong correlation was also found between Barrett's measurement of cultural entropy and Hewitt's measurement of employee engagement.



The 0.8 correlation between entropy and engagement indicates that entropy plays a major role in engagement levels.

One conclusion we can draw from this research is that if we regard cultural alignment as significant factor in revenue generation, then cultural entropy can be regarded as an expense.

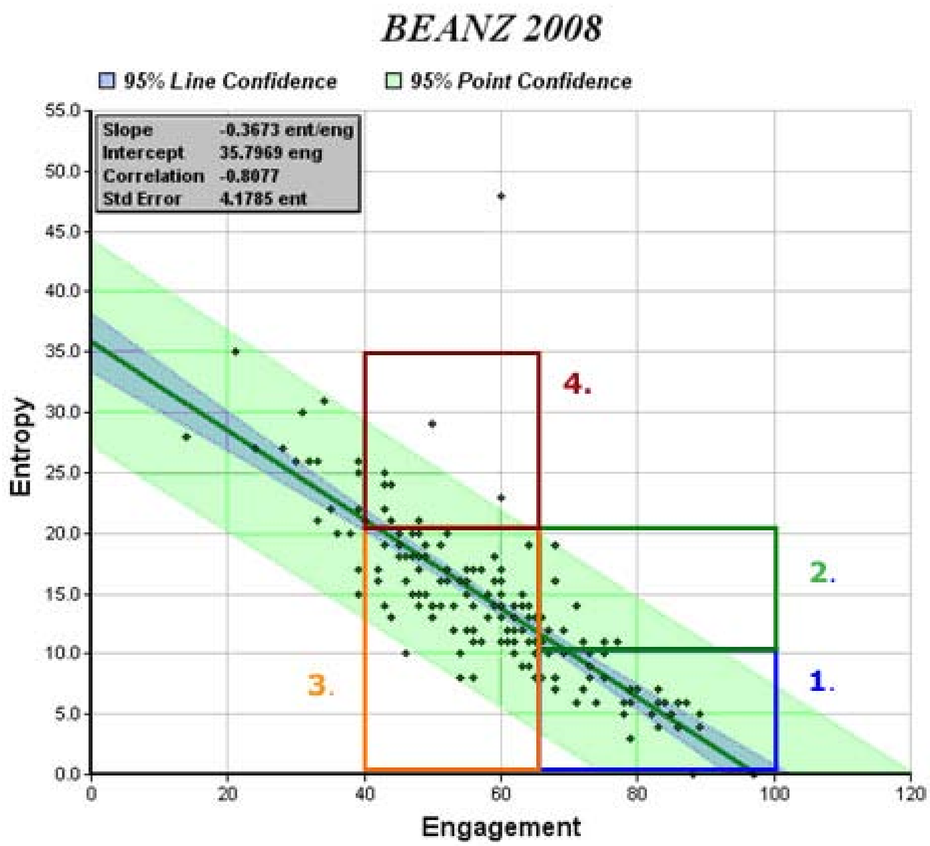
The data from the Australia and New Zealand Best Employer survey allowed us to examine how the combination of employee engagement and cultural entropy scores impacted revenue generation. We broke the data into four categories as shown in the diagram below.

High engagement (greater than 65%) and low entropy (less than 10%) – Box 1.

High engagement (greater than 65 %) and moderate entropy (above 10%) – Box 2.

Moderate engagement (40% to 65%) and relatively low entropy (less than 20%) – Box 3.

Moderate engagement (40% to 65%) and high entropy (above 20%) – Box 4.



Sample	Average Entropy	Average Revenue Growth
1) **Engagement > 65 and Entropy < 10**	7%	35%
2) **Engagement > 65 and Entropy > 10**	12%	33%
3) **Engagement 65-40 and Entropy < 20**	14%	24%
4) **Engagement 65-40 and Entropy > 20**	22%	7%

This analysis shows very clearly that the combination of high engagement with low entropy produces the highest financial rewards, whereas low engagement and high entropy significantly impacts an organizations' potential for growth.

Our research also shows that the limiting values which created the cultural entropy in all four categories were exactly the same. The only difference was the degree to which these limiting values were present in the Current Culture.

Conclusion

Using employee engagement and cultural entropy as measures for cultural alignment or cultural capital, we can categorically state that organizations with high levels of cultural alignment will have superior levels of financial performance.

Thus, based on the data from the Best Employer Survey in Australia and New Zealand, we can state that financial performance can be improved by:

a) Improving cultural alignment through measures that increase the level of staff engagement, and

b) Addressing and eliminating energy draining systems, processes and behaviours which contribute to cultural entropy.

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