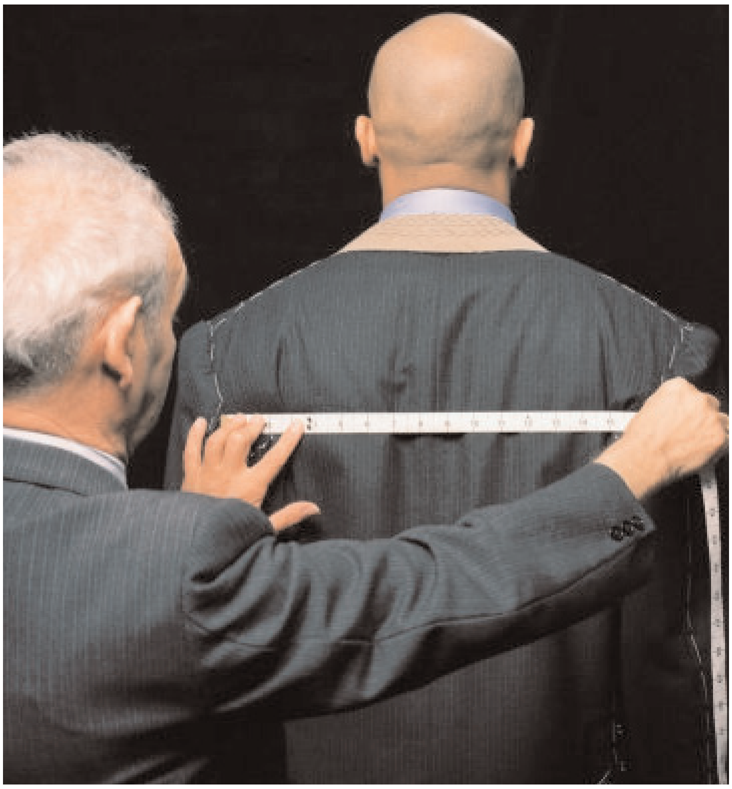
MANAGEMENT EXTRA

A monthly review of current thinking in core business areas

FINANCIAL STATEMENTS AND HUMAN CAPITAL

Measuring the real value that people bring to any organisation is problematic. There are many factors to be considered, and traditional financial standards are not directly relevant. In this *Management Extra* article, **Professor Andrew Mayo** of Middlesex Business School analyses the case for measuring human capital, and outlines the different approaches available.



The statement 'our people are our most important assets' has become a cliché that often leads to a cynical smile. One reason is that what people experience in practice is not necessarily consistent with what they think this statement means. Others will be more analytical in their critique. In this article, we will look at some of the issues surrounding the statement, and current thinking about what is generally called 'human capital management'.

There are of course problems as soon as we start to apply well established financial terms to people – who certainly do not fit comfortably with the standard definitions of 'assets'. Most of them appreciate in value with time, and it is rare that they can be 'transacted' at will. The concept comes more from the distinctions between 'tangible assets' and 'intangible assets' as drivers of value, and the original work of Leif Edvinsson and others in Sweden in the early nineties. As they, and others, recognised the ever widening gap between market and book value of most firms, they analysed it by distinguishing different types of 'capital' contribution. One of these was clearly a firm's 'human capital'; however they never did imply that all people in a firm were automatically 'value creating assets'.

Indeed Karl-Erik Sveiby, one of the pioneers, named it 'competence capital' and saw it in terms of specific areas of strategic expertise. It was in the same era that Kaplan and Norton developed their 'balanced business scorecard', arguing for a set of balanced and interconnected measures that support business strategy. They also did not use the term 'people' (in the way that some have simplified their model) but rather defined one quadrant of measures as 'learning and innovation', as the key product of the human contribution.

People on the balance sheet?

There have been efforts to value people financially – as there have also been with brands – in order to amplify that part of the balance sheet that states 'intangible assets'. The father of a discipline called 'human resource accounting' is Eric Flamholz, professor of management at the Anderson Graduate school of Management in the University of California. Flamholtz asserted that the aim of human resource management is to optimise human resource value. He defines the measure of individual value as resulting from two interacting

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variables – a person's conditional value and the probability that he or she will stay with the organisation. An individual's conditional value is the present worth of the potential services that could be rendered if the individual stays with the organisation for x years. The conditional value is a combination of productivity (performance), transferability (flexible skills) and promotability. The latter two are heavily influenced by the first element. This is then multiplied by a probability factor that he or she will stay for the x years. This gives the expected realisable value, which is a measure of the person's worth.

He extends the principle to evaluating the effectiveness of development programmes. If a programme produces a measured change in productivity, transferability or promotability, this translates into increased value of the individuals concerned.

There are a number of difficulties with this approach, not least of which is the estimation of potential future services. It also leads to lower values for older and more experienced people who have less time to render future services. There is a case for looking at them this way if we consider value over a future lifetime, but it fails to take account of the wealth of value in past experience.

Lev and Schwarz devised a methodology of human resource accounting which has been followed for some years by the well known and innovative Indian IT company, Infosys. Their annual reports include a section entitled 'Human Resource Accounting'. The evaluation is based on the present value of the future earnings of the employees and these were discounted in 2006 as 12.96%, the cost of capital for the company. The resulting value is then used in a number of ratios, whose value is in year-to-year comparisons.

The question is how much this approach adds values to investors or to corporate governance. There is currently little pressure from any source for this kind of valuation and there are thus very few attempts.

The case for human capital measurement

Nevertheless, the case for having better measurement and control of intangible assets exercises accounting bodies, as they are well aware of their importance. The Danish government conducted a three year experimental study with volunteer firms resulting in an erudite set of recommendations. Few, however, have taken them up. In the UK, the DTI's 'Accounting for People' workforce in 2001 created much excitement with the HR profession. Seven years later we do not have any prescription for specific measures, although bodies like the CIPD have produced intelligent recommendations for both external and internal reporting.

Yet the logic for attention to measurement remains, since every senior executive knows that their 'talent', 'competitive expertise', 'unique knowledge' – however it is described – is actually foundational in their task of delivering and growing value – both in private and public sectors. It does require first an understanding of exactly where the assets are in an organisation. Traditional 'human resource management' (HRM) is built largely on a hierarchical approach to administering and managing people. Critical 'assets' may be found however at any level, and their potential for adding (or subtracting) value may bear little relation to their cost. Not all roles are value adding by definition, and even within such roles that are, individuals may vary significantly in their contribution.

Continued on page 26

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For the purposes of human capital management, roles could be classified as follows:

1. those that are pure labour, essentially 'machine substitutes';
2. those that are 'maintenance and administrative' workers – charged with keeping the organisation in order and within the law;
3. those whose prime role is directly connected to delivering value to a stakeholder; and
4. those whose prime role is about creating new kinds of value for the future.

Traditional reporting counts all these as 'headcount', and yet at one extreme people are literally a cost of production, and at the other they are actually an investment in the future. In knowledge-based companies, some roles (especially managerial) may combine categories 2,3 and 4 – and the issue is how much time is spent on each.

It is the characteristics of those in categories 3 and 4 that are our key assets and that we should have some way of measuring and tracking. Specific to a particular group, it may include such factors as:

- personal skills and behaviours;
- business and professional knowledge, skills and experience;
- critical relationships held;
- achievement – ability to get results;
- alignment – to organisational values;
- mobility – willingness to be flexible in location; and
- potential – to grow and contribute at a higher or deeper level in the future.

Many companies use summary models such as GE's 'nine box model' of ranking performance and potential in a 3x3 matrix. These are often confined to the top management only however, a product of HR's hierarchical approach. Systematic A/s, one of the Danish companies that continued with an 'intellectual capital report', reports on areas such as qualifications, the percentage of a group rated as experts, and investment in training.

It seems logical, even essential, that organisations should have some measure of the value of their strategic human assets, and to know whether they are increasing or decreasing. The answer seems to lie in identifying critical qualities, and then assessing them on a suitable weighted scale. In 1972, the professional bodies then known as the IPM and the ICMA commissioned a joint report to study this very subject, and came to that conclusion.

People statements to match financial statements
Basic financial management teaches us to:

a) make a plan – a budget;
b) monitor against the plan; and
c) from time to time take stock, and balance assets and liabilities.

This system of control is distributed down to units and departments. In terms of people, this thinking is usually confined merely to headcount, the crudest of measures. How would we become more sophisticated and get a much fuller picture – and hence monitoring opportunity – of our human capital?

Many possible measures are available, and unfortunately they are of different 'currencies' – many requiring subjective judgement. We would certainly want measures of human capital as discussed above. Fitz-Enz published in 2000 his comprehensive summary of people-related measures under the title of *The ROI of Human Capital – Measuring the Economic Value of Employee Performance*. He organises measures at three levels, all of which need to be integrated:

- the overall enterprise – the relationship between human capital and its contribution at the level of the whole enterprise. This level focuses on ratios of productivity, and manpower flows;
- by process or function – leading to service, quality or productivity; and
- how human capital is managed. This focuses on six HR functions – planning, acquiring, maintaining, developing, retaining and evaluating – and metrics for assessing their efficiency.

It is better not to confuse measures of HR function services and processes with those which are about people themselves. However there is one essential measure of how human capital is managed, and that is the level of engagement or commitment of a group of people. Research has consistently shown that this is the strongest driver of productivity or performance. It started with Heskett, Sasser and Schlesinger's *The Service Profit Chain*, in which they argued that employee attitude was directly linked to customer attitude, and thence to profitability. Recent studies, particularly by banks and retailers have been built on Gallup's 'Q12' engagement indicator. This is used with employees in a number of similar locations, and the scores ranked. The average of the top quartile is compared with the lowest quartile against key business parameters of a typical store or branch. The effect on performance of high engagement is often dramatic.

The choice of people-related measures to go into the 'people plan' will depend on the strategies and goals of each manager's unit, and the part that people will play in that achievement. However, research would indicate that each framework would include some carefully chosen workforce analytics; measures of human capital value, employee engagement, and of productivity and value added.

We can from time to time summarise where we are in a 'balance sheet'. This is not in a particular currency, but represents on the one side our 'assets' and on the other our 'liabilities' in people measure terms. The distinction between each side will be mostly derived from targets or benchmarks that we have set, but sometimes the absolute measures clearly indicate one side or the other. The liabilities are indicators for action.

HR and the bottom line

As a footnote, we should note the volume of research that has been done relating HRM practices to business performance. The latest in a long line of studies is entitled *People and the Bottom Line*, recently published by the Institute of Employment Studies and supported by the Work Foundation. It asks: 'Does the way people are treated at work make a difference to the performance of the organisations that employ them? Are there returns to investment in human capital in a similar way to investments in physical capital?' The report tested 40 'measures' (related to skills development and wider people management practices) to organisational performance. Researchers found that an individual practice on its own has very little effect on performance, but a comprehensive culture of positive people management does make a significant difference. This supports previous studies – it is, however, hardly a surprise that if you take a lot of care over choosing, managing, developing and engaging your people they are likely to do a good job for you.

Conclusion

Most organisations are a long way from current best practice, and very few have a fully integrated approach to human capital measurement. This is partly because of the lack of – and difficulties of – standardisation in this field. It must be very much in the interest of executive management, however, to understand and manage intangible assets more effectively. There is plenty of knowledge now as to how this might be done, and evidence of its benefits. ■

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