

Managing Human Capital as a Real Business Asset

By Jeanne M. DiFrancesco

As you peruse the avalanche of annual reports that will be released this year, how many will loudly and confidently proclaim, “people are our most valuable asset?” How many CEOs will make similar declarations at their annual shareholder’s meeting? Although we would agree most CEOs are acutely aware of their investments in their “most valuable asset” (salaries, benefits, training, recruiting programs and the like), almost none could tell you what their “most valuable asset” is worth.

This issue has been examined and hotly debated for well over 30 years. The finance profession will tell us that people are not a business asset — they do not meet the criteria and they are impossible to “value.” Although many (perhaps most) managers actually have the intuition that if they make an investment in their people, some value would be realized, most could not tell you how that value would be generated or how to calculate it.

This is the dilemma most companies face today. It has only been exacerbated by the trend away from financial and physical capital as sources of competitive advantage as the information age has unfolded. Talented people, brilliant product designs, strong brands, customer relationships, intellectual property have dominated the landscape and make the difference between success and failure in most businesses. These types of assets are called *intangible assets* by the accounting profession. Intangibles are not generally captured on the balance sheet of an organization and investments in intangibles are generally considered “costs.” So when companies go through exercises of “cost reduction,” which investments tend to go first?

So, is our “most valuable asset” an asset or not? If it is an asset, how would we calculate our investment, what would

be its value, and how could we improve our return on investment (ROI)? In the end, is measuring just too hard or too pointless — should we just give up?

DEFINING OUR “MOST VALUABLE ASSET”

To define the characteristics of an asset, we look to the U.S. Financial Accounting Standards Board who defines an asset as something tangible or intangible obtained by an entity and exhibiting three characteristics:

- ▶ The asset embodies probable future benefits that will have an impact on cash inflows,
- ▶ The owner can obtain the benefit from the asset and control the access of others to it, and
- ▶ The event leading to the rights to control the benefit is in the past.

In other words, an asset is something the company controls the rights to and uses to produce future returns.

In a business, people do not seem to meet these criteria. The company cannot control access to people. They can come and go, as they like. Therefore, are people not assets as the finance department has always said? Is the CEO’s statement that “people are an asset” just a politically correct expression?

STRATEGIC FRAMEWORKS AND ANALYTICS — A PERSPECTIVE

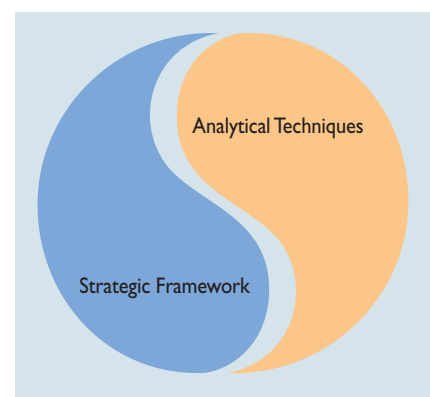
This is not the first time this problem has been considered, as the world is only getting more complex not less. This is the reason physicists search for a unified field theory — not because they do not want to contemplate complexity, but rather because they do. The following is not an exhaustive dissertation on the intricacies of organizational dynamics, competencies, incentive plan designs or leadership styles. There is plenty written about these topics. This is a strategic

framework for thinking about what human capital is and how it can be handled as a business asset both strategically and quantitatively.

This framework allows the more specialized work in the areas of human capital to be considered in the context of business value. The simplification and clarification offered here is not intended to be simplistic, but rather to offer a clear path to think about the relationship between variables — more like a framework on which to hang more complex concepts.

Perhaps there are CEO’s that do not care about returns on their investments (I have not met them, but that does not mean that they do not exist). There are authors that argue that business is just too complex and attempting to quantify any of this is just futile. They scoff at the notion that you can measure these things and find it quaint to even try. Others argue against attempting to “account” for intangibles. People approach this topic with a variety of emotional and cultural perspectives (“you can’t be serious — people cannot be valued”).

The insight offered here requires that you suspend disbelief. Recognize that solving this dilemma will require a paradigm shift and it may require reconsidering what you think you know. Smart peo-



ple have been thinking about this for decades and if the issue were solvable by the tools of any single discipline, it would have been solved already. There is so much writing going on these days about this topic that defining terms and carefully constructing the relationships between variables is half the battle. This ap-

proach employs the tools of economics, finance, operations research, strategy, and the human resource disciplines, but they may be in a completely different context than they have been used in the past.

This approach to analytics is less about formulas and accounting reports and more about using numbers to both

tell a story and inform a decision. The paradigm will put what is happening into context, the analytical techniques will help to find the value proposition. One cannot be done without the other.

BUSINESS STRATEGY AND THE CREATION OF VALUE

To clarify our use of terms, we will begin with how a business creates value (see Figure 1). Every organization has ability to do certain things (like making cars, filling vending machines, designing computer chips, etc); these are *Organizational Capabilities*. These capabilities are able to meet certain needs that buyers have for goods and or services; their *Market Needs*. The intersection of an organization's capabilities and the needs in the market is referred to as the *Market Space*. Now, in order for an organization to make any money, it must actually offer goods and services into the market space: these are the *Offerings*. Offerings are what a customer actually buys — they generate revenues (now or in the future). The notion of *Market Share* is the percent of the market space that is populated by a company's offerings.

Organizational capability is comprised of three classes of assets (see Figure 2) that are core to its ability to produce goods and services — *physical capital, technology capital and human capital*. Physical capital is widely known and understood by financial accounting and includes expenses such as plant and equipment, facilities, desks, chairs, etc. Technology capital includes both product technology (patent formulas, product designs, etc) and process technology (the methods that delineates the steps in the process). Information technology tends to be a combination of some physical capital (computer hardware, printers, etc.) and some application technology (software, procedures, standards, etc.). So what is human capital? The human capital of an organization is *not* people. People own their human capital and invest it in many different areas of their lives: family, community interests, hobbies or sports and *work*. Therefore, a company's human capital asset, is the sum of the talent, energy, knowledge, and enthusiasm that people invest in their work.

In financial accounting, physical capital is generally the only class of core as-

Figure 1. Business Strategy Development.

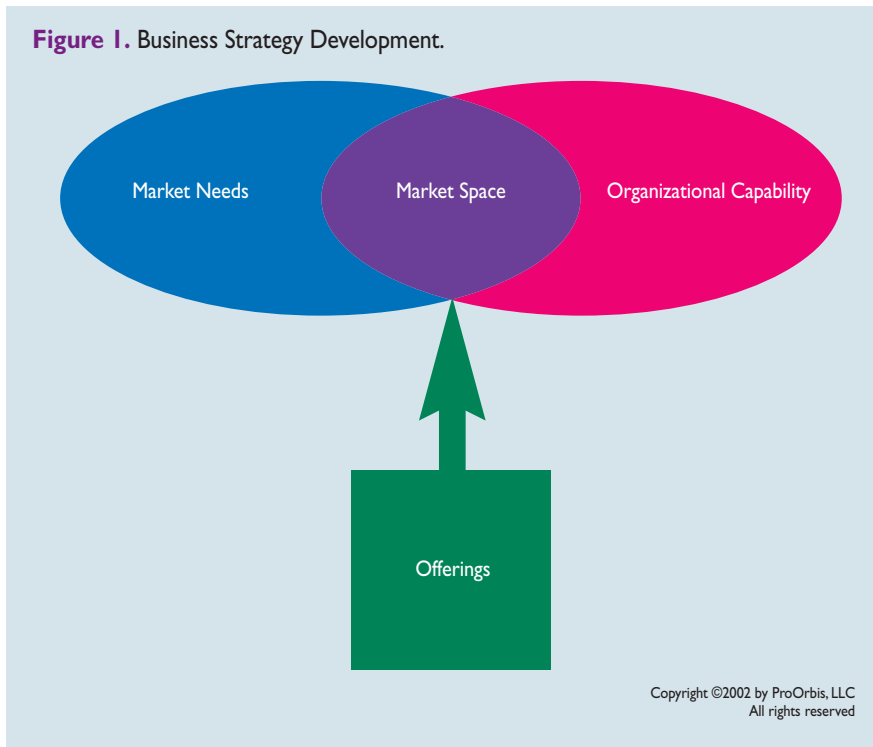
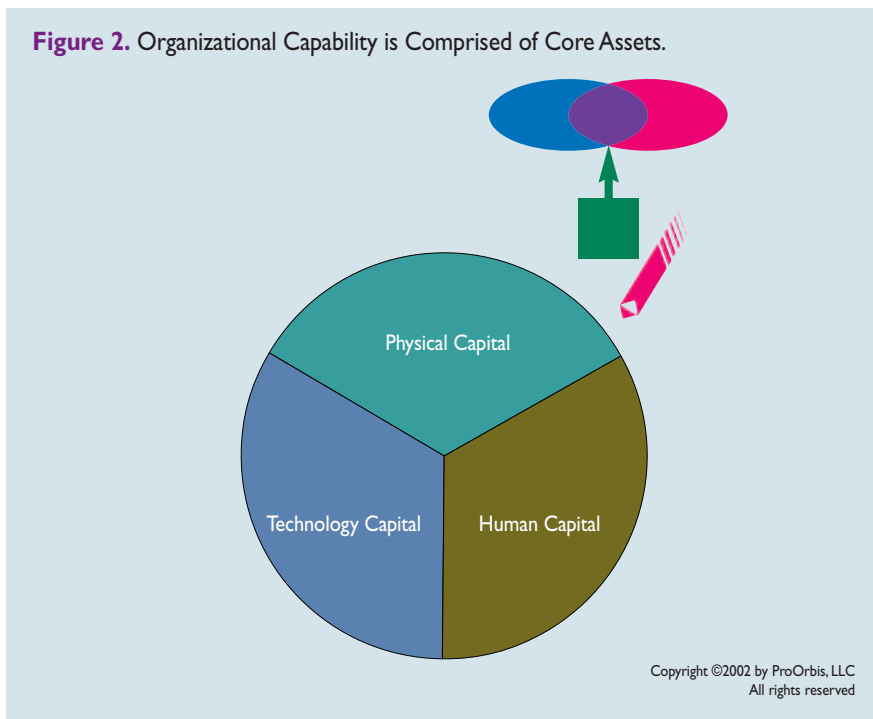


Figure 2. Organizational Capability is Comprised of Core Assets.



set to be considered *tangible*. Human and most of technology capital, as we have defined them, are generally considered to be *intangible*. Of course, there seems to be more to organizational capability than the core assets — there are brands, channels, customer relationships, intellectual capital, knowledge management, networks and the like. We will revisit the treatment of these after we consider how assets create value.

BUSINESS OPERATIONS DESIGN

Process technology takes human capital, physical capital and product technology and configures them in to business process designs (see Figure 3). Think of any business process you can imagine, and you will find it is comprised of these core asset classes. The business processes configured by the company's core assets require something to process — that is, Inputs such as raw materials, energy, subassembly or subcontracted services. Inputs are not a part of the productive capability of the organization — they cannot produce anything — they are made into something.

These business processes are designed to produce something that has value — the *Offering*. The offering is produced through myriad business processes (production, marketing, distribution, and so on) the output of which has value — something a customer will pay for now or in the future. This valuable output we term *throughput* to distinguish it from output that does not have value (such as obsolete inventory or management reports that no one reads). We term the processes involved in producing the offering as the *main transform*.

Inputs are generally another organization's throughput. If you think about it, the outsourcing decision is usually one of simply redrawing the boundaries of the organization. This typically leads to a reduction in the assets a company holds, but an increase in the cost of inputs (see Figure 4).

As you can see, expenses fall in to four principal categories — inputs, human capital, physical capital or technology capital.

VALUING ASSETS

Using this strategic framework, the value of the assets starts to become

clear. Recall that organizational assets are not purchased to be resold directly. These types of asset investments are undertaken to *create* something that has value. In this way they “derive” their value from the offering (the thing the company does intend to sell). Therefore, the value of an asset depends on how it contributes to the value the firm creates in the business process (throughput).

If assets create the business process and the business process transforms inputs into throughputs, then it follows that the value of the assets is the difference between the cost of the inputs and the value of the throughputs. This is the value the assets created. Therefore:

$$\text{Throughput} - \text{Input} = \text{Value of the Core Assets}$$

This form of valuation assumes there is a going business concern. This is different from the value placed on assets when a firm is to be shut down. Liquidated assets are only worth what you can sell them for, not what you can make with them. It is also true that core assets in a going concern only have value in *combination*. To gain intuitive insight on this concept, try thinking of any business process in your firm and imagine taking any one asset completely out of it. What is the value of the throughput? Generally, zero. It is especially problematic to think about the value of intangible assets outside the context of their working with other assets. Because one asset can often be used in place of another (i.e., more computers, less people), there is a concept of the best possible combination we refer to as the *optimized* asset mix.

Figure 3. Core Assets are Configured to Create Business Process Designs.

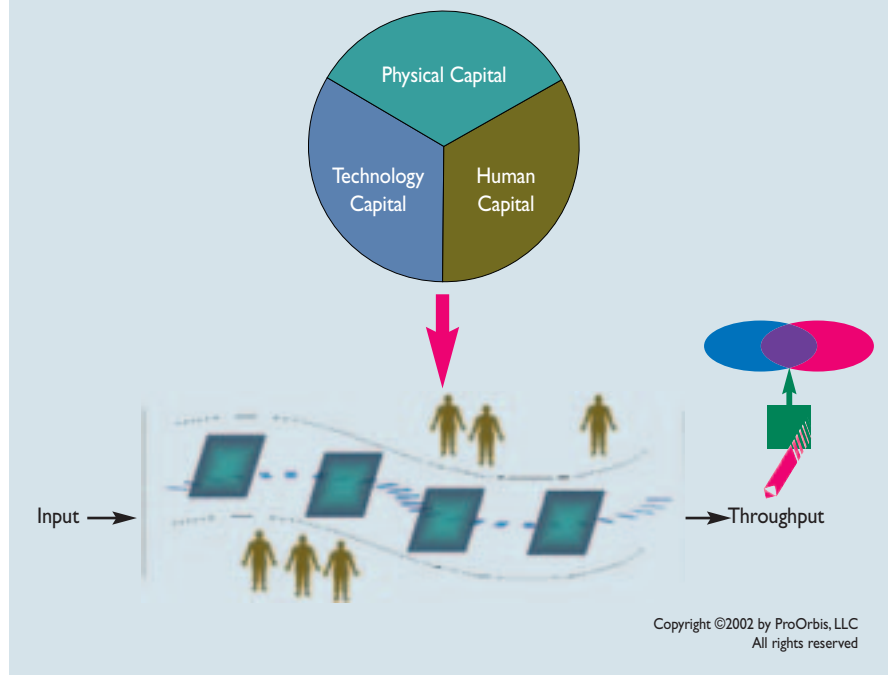


Figure 4. Outsourcing in the Main Transform.

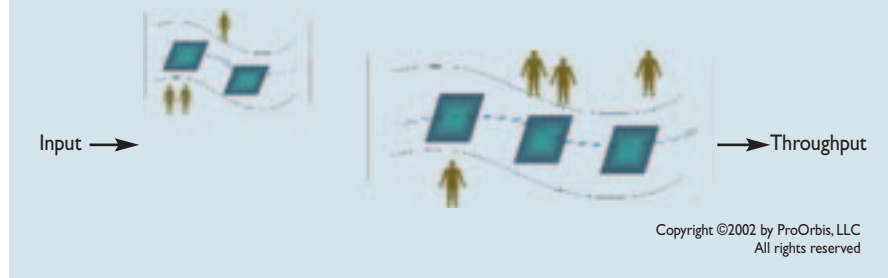
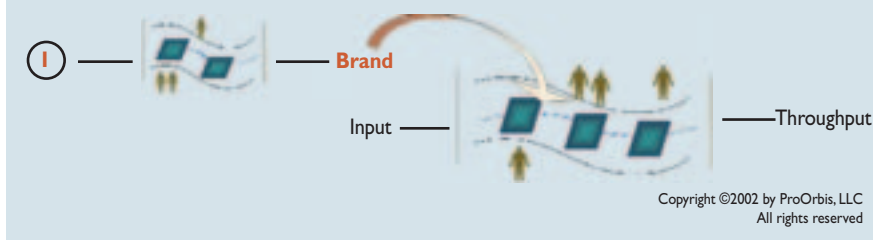


Figure 5. Creating a Non-Core Intangible Asset.



OTHER INTANGIBLE ASSETS

As mentioned previously, there are other intangible assets that are not core assets such as brands, channels, customer relationships, and the like. These assets are created by the core assets using business processes and are “reused” in future periods. The best example to think of is simple brand valuation. A brand is not created all at once, but rather is the accumulation of significant effort over long periods. Some of brand management is done with a company’s “internal” resources such as marketing staff, their computers, their offices (core assets) and this team may purchase market research and hire an ad agency (inputs) as part of the process of creating the brand. A product with a helpful brand can sell more and at higher prices than the same product unbranded (causing throughput to go up). However, the brand is not used up — rather it is used repeatedly in multiple periods. It behaves more like an asset. Most classes of what is generally termed intangible assets that are not the core assets have this characteristic. The other type of intangible often referenced is knowledge capital. This type of resource is a little different in that it is not an asset at all. Knowledge (in an of itself) does not have productive capabilities. Knowledge becomes productive when it is embedded in a core asset (if someone can read it and use it in their work, or the knowledge improves a product design, etc.). Most of what is termed intellectual capital (if it is not knowledge) falls in to the product or process technology arenas (like patents, trademarks, contract templates, etc.).

RETURN ON INVESTMENTS

Once we have both the value and the investment in the core assets, it is now possible to do a return on investment

(ROI). This is the ratio of the value of the assets (throughput minus inputs) to investments in the assets. Therefore:

$$\frac{\text{Value of the Core Assets/}}{\text{Investments in the Core Assets}} = \text{Return on Investment}$$

This concept of ROI is also the intuitive concept of *Productivity*. Most managers, when they say they want to improve human productivity, mean that they would like to improve the *relationship* between the value and the investment.

Investments made in the company’s assets may pay off over a long period. Therefore, when we talk about return on investments in assets, we need to try to match the investment with the period in which the value is generated. This concept of periodicity is clearly recognized in the way traditional accounting methods treat investment in physical assets. The practice known as depreciation allows such investments to be expensed over the useful life of the asset. However, since traditional financial accounting does not treat intangibles (as we have broadly defined them here) as assets; all investments in intangibles are expensed immediately, creating a mismatch between investment and the return in any short-term period (e.g., one year). Those looking for short-term results may discourage longer-term investments in intangible assets.

HUMAN CAPITAL — THE ASSET REVISITED

Hence the resolution of the first dilemma — people are not the asset of a company — but human capital is. In the context of the criteria for an asset, this definition of human capital meets the FASB requirements as:

► A company makes an employment arrangement with an employee (The

event leading to the rights to control the benefit is in the past);

► Generally, the employee’s activity is in control of the company while they are “on the job.” (The owner can obtain the benefit from the asset and control the access of others to it); and

► The employees’ activities are part of the production function that will create the cash flows of the future. (The asset embodies probable future benefits that will have an impact on cash inflows.)

It is true that some employees are more “asset-like” than others. The more stable the relationship, the more the company invests in the employee with the expectation that they will stay with the firm, and the more “asset-like” the employee is. This is technically true and intuitively obvious.

It is hard to say how different organizations would be if they managed their human capital with the same care as their physical capital investments. Arguably it would be a far different decision-making process when earnings are not meeting expectations. Can you imagine the reaction of the Wall Street analysts if a company said it was going to cut costs by shutting down one of 10 plants? Imagine if they said they were going to “pay” to get rid of the plant? Can you see the stock price soaring? Now, think of the typical 10 percent reduction in force lay-off with a generous severance or early retirement package. How attractive is that to the company’s shareholders?

I can recall an encounter with a senior manager whose spending on human capital was about \$7 billion a year. He approached me with some anxiety and distress looking for ways to reduce the cost of this budget. Salary policy was well within this senior manager’s control. I thought for a moment and replied, “We could reduce the cost of payroll by 10 percent before lunch, but what would we do the rest of the day?”

The truth is, any monkey can reduce costs. Reducing costs while maintaining value (improving productivity); now there’s the challenge.

INVESTMENTS IN ASSETS

The core assets of the firm do not magically materialize, of course. Assets must be acquired, operated and, perhaps at some point, divested to keep the busi-

ness processes optimized. We refer to this process as *Asset Management* (see Figures 6 and 7). Each core asset requires asset management. In a manufacturing firm, physical capital generally may have legions of engineers, maintenance, and construction services to ensure that the physical capital contemplated by the operations design actually shows up doing what it was intended to do. Often times technology is supported by large research and development (R&D) organizations whose sole responsibility is to invent the formula, design, etc., to make the offerings come into being.

So what about human capital investments? The investment in the asset includes all the costs of managing the asset. For human capital, this would include everything from compensation and benefits to training and development, recruiting, selection, performance management and the administration of the human capital asset, e.g., the HR information system, benefit administration, and the cost of the HR staff.

Companies also invest *time* in managing human capital assets — time, not just of HR staff, but of managers and employees involved in HR management processes such as pay administration, performance evaluation, hiring, etc. If the cost of this time were added to out-of-pocket expenses, many organizations would find their investments in human capital are significantly higher than they ever imagined.

HUMAN CAPITAL ASSET MANAGEMENT

What does it take to manage human capital (HC) as a business asset? For the most part the cost of “HR stuff” is recognized as investments in HC, but rarely is it recognized that there is a *process* for managing human capital. To review, human capital has value. The value is derived from the value of the offerings (the throughput). The source of the value is the work that people do in the business processes (main transform). The work has value because the offering has value. We term this *keeping the bead* on the value and is critically important for establishing value propositions.

So how do you get people to show up and do the work that was imagined in the business process design? How do you

keep large groups coordinated? How does each individual player know what to do? How would you know if what they did was any good? This is the business of *asset management*. Asset management is also a business process. It is comprised of assets; it has a throughput and inputs.

One of the hallmarks of a process is that it is *integrated*. This is another term that is used often, but with different meanings. For our purposes, integration is when the output of one step is the input of another. It is the concept of being linked. This is different than the concept of *alignment*. Alignment is more of a “go togetherness” concept. It is typically used to describe relationships between

elements that “can live in the same cosmic space.” Things can be aligned without being integrated.

The system that manages the human capital asset is depicted in Figure 8. It is actually a closed loop process — not a series of disconnected boxes. There are three distinct parts of the system that integrate in a specific pattern. The complexities of Human Capital Asset Management (HCAM®) are substantial, but only the basic understanding is needed to facilitate the calculation of value proposition.

The first part of the system we call Performance Management. This system starts with the work that human capital should do as designed into the business

Figure 6. Asset Management.

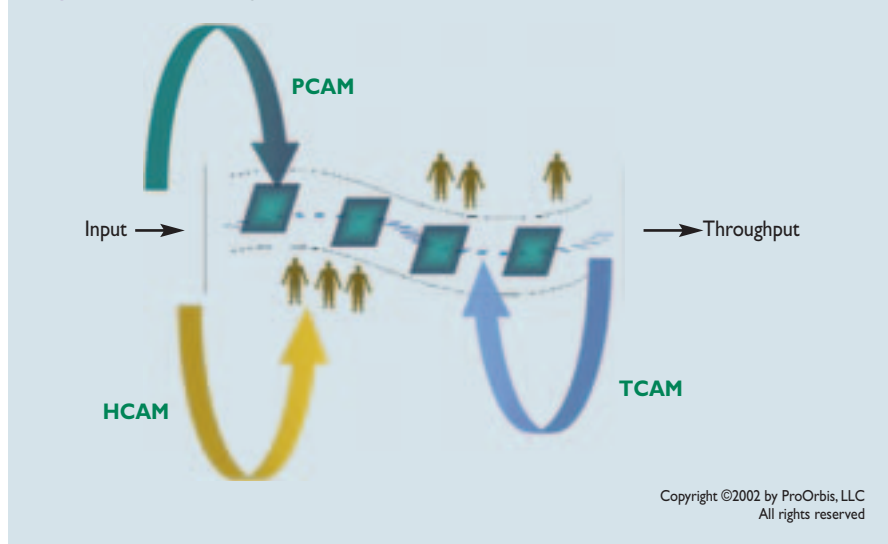


Figure 7. The Human Capital Asset Management System.

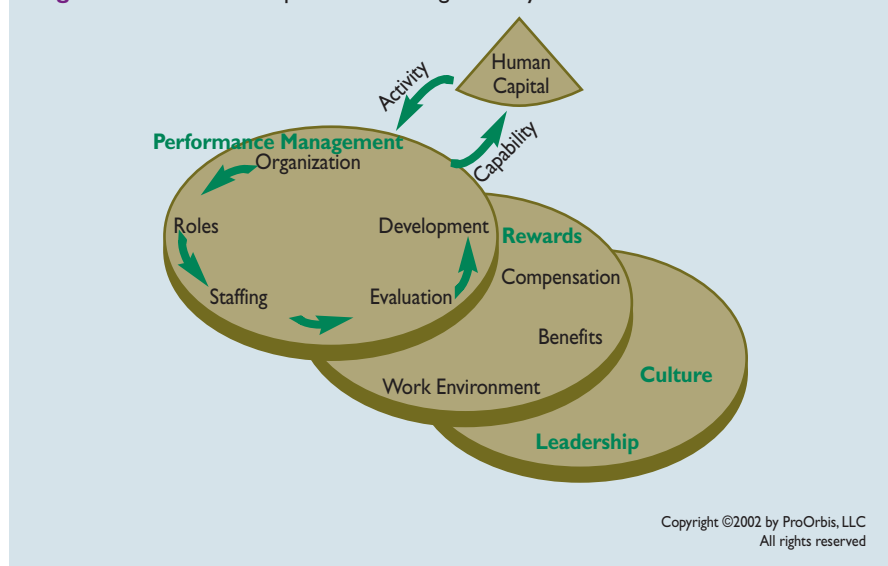
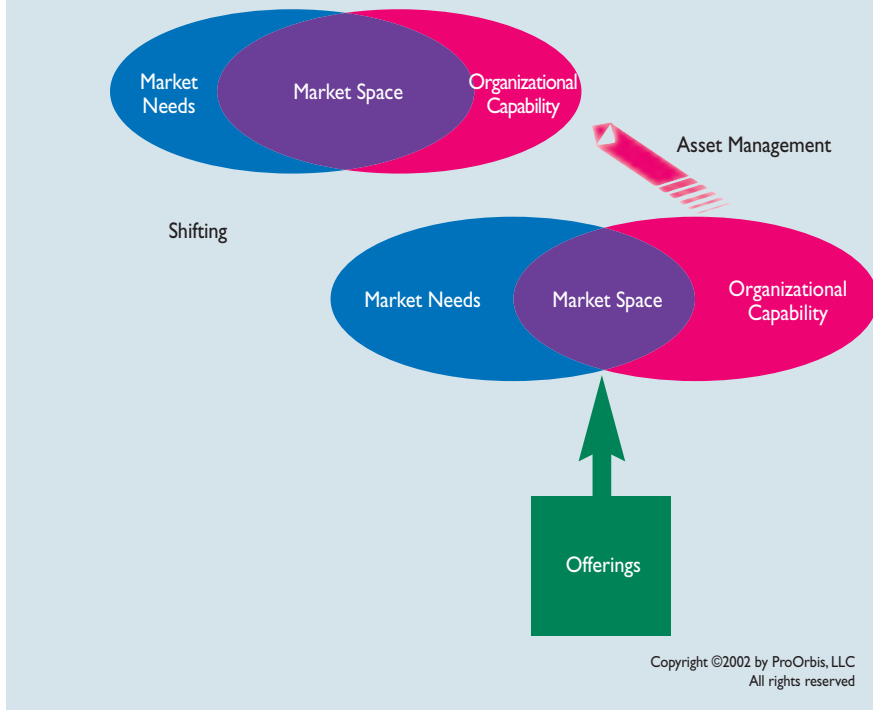


Figure 8. Asset Management can create the capability to position competencies for the future closer to the market needs, creating more market opportunities.



process. Once you know what people are intended to do (where they will be doing it, with what resources, etc.), you can then organize. Organization facilitates the management and coordinates the activity of human capital and actually creates additional work; management, coordination and communication-type work. The roles step is where work is “bundled” into jobs and performance expectations are established. Staffing is where the human capital owner “enters” the system and the staffing process matches people to the role. Evaluation is a gap analysis that determines the difference between what you asked for (Role) and the performance you got from the person in the role. Then development, of course, fills the gap in performance. At the end of the process you have more “productive” human capital than when you started and in this way the Performance Management System “manufactures” human capability (competence and capacity). Notice how the output of one step is the input of the next. This keeps all the activities linked to the thing that has value (the work people do in the business process). The performance management system alone represents an enormous investment in

HR staff, HRIS systems, management time, etc. We call these types of expenses HCAM *Operating Expenses*.

Rewards is what you give to employees in exchange for “showing up” and doing what you need them to do. The problem with most concepts of rewards is that employers think of this as compensation and benefits at the most. The reality is that employees consider compensation, benefits and a variety of other factors (such as “Do I like my job?, How far is my commute?, Do I have a future here?, Does my office have a window?, Does my boss know what he is doing?, etc.”) as a kind of “pie” of rewards that they weigh against the investment they make in their work (the individual’s human capital investment). We call this array of other factors Work Environment and consider this as part of the rewards mix and trade off for other aspects of rewards (longer commute for higher compensation). The employee considers the “trade” of the total rewards for performance between themselves and the company and determine if “net net — it is worth working here.” All rewards can entail some form of investment (even good management, reasonable working hours, etc.). The rewards expense that go

directly to the employee we term *Direct Transfers*. The rewards expense for compensation administration, payroll service, etc. are *Operating Expenses*.

The last, but not least aspect of the system is Culture and Leadership. These are the affective aspects of performance management. These are the parts of the system that appeal to and touch human emotion and effect motivation, will and commitment. We use the term leadership to refer to the force that focuses and inspires human capital and it propels people in a direction. Leadership can come from any level of the organization and can propel people to where the company would like them to go — or someplace else. Culture is more like a melieu. It is what people fundamentally believe about working at the company and it is the filter through which they hear all communication. If people in your organization fundamentally believe that it is not “what you know but who you know,” that will be the filter and your communications about “high performing people being selected for the top assignments” will have a very tough time getting through. To execute a particular strategy, there may be attitudes or perceptions that are essential to delivering the company’s overall value proposition. A major chemical company that makes hazardous materials will need safety as a *cultural imperative*. Leaders are the stewards of the culture. Both leadership and culture can be managed, but again, this takes investment.

Within each aspect of the three layers of the system there are very tight linkages. We call this *strong form integration*. Between the layers there are also linkages, but they are more diffuse. A single cultural imperative may have influence on: 1) organization design, 2) performance expectations in roles, 3) screening criteria in staffing, 4) development objectives, 5) incentive plan design, etc. We call this more diffuse pattern of linkage *weak form integration*.

By connecting the entire HCAM® system to the thing that has value (the work people do in the business process), we put all aspects of activity traditionally thought of as HR stuff into a kind of supply chain, in which there are *causal relationships* between the elements.

Once the HCAM system is integrated, the world of operations research tech-

niques can be applied to HR plans and programs instead of relying on the inferential techniques of statistics to give you correlations. You can determine issues such as, where the bottleneck is and what kind of investment it takes to release it.¹ Integrated systems give you the ability to “keep the bead” on value. This makes it possible to not only explain what is happening, but to predict what would happen with a particular kind of investment. The system efficiencies created when global supply chains were integrated during the past 20 years has been astounding. Imagine how much wasted effort there is in a disintegrated system that does not know what “valuable thing” it is making. How much of your HR and HRIT functions efforts are really “pointed” to value?

THE RETURN ON INVESTMENT IN HUMAN CAPITAL

Recall that to calculate the value of the assets, we subtract the inputs to the business process (e.g., raw materials, energy, subassembly, subcontracted services) from the throughput. This is the value of all the assets in combination and is the primary equation to watch when you are “mixing” assets in a production function. Once it is determined what you intend for HC to do in the process, then a derivative of this equation can be generated to determine the value of each asset.

Although this can be a bit complex in practice, the easiest way to think about it is to handle the situation in which assets are optimized. In this case, the value of any *single* asset is a portion of the value created by all the assets. So if human capital represents 60 percent of the total investment in all assets, 60 percent of the value of those assets can be attributed to human capital. So the return equation is:

$$\text{Value of Human Capital/Investment in Human Capital} = \text{Return on Investment in Human Capital}$$

Note that this equation is useful for making decisions *after* you have determined the right mix of assets. In other words, physical and technology capital must be held constant. This equation is used for making decisions about trade-

offs in various human capital investment arenas — should we spend more on better selection or a new incentive plan.

Populating equations with hard data requires that all investments have been credited to the right asset and that inputs have been isolated (accounting statistics require the same rigor). Account-

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ing methods would not produce these aggregated numbers today with the classification criteria that exists, although most of the needed data is already captured in the transactions and the classification methods for accounting data that have been developed.

Although much of the investment in human capital, like wages and benefits, is “used up,” there is some that is not. Training, development, teambuilding, performance appraisal systems, and recruiting programs often are not used up right away. These parts of the investment can be used either by building human capital “capabilities” in many people over many years, or by building a capability in one person who will be utilized for many years. Therefore, as you consider return on any investment in human capital, the question is, what value will it generate, and for how long?

How does the investment in human capital generate value again? Go back to the concept of throughput. Assuming inputs stay the same for a moment, the only way an additional dollar invested in human capital can generate a return is if throughput goes up more than one dollar. Therefore, to understand improving productivity, you must understand the relationship between the work people do and the value of the throughput. Can people make a difference? Every business process can “tolerate” (i.e., use or accept) a certain range of performance for all the assets. If the performance falls below the range, it is said to be “unsatisfactory;” if it is better than what the system can use, it just goes to waste. Understanding *how* human performance affects the performance of the business process in creating the throughput is essential to

doing human capital value propositions. Ask yourself this question, “If everyone in my company performed at the highest level according to my performance appraisal system, would throughput go up? Would it go up enough to cover the investment?” Most companies have yet to identify the human performance that

would actually change the performance of the business process.

These equations must be drilled down carefully depending on the question being asked. It is very important when handling derivative equations to understand the question that is being asked and what variables must be held constant. Carefully constructed, these analytical techniques can be used to inform decision makers on such things as “What is the highest-return solution for my HR information system to which executive incentive plans will most efficiently target the behavior that “makes a difference?”

Often times you will not have all the data needed to make a perfect quantitative equation. Should this stop you? Perfect data does not exist now, yet decisions are made every day. Even being able to construct the value proposition in “words” can be tremendously helpful in clarifying the issues and identifying the likely “right answer.” By introducing this discipline, you can begin to make estimates and proxy data while your organization works to accumulate the right data sets.

ASSET MANAGEMENT — AGILITY FOR THE FUTURE

Another capability sometimes thought of as an intangible asset is the ability to change. Asset management systems can reconfigure assets (new requirements go in, assets come in and out). Asset management can be an amazing competitive advantage. As markets shift, market spaces can evaporate — especially if the organization’s capabilities are too slow to shift. Responsive asset management can be “investment intensive” (read: expensive). So just how

fast do you need to be? The question is, “How fast do your markets move?” Speed is a relative concept. In dealing with change, there are two knobs to turn — market foresight or fast changing assets. With market foresight and asset changing speed, asset managers can reposition a company’s capabilities creating larger market spaces in the future,

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giving managers more “room to play” in formulating offerings. All speed will not necessarily show a positive ROI; balancing speed and foresight in the value equation will help to formulate the optimal return.

Some organizations, by taking all the “slack” out of their systems, often forget that *changing takes capability*. Capabilities are created with assets. When you introduce time in to this model, scenarios for the future must be imagined. You can create an organization that beautifully executes today, yet is paralyzed in its ability to respond to the future. In financial accounting terms, this organization will look spectacular. Net income, earning per share — these terms will be at an all time high. Most managerial incentives are keyed from these accounting profit statistics, so this company’s managers will likely get unbelievably high bonuses. Could Wall Street read the warning signs? Would you buy the stock?

THE STRATEGIC ROLE OF HR AND HUMAN CAPITAL ASSET MANAGER

We have covered a lot of ground. The strategic question for the HR discipline is: “Would these tools be helpful in our role as a strategic business partner?”

In the quiet of their office, top senior managers have expressed a resigned exasperation with the HR function. They know that people are important. For many of them, human capital-related expenditures are the highest percentage of their total costs. In many businesses, people are the only real asset. Many CEO’s understand that people are the source of their competitive advantage. They see the evidence every day — from

the way in which their managers make decisions, to the call center representative that may have just interacted with the vice chairman of their next big client who was calling about his mother’s healthcare claim. They would love to make investments and know what kind of return they could expect, or how to know for sure that they got it.

I recall a conversation with one very senior executive looking for strategy assistance in attracting and retaining his talent. I asked about his HR group and what role they would play in the project. He said “This is a business assignment — we are looking for help on our business team. HR is not involved.”

We insist that even when doing something as seemingly “administrative” as organizing an HR department, that our clients understand the strategies of the businesses they serve, the operations that create the value; and the role that human capital plays in executing those operations. Only in this way can an HR function actually “add value.” I cannot tell you how many times we are criticized by HR staff for being completely “off task.” Why would anyone need to understand a business strategy to organize an HR function?

HR managers must understand that when the HR system (as designed) is not integrated, people (especially first-line managers) will attempt to integrate them for their employees. The closer you are to the “ground” — the more acutely aware you are of HR practices and program disintegration. So if a new performance appraisal is “launched from corporate” and it was not accompanied with new role expectations, rewards systems, etc., managers will try to put the process back into some kind of equilibrium by adjusting it so it “works.” This is why many well-intentioned and expensive HR initiatives fail.

I am often asked if it is hard work to manage human capital with the same rigor as a company uses to manage physical capital. My reply is, “Hard compared to what?” A perfect example of an inte-

grated system is the web of life in nature. I often tell a story of someone who loves to weekend in the rainforest. To anyone who does not understand ecology, I am sure the rainforest looks like pure chaos — no order whatsoever. If a mosquito bit that unenlightened person while they were enjoying their weekend visit, they might be inclined to say, “Please, someone spray to get rid of these mosquitoes — I hate mosquitoes.” When the person returned the next weekend, they might be shocked to find all the frogs had died. The question, of course, is not “Will all the frogs die?” The question is, “Will you be surprised that they died?”

Most of us would understand these relationships in nature. Because some HR managers do not understand the integrated nature of asset management, they tend to spend a lot of time fighting fires. They have unexpected legions of dead frogs and spend extraordinary amounts of time in quest of an explanation, cleanup and consolation of the survivors. This is enormously time-consuming and tends to take their eyes off the “strategic and future-thinking ball.”

IS YOUR CURRENT RETURN ON INVESTMENT GOOD OR BAD?

Once you have constructed your return statistics, the next natural question will be “Are my returns any good?” This is a question with several different answers depending on what definition of good you use.

Let us begin with the way to interpret a return statistic as we have constructed here. If the return ratio were 2.3, the interpretation would be — for every dollar we invest in assets, we get 2.3 dollars back.

The first test of a return statistic is, “Is it greater than one?” Assuming all the data has been properly periodicity matched and discounted, a return statistic of one or higher would be acceptable (hurdle the required return rate). Assuming the rate was hurdled, the second question you might ask is, “How are my business units performing compared to each other?” Interesting, but a tough comparison if managers are facing many different market conditions, opportunities, competitive dynamics, raw materials prices, etc.

Therefore, a third question you might ask is, “How the business is doing this

year compared to last year?" This poses many issues of adjusting for economic conditions, changes in raw material prices, etc., over time and it's not hard to imagine how this year could be very different from last year.

To address some of these questions is the fourth question: How well did we do against the competition. This is a wonderful question in that it "washes out" a lot of market condition variables (everyone faced the same market) as long as the companies are in the same industry. Isolating the input variable allows more valid comparisons between companies that approach the market with very different production functions (highly virtual versus vertically integrated). It is also a particularly good measure for evaluating executive management. After all, much of their job is positioning "their team's assets" against the competitors; determining how well those assets were positioned and managed for return would be reflected.

For those of you with large diversified firms to manage, industry comparisons can also be used to index diverse businesses so they can be compared to each other. By producing a ratio of each business's return statistic with the industry statistic, you will see who is above and who is below the industry return and by how much. These "normalized" returns can then be used to compare one business unit to another.

Notice I did not ask, "How did we do against the goal?" What goal? Where did we get the goal? Think about the goal-setting process in your organization. How many times have goals been achieved and firms lagged their industry groups and/or their opportunities? Goal setting is a topic unto itself, but asking where your company's goals come from and what they have to do with the value of your company should be an interesting place to start.

BEYOND RETURN ON INVESTMENT

Are there other relevant measures besides return? Of course, the most important being:

Value - Investment = Value Added

This is like the concept of absolute dollar profit. With data that is projected

over long periods and discounted to the present is the concept of Net Present Value (NPV). This gives a sense of the size of the value created. After all, a return ratio of 10 looks wonderful, but if it is on a \$100 business, it is only so interesting. Both return and size are important. Depending on the weight a company puts on these objectives, these numbers can also form a composite metric that takes both in to consideration. If you watch the change in the composite over time, it is a good measure of growth.

The "Quad" — Return, Value Added, The Composite and Growth are the best four measures to keep your eyes on if you have an executive that wants the proverbial "bottom line." If you can get the periodicity match between the investments and return (forward looking), you will be in great shape.

TAKING ACTION

Keep in mind that accounting, as a discipline is about 500 years old. Accounting for human capital has barely been imagined and as they say, "Rome was not built in a day." It is critical that we keep in mind that this is a paradigm shift. You may not be able to get your organization to adopt the practice of handling human capital as an asset all at once. Do not despair; there are many affirmative steps you can take to prepare yourself and your company to get moving down the right path. Some of them include:

► **Expanding**

- Your personal development — educate yourself (you will be challenged);
- Making time — reading and meeting. Interact with other "practitioners;" and
- Look for the opportunity.

► **Experimenting**

- Develop a strategic HR agenda;
- Analyze a current project you are leading for the "systemic" implications;
- Solve a business problem;
- Develop new dashboard of measures; and
- Obtain comparative benchmark data — put the data in to a strategic market context.

► **Exploring**

- Introduce concepts to your HR or management team;

- Validate your agenda with them;
- Revisit your measures — are they helping you to make good decisions?

► **Enacting**

- Involve your team in a small-scale intervention;
- Develop a HC strategy for a business — implement and measure the results; and
- Develop your HR agenda from a HC strategy (infrastructure, programs, measures).

CONCLUSION

Human capital is a business asset — for most companies, it is their most valuable asset. Human resource professionals are in an outstanding position to take the lead in managing this asset for the firm with a powerful strategic framework and analytical techniques. They are also in a position to enable the Human Capital discipline to take a major role in the shaping of companies for the decades ahead. This will require a willingness to shift the current paradigm and build value propositions that are strategically coherent and quantifiable. HCAM is an introduction, but an important step down the road of creating HR as a true strategic business partner.

Managing human capital with strategic tools can also have a monumental effect on the return on investment companies achieve. When employee productivity goes up, options for new investments in offerings emerge, working hours can be reduced and the economy can grow faster. Think of how much human capital is wasted today. Think of what it would mean for that human capital to be devoted to a truly valuable use. The potential to make a difference for the individual, companies, industries and the economy are well worth the effort of the exploration.

ENDNOTES

I For those of you uninitiated in the discipline of operations analysis and systems thinking, I strongly suggest reading *The Goal* (see references). This will be the fastest way to come up to speed on these concepts and is a very fast and fun read.

ADDITIONAL RESOURCES

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Jeanne DiFrancesco is principal of ProOrbis, LLC, a consulting firm specializing in the development and application of advanced management concepts. ProOrbis is currently focused on using their comprehensive strategy techniques to reposition leading clients with new product design and portfolio strategy, comprehensive business process architecture, complete reconfiguration of the human capital management systems and new management dashboards to do returns on intangible and tangible assets. ProOrbis takes clients from strategy through implementation and one of their cases will be featured in soon to

be published Harvard Business Case. She holds an MBA from University of Pennsylvania, Wharton School of Business. Her previous experience includes 15 years of executive and strategic level positions in human resources for firms ranging from small startups to multi-billion dollar global concerns. She is the author of the general theory of Human Capital Asset Management (which includes the economic methods for the valuation of intangible assets). ProOrbis is partnering with other organizations offering a cross-company comparative profile (HCPPro®) to compare returns on investments in human capital, is the principal author of the course on "Valuation and Accounting for Intangible Assets," and is collaborating to embed these techniques in data mining, database and analytical software. DiFrancesco guest lectures at the Wharton School, has been featured in publications such as CFO Magazine, and speaks regularly at corporations and conferences. She will be presenting two sessions at the upcoming IHRIM 2002 conference in Orlando. Her current schedule of speeches and events can be found at ProOrbis.com. She can be reached at jmdifran@ProOrbis.com.

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