Human Capital Accounting

William D. Henderson

Indiana University Maurer School of Law, wihender@indiana.edu

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BY WILLIAM D. HENDERSON

HUMAN CAPITAL ACCOUNTING

Shunning intuition and using data to predict who will fit best with your firm.
In this article I endeavor to set forth a few basic facts and principles that can aid law firm leaders to obtain a large, sustainable competitive advantage in the market for legal services. All of these facts and principles relate to the acquisition and development of human capital. Collectively, they form the basis for a system of human capital accounting, albeit one that is specifically designed for lawyers.

Readers may wonder why I’m limiting my focus to human capital. Practice specialization is bound to be a strategic differentiator in the years to come, as are industry focus and geographic reach. This is all true. Yet, regardless of other strategic choices, no law firm can do better than developing its personnel to their maximum potential and coordinating that talent to efficiently serve the best interests of clients. This is a strategy based on human capital. Any organization that successfully implements a human capital strategy is bound to be financially successful. Further, it would produce organizational glue several times stronger than money.

**Resource Allocation Decisions**

Human capital accounting is very similar to the field of cost accounting as the purpose of both is to create the data needed to make resource allocation decisions. Whereas cost accounting reveals portions of company operations that enhance or undermine productivity and profitability, the purpose of human capital accounting is to identify the investments of time and money that enhance the quality and longevity of individual workers and teams. Specifically, to focus on human capital is to focus on people—what they need to grow and flourish as professionals and how that talent can be managed to improve long-term enterprise value.

Similar to other accounting methodologies, the core analysis of human capital accounting is the “netting out” of two columns—in this case, expected costs and expected benefits. Stated more simply, decisions surrounding the selection, development and retention of legal professionals are made through a simple comparison. When the benefits consistently and significantly outweigh the costs, the organization should make the investment. If resources are limited, priorities should be set based on return on investment (ROI). This is calculated by dividing the net amount (expected benefits minus expected costs) by the expected costs.

Consider a simple, stylized example. The firm is considering a new work allocation system that costs $50,000. Expected benefits total $200,000, primarily through lower attrition of higher-performing midlevel associates. The net benefit of the proposed system equals $150,000 ($200,000 minus $50,000). Its ROI is 300 percent ($150,000 divided by $50,000), which could be adjusted based on the time period needed to attain the full expected benefit.

I have made human capital accounting seem very simple. And, analytically, it is. Similar to a healthy diet or a training regimen for a challenging athletic feat, the difficulty is entirely based on an organization’s ability and willingness to stay focused on the end goal.

To be successful, firms have to brace themselves for two grueling challenges. First, human capital investments are often large and easy to calculate—in time, money and emotion. In contrast, calculating benefits requires substantial knowledge of how lawyers become great and, in turn, what it takes to get them to work together as a team. The worst possible preparation for this type of analysis is a long period of prosperity, yet that describes what many law firms experienced during the 1980s, 1990s and much of the 2000s. Many law firm partners are bound to disbelieve the claimed benefits of large human capital investments—and likewise balk at the cost. And I can understand why, as their entire life experience offers a compelling counternarrative.

The second major challenge to implementing human capital accounting is the cost of creating and analyzing the requisite data. Here we can take a lesson from the field of cost accounting.

One of the pioneers of cost accounting was Carl Braun, the president of C.F. Braun & Co., which was an engineering, manufacturing and construction company that designed and built oil refineries in the U.S. and abroad during the early and mid-20th
century. Braun’s contributions were driven largely out of necessity as his company had to perform immensely complex projects on time, on budget and with no compromise in quality. The only way that he could achieve these goals and also turn a profit was to methodically track company time and resources and accurately allocate them to the myriad internal and external projects.

It’s worth noting that Braun was less interested in numbers and more interested in words. Specifically, Braun conceived of cost accounting as a form of communication that translated charts and graphs into inferences and conclusions. Indeed, every insight based on data had to be expressed in simple, declarative sentences lest its meaning and significance be lost on the rest of the organization. Without an effective cost accounting system, Braun had no hope of achieving broader company goals. As a result, in the year 1953, when he published his classic book, *Objective Accounting: A Problem of Communication* (written entirely for an internal company audience, not the public), a full 2 percent of company revenues were dedicated to collecting and analyzing data. It’s noteworthy that Braun’s accounting department was run primarily by engineers as they were the best qualified to understand and interpret what was being measured.

Note that tracking and measuring human capital is not a human capital investment. Rather, it’s the creation of a system, akin to Braun’s, that enables an organization to make better decisions. In this case, the focus is on the organization’s most valuable assets—talented and motivated legal professionals. But are law firms ready to allocate a substantial amount of their revenues toward tracking and measuring human capital? Most law firm partners would likely need to see such a system in operation before committing their own money. As a result, like many innovations, the diffusion will occur over time as early adopters obtain a
competitive advantage and the rest of the market struggles to keep up.

**Three Buckets**

Human capital accounting tracks the life cycle of an attorney's career, that is, (1) selection and recruitment, (2) professional development and (3) promotion and retention. An effective human capital strategy views these three buckets as part of a supply chain process that produces the right types of legal professionals in the proper amount. Human capital accounting is necessary to assess whether this strategy is actually working and, equally significantly, how it can be improved.

Setting up a human capital accounting system begins by realistically assessing an organization's current market position and assets—including human assets—and answering two questions. First, What type of firm do we want to become? Some answers might include "a premier general service firm with deep expertise in technology and energy" or "a national labor and employment firm with deep, enduring relationships with Fortune 500 legal departments" or "a commercial litigation firm that provides the best combination of price certainty and outstanding results."

The second question is, What are the knowledge, skills and behaviors of the lawyers and legal professionals who work at the firm we envision? When a firm answers this question, it has identified the requisite criteria to select and recruit (Bucket 1), develop (Bucket 2) and promote and retain (Bucket 3) the human capital needed to achieve its broader economic and reputational goals.

This second question is easy to ask but difficult to answer. It's difficult because many partners (i.e., the owners) are bound to have strong ideas and opinions on the essential knowledge, skills and behaviors. Further, even if the list can be winnowed down, partners are bound to disagree on relative importance. Yet the most formidable aspect of the knowledge, skills and behavior question is that the answers are not debatable, subjective opinions. Rather, they are empirical claims about what drives the organizational success. Stated another way, some answers are a lot better than others. The virtue of human capital accounting is that, over time, the right answers will be found and used to create a competitive advantage. How is this done? Through a reasoning process based on estimation and measurement.

**Getting Practical**

At this juncture it's worth expanding on netting out and ROI, and directly addressing the challenges of implementation.

On the cost side, let's start with what is difficult and obvious—the cost of obtaining partner buy-in. Investments of partner time and money are easy to calculate, and in the aggregate it's bound to look expensive. Yet, as high as that cost might be, the emotional costs could be significantly higher. For example, developing a consensus or compromise in a partnership is emotionally and mentally challenging. Not every partner will come to the table with an open mind, preferring instead to stick with the status quo even though a reasoned process would reveal that a status quo strategy has its own serious risks. Likewise, once a human capital strategy is adopted, uncertainty over uneven distribution costs is itself a high cost to pay.

To pay the high price of obtaining partner buy-in, there needs to be large, countervailing entries on the benefits side of the ledger. These are the benefits that flow from achieving the firm's broader strategic objectives. The table on page 37 presents a stylized example of the costs and benefits of a proposed new investment or policy related to human capital.

Comparing the cost and benefit columns, a lawyer is bound to ask, What is the likelihood that our investment on the left side will produce all of the benefits on the right side? The answer is bound to be unsatisfactory to some. Benefits are estimated using a reasoning process in which assumptions are made explicit and then documented. Thereafter, at periodic intervals, these assumptions are compared with actual results. Over time the quality of estimates improves. To reduce the error cost, the best place to start is typically small pilot projects. This is because pilots enable us to test ideas and concepts at a relatively low cost. In turn, this learning can be used to more effectively scale the most promising initial results.

For the vast majority of legal service organizations, running a human capital accounting system is a departure from past practices on several levels. Specifically, it requires (1) formal

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deliberation and documentation, (2) making significant human capital investments and (3) evaluating operations through data. Many partners are bound to prefer the old approach, which was cheaper and associated with decades of organizational growth and prosperity. But was this correlation or causation?

The need to adopt a system of human capital accounting is based on reason rather than experience. It requires leaders who understand how the industry is changing and have the communication skills to persuade their firms to embark on a challenging new future that requires shared risk and responsibility.

I recently participated in a conference on law firm compensation that was attended primarily by law firm administrators who generally work directly under senior law firm leaders such as managing partners or firm chairs. During the Q&A session, one of the participants suggested that the most valuable human capital in the legal industry was the rainmaker. Yet a majority of the room immediately challenged that assumption, countering that capable leadership was in shortest supply. As one participant wryly noted, “Smooth seas make poor sailors.”

Invest In What?
Once the firm’s strategic goal has been identified, the purpose of human capital accounting is to enable prudent, cost-effective investments and trade-offs in human capital. In the course of setting and administering human capital strategies, firms will inevitably address several threshold issues that may seem philosophical but are fundamentally empirical in nature. Here are some example inquiries:

- What will produce the greatest ROI for the firm—investment in lawyer selection or development?
- How heavily should a firm weight law school grades and pedigree? Stated another way, are there under-valued “moneyball” factors?
- What has greater enterprise value: partners maximizing current fiscal year revenue or, alternatively, allocating significant time to delivering specific, timely feedback to associates?
- Is there a large positive ROI to upward reviews of partners and management after netting out the emotional discomfort of implementation?
- Can a law firm cost-effectively develop leadership?

Many law firm partners will want to answer these questions without the requisite data. To indulge this impulse is akin to a sugar cookie diet; over the long run, it takes us to an unhealthy place.

Fortunately we are not operating in a vacuum, as there is a rich literature on employee selection and development. Even if the legal field is exceptional or idiosyncratic in some dimensions, the experiences of different industries provide a set of baseline expectations that can be improved through trial and error.

Returning to the three buckets that comprise human capital accounting: The first analytical bucket is selection and...
recruitment. Selection and recruitment are not the same thing. Selection is about identifying the best available candidates using a methodology that is reliable and valid. When a selection method is reliable, it means that multiple evaluators are likely to give the same candidate a similar score, which reduces the influence of subjectivity and bias. For a selection method to be valid, it must be reliable. Valid means that the factors used for selection are positively associated at statistically significant levels with on-the-job performance. To select using a valid method is to select, on average, a better employee. After making offers based on scores from a reliable and valid selection method, the firm can move into recruitment mode.

The most common selection method used for knowledge workers is the behavioral interview. A behavioral interview is based on the empirically valid principle that past behavior is a fairly accurate predictor of future behavior. In his book *Thinking, Fast and Slow*, the Nobel laureate Daniel Kahneman offers a wonderful example of this approach.

During the 1950s Kahneman was a member of the Israeli army. Because of his undergraduate degree in psychology, he was given the responsibility of selecting candidates for officer training. Kahneman’s primary tool was the leaderless group challenge, a methodology developed by the British army. Under this selection method, a group of soldiers is instructed to carry a large, heavy object through an obstacle course as rapidly as possible without letting it touch the ground. When they drop it the soldiers are forced to start over. Through this process of trial and error and coordination and communication, the attributes of leadership are revealed. At least that is the theory.

After running many soldiers through the process, Kahneman and his colleagues were confident that they had selected a large cadre of first-rate officers. Yet Kahneman's undergraduate studies had taught him how to conduct a validation study. If the leaderless group challenge was working, those with higher scores should be performing better in the field as actual leaders. Yet that was not the case. There was no correlation between the strength of Kahneman's recommendations and subsequent performance.

Embarrassed by this fact, Kahneman delineated the attributes of an effective and successful infantry officer and described in specific detail how these attributes would manifest themselves on the job. Kahneman then wrote a series of questions designed to elicit how candidates responded to similar situations in their past.

Unlike the leadership group challenge, Kahneman's new system delivered a useful, positive correlation with future performance—that is, it was a valid method of selecting infantry officers. Much to his delight, Kahneman returned to Israel 50 years later and...
discovered that his system was still being used to select infantry officers.

Over the last several decades, myriad studies cutting across all types of industries have demonstrated that the unstructured job interview has essentially zero predictive power. Yet, similar to the leaderless group challenge, most lawyers develop strong views on who are the best candidates through a process that is unreliable and invalid. As Kahneman observes, "Overconfident judgments ... are determined by the coherence of the best story you can tell from the evidence at hand." Telling plausible stories based on incomplete facts is part of the lawyers' craft. Yet in this case we fool ourselves with our pleasing, plausible narratives. If we want to make consistently better hiring decisions, we need more than "the evidence at hand." One of the purposes of human capital accounting is to collect data that reliably corresponds to valid selection criteria. Otherwise, copious amounts of lawyer and administrator time is being wasted and no competitive advantage is attained.

Some firms may worry that a rigorous selection process may offend the most desirable candidates, which is often reflexively defined as some combination of law school grades and pedigree. This view assumes that the value of grades and pedigree are known. But these valuations ultimately reflect testable empirical claims. Wouldn't a sound human capital accounting rely on data to test its most important assumptions?

Over the last several years I have worked with several law firms to model résumé and transcript data at the time of hire against performance as an associate several years later. One of our most consistent findings is that law school pedigree seldom, if ever, matters (and when it does, it could be negative). In contrast, grades are generally a positive predictor. Yet the relationship between grades and future performance may have less to do with cognitive ability and more to do with motivation. For example, we often find that membership on the law review is (after statistically controlling for grades) a negative predictor of future performance but publishing a law review note is a strong positive predictor. Why? Perhaps because the latter requires drive, persistence and/or intellectual curiosity, and presumably those are linked to on-the-job performance.

My colleagues and I recently extended our research to the partner level and examined the relationship between various behavioral and biographical factors and partner track records in generating business. Two of the best predictors for the ability to generate business were (1) working to put oneself through college and (2) attending a non-elite law school. (The drive for intergenerational mobility is likely at work here.) A strong negative predictor, in contrast, was enjoyment of law as an academic pursuit. (Clients hire lawyers to solve practical problems.)

Note the importance of the reasoning process in human capital accounting. In all of this applied statistical work, we (1) look at very high-quality data and (2) work backward to tell the most plausible story of causation and association. Each round of new or better data enables us to sharpen our understanding.

**Learning From Data**

After several years of doing applied research in this area, I have gradually concluded that traditional law firm hiring criteria are no better at predicting performance than the leaderless group challenge. Yet for reasons of inertia and self-image, we pretend that it is.

Human capital accounting can and should be extended to the full arc of an attorney’s career, including lawyer development, promotion and retention.

Regarding lawyer development, the most advanced skill set a lawyer can attain is intuitive expertise, which is the ability to recognize and respond to situations in a very rapid and effective manner. Even at $1,000 per hour, this skill set can be a bargain. Yet, as Kahneman observes, "Whether professionals have a chance to develop intuitive expertise depends essentially on the quality and speed of feedback, as well as on sufficient opportunity to practice." Stated another way, great lawyers only become great through opportunity and investment. Yet we don't need to leave this process to chance. The most cost-effective development and retention strategies are discoverable through a focused commitment to human capital accounting. That knowledge, in turn, can be used to take market share.

This most competitive legal marketplace may eventually cause many law firms to revisit their roots. The success of the original associate-partner model was based on its ability to create a sufficient supply of specialized lawyers to keep pace with client demands. Decades of uninterrupted prosperity have changed this conversation to one of leverage and profitability.

In the more competitive marketplace, however, law firms will have to get back to the fundamentals of developing their own human capital. This will require firms to back off of extravagant revenue targets to make room for better evaluation processes and more timely and useful feedback. A human capital accounting system would help a law firm make these trade-offs in an optimal way. LP

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**William D. Henderson**

is a professor at Indiana University Maurer School of Law. He is also a principal with Lawyer Metrics LLC.

wihender@indiana.edu