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Human Capital Leadership

Insights

Graduate Cohort 2020
Master of Human Capital Leadership
Singapore Management University

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Value Creating Drivers for Effective Human Capital Management

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It is common for modern-day corporate leaders and academic writers to make claim that human resources is one of the most important assets in their organization (Guest, 2001). If that were the case, effective management of human capital would be a critical factor in the success of any organization. As an important organizational resource, human capital is expected to generate significant economic benefits from its deployment, development and retention (Flamholtz, 1999). There is widespread evidence that the effective use of human capital can also create durable competitive advantage for an organization (Barney, 1991; Becker & Gerhart, 1996; Lado & Wilson, 1994). Given its importance, the purpose of this article is to highlight the key drivers of value for effective human capital management.

Generally Accepted Accounting Principles (GAAP) governing the preparations and reporting of financial information of the firm, prescribes that rental value of the critical human resources (e.g. wages and perquisites arising from the hiring of such resources) are recorded as expenses in income statement. These are matched against the revenue generated as a result of their use. However, GAAP prohibits the inclusion of the sum of future benefits that accrues from the "ownership" of such resources to be captured as assets of the firm. There are two reasons why this is so. First, there is a fair amount of subjectivity with respect to the valuation of human capital. In reality, what objective yardstick can we adopt to measure human capital? In addition, unlike physical assets, human capital cannot be owned by a corporation (Barber & Strack, 2005). In the labor market, there is intense competition for the best talent. Thus, talents can render their services to the highest bidder for their skillsets and abilities.

Such issues are also extended to intangible assets such as brands. Similarly, under GAAP, self-developed brands cannot be booked as assets in the balance sheet. The value of brands can only appear on balance sheets if they are acquired in arms-length market transactions. As a result of this, balance sheets tend to understate the true value of many assets. In practice,

instead of recognizing the value of human capital and other intangible assets in balance sheet as separate items, they are usually bundled under a basket term titled "Goodwill". This represents a catch-all item when the overall value of the firm exceeds that of the net book value of assets. As a result of the lack of formal recognition of value of such specific assets, there is a tendency that this important asset is neglected when management and investors make corporate and investment decisions, respectively (Likert, 1979).

This neglect can have significant consequences on firm value, as there is evidence of strong positive correlations between investments in human capital development and effectiveness of human resources, in terms of the development of human capital and its impact on financial performance. This in turn translates to better financial and non-financial performance (Marimuthu., Arokiasamy, Ismail., & Development, 2009).

We can easily value human capital when there is a ready market to transact those assets, such as self-developed brands or even human talent (e.g. professional athletes like professional footballers and soccer players) that can be transacted via a market sale. In the area of entrepreneurial finance, this concept is similar to the idea of "sweat equity" which involves external investors (angel investors, venture capital firms etc.) offering to buy part of a new venture at a certain valuation. This is seen as crediting the founders for their effort in creating a promising business venture. For example, a founder of the firm invests $100,000 of his own capital into the venture. A year later, a VC investor agrees to invest in the new venture valuing the firm at $800,000. The value we can attribute to sweat capital (effort) in this case is $700,000 which arise because there is buyer who is willing to pay $800,000 for the venture. In the context of human capital, the additional value a buyer is willing to pay for superior human resources and management is the value of human capital.

Another technique in valuation relates to the fundamental economic benefit of asset ownership. In finance, two criteria are used when determining whether an object counts as an asset. An asset must not only have value but must also generate return. It is the return generation capacity of an asset that gives the asset its market value. Technically, the market value of an asset is determined by the present value of future cash flows generated by that asset. Two things that valuation methodology handles well that accounting standards do not, are subjectivity and uncertainty. In

deploying valuation technique, it is inevitable that one has to engage in the estimation of several parameters, including future cash flows, growth rates and hurdle rates, both of which are subjective and uncertain. In general, valuation increases with higher cash flows or lower hurdle rates. The latter reflects exposure to risk.

A practical way to ascertain the value of human capital is to value the entire firm with base-line parameters. From literature, there is strong support for several metrics for human resources that are strongly correlated to firm performance and therefore can serve as good drivers of valuation. These include billing potential, employee turnover or retention, revenue per employee and employee absenteeism. These parameters can vary according to the firm's human capital strategy. Thus the deployment of effective human resource strategy, can potentially increase the billing potential of the employees, increase employee productivity (higher revenue per employee) or reduce the rate of absenteeism (Fulmer & Ployhart, 2013). Simply, the differences between the base line valuation (without enhanced human capital management) and the valuation with effective human capital management, would be the estimated value of human capital. The key issue here is the level of base line performance that we use. In this regard, one pragmatic, yet conservative approach to establishing the firm's base line performance for human capital management is the industry average performance. Based on this method, a firm would only achieve a positive value for human capital if it has better human capital performance than their industry peers. Under this method, firms that perform poorly relative to industry average would not have any value of human capital assets.

Furthermore, when investing in extensive Learning and Development (L&D) programs or any other highly significant human capital programs, firms can also adopt similar techniques used in capital budgeting, such as NPV and IRR decision rules, to estimate if the investment in L&D will generate positive outcomes for providers of capital. If this is done consistently, then the benefits of value creation will be reflected in higher valuation of the firm. This would then address the issue of neglect arising from the non-recognition of this asset.

With a clear understanding of the drivers of valuation, human resource professionals will be in a better position to craft human capital strategies that deliver superior financial and non-financial performance, creating value and enhancing the firm's valuation. However, the issue of

valuation of human capital depends on the relevance of these techniques on the firms or industries in question. Problems arising from the valuation of human capital are more pronounced in businesses that rely heavily on human capital, such as consulting, investment banking and software firms. Conversely, they are less relevant to firms in highly capital-intensive industries such as semi-conductor manufacturing.