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# Human Capital: The ROI Perspective

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Heraclitus, the famous Greek Philosopher had once quoted "Change is the only constant thing in life." It goes without saying that in the context of todays' complex organizations, technology has revolutionised the way organizations function. Organizations today have become more lean, agile and customer centric as they unceasingly strive to drive Customer *Value*. Implicit in this *value* is the undeniable contribution made by the human resource.

It goes without saying that any organization is as good as its employees. The bottom line here is that employees should positively and meaningfully contribute towards achieving the strategic organizational objectives. If the reverse happens, then the organization would end up spending millions on employee compensation without any considerable return on capital employed. As organization's give more thrust to a value driven work process, it is implicit that ultimate value, can only be accomplished through a highly knowledge driven, competent and motivated workforce.

The Theory of Human Capital propounded by Theodore Schultz is based on the premise that individuals and society generate economic benefits from investments in people. Schultz professed that the only way to improve the welfare of the deprived class of society was to upgrade their level of skill and knowledge rather than by investing in the other factors of production; viz., land, equipment, or energy, knowledge. In his opinion ''human capital" was the qualitative aspect with had a more significant influence on organizational performance. Schultz, who won the Nobel Prize in 1979, described human capital as:

**Consider all human abilities to be either innate or acquired. Every person is born with a set of genes, which determines his innate ability. Attributes of acquired population quality, which are valuable and can be augmented by appropriate investment, will be treated as human capital.**

This theory refers to the cumulative value of individual competencies, knowledge, and personal attributes which are inherent in employees, which play a vital role in creating intrinsic value as well as economic value. The human contribution in organizations was always given passing attention as there were rarely any solid data to back up the proclamation. For years, it has always been supposed that an organization's pathway to success was solely based on its investments in its tangible assets such as plants, machinery and technology. The general perception among management professionals was that the compensation received by the workers was only in return for their labour and had nothing to do with value creation.

The following are some of the factors comprising human capital:

- Employee traits—which includes aptitude, mental acumen, intelligence, dynamism, a positive attitude, dependability, dedication
- Employee's learning capacity— imagination, innovative spirit, creativity
- Employee's motivation and outlook in terms of dissemination information and knowledge—a spirit of camaraderie and a sense of group cohesiveness

Human capital is the value of the skill, knowledge, and experience that an employee brings to the workplace. As human capital is akin to intellectual capital and emanates from it, so it cannot be easily accounted for in a balance sheet like equity capital. As human capital has an intangible asset value, it must therefore be inherent in each employees' intrinsic capabilities which they have acquired through specialized work know how or through exclusive training. The advantage of human capital is that is a perpetual source of competitive advantage as all other tangible resources deplete or depreciate with time, whereas the intrinsic value of the human resource always appreciates with time. This helps an organization to achieve sustainable competitive advantage.

In this context, management needs to ask itself the question "how do we drive productivity of our workforce so that they create value?" Simply speaking, productivity is just the end product. The vital aspect is the sense of satisfaction and fulfilment an employee has in his assigned job. If management can ensure a high sense of fulfilment by redesigning jobs and matching employee competencies with their jobs, then performance and profitability would automatically follow. What finally matters is that, if any organization can ensure challenging and rewarding work for their employees, which in turn will instil a sense of fulfilment in them, then they will surely be able to craft a world class workforce. This will consequently help them to retain the most productive workers and enjoy high customer loyalty.

As there is a consensus that people are the bedrock of an origination in today's knowledge-based world, one question that pops up is how can we improve the return on investment on our human capital? As organizations invest millions to develop a more competent workforce, they also need to devise quantitative metrics which justify their investment in their human resource.

A study done in 2003 by Watson Wyatt established that "Firms that carefully link HR activities to business strategy, measured by metrics have a 33% higher return on total capital than organizations that do not." There is numerous research which highlights that a higher productivity and employee retention is critical to generating a higher Return on Investment. This can only happen with a focussed leadership and a highly skilled and engaged workforce.

The following are some of the attributes that are involved in developing an efficient Human Capital.

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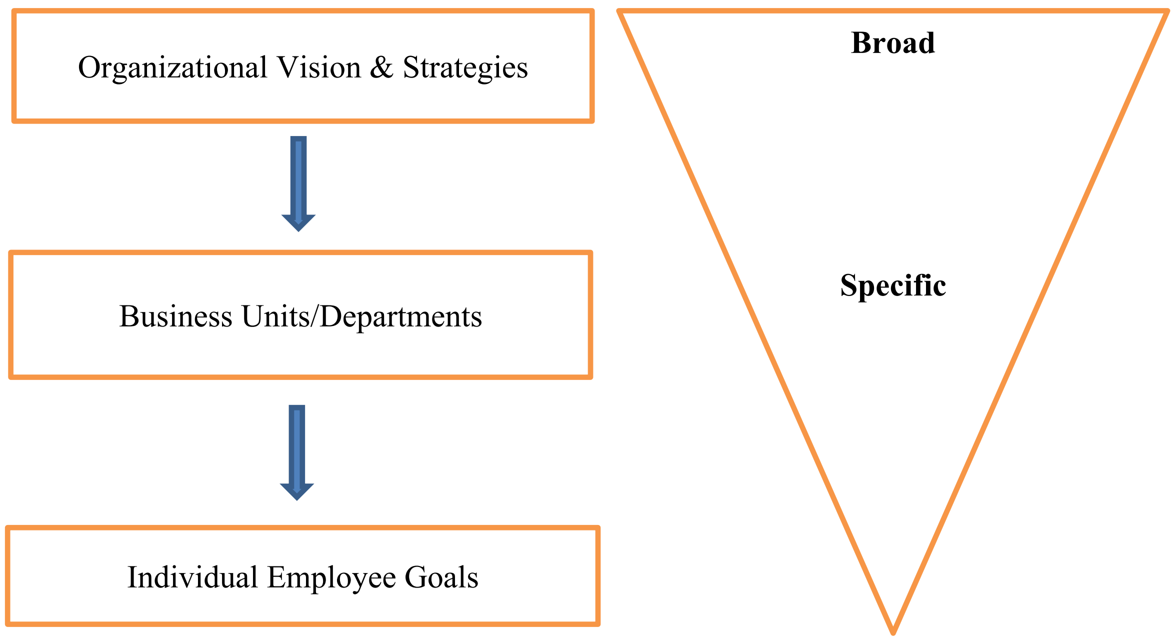
**1. Aligning the HR strategy with the overall corporate strategy:**

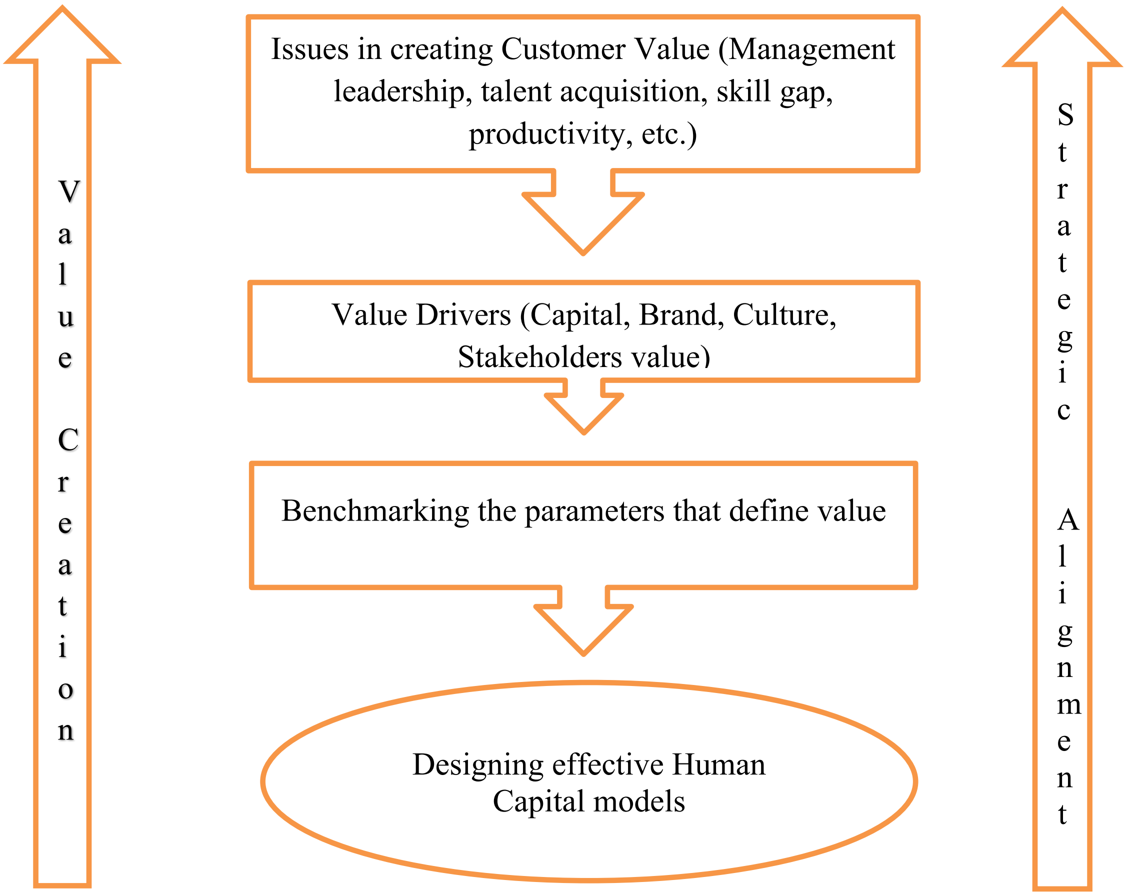



Strategy always has a top down approach. In any organization, there should be constancy and alignment with the organization's vision. The vision of the CEO indicates the roadmap for the organization's brand and culture. HR strategy must therefore always emanate from corporate strategy and should be aligned with it. HR should strive to become a business partner by understanding the intricacies of the business which will result in understanding the linkages between the organizational level, business unit level and the employee level. The organization needs to be focused on identifying the enablers which drive revenue at both the strategic and tactical level and coordinate the various functions that are critical to the optimum functioning of the organization.

**2. Identifying the enablers that drive enterprise value:**

All the initiatives taken by the HR right from acquisition, training, appraising, compensating are critical components in the value chain as they are acting as a catalyst in contributing to the overall success of the value chain. As human capital value is closely linked to corporate productivity, cost structure and profitability; so the management has to put in place both qualitative and quantitative metrics by which they are able to gauge the effectiveness of their efforts and objectives rather than on hunches. The model below identifies the factors that act as drivers in developing an effective Human Resource Value system.

**Creating Human Capital Value**




### 3. Creating metrics to benchmark the Human Capital:

In simple terms, benchmarking is a process to identify gaps in an organization processes in order to achieve a competitive advantage. Benchmarking measures an organization's products, processes or services against the industry leader, which help identify opportunities for improvement. Benchmarking aids an organization in uncovering problems and possible solutions to more effective business practices. Some commonly used human resource metrics areas are as follows:

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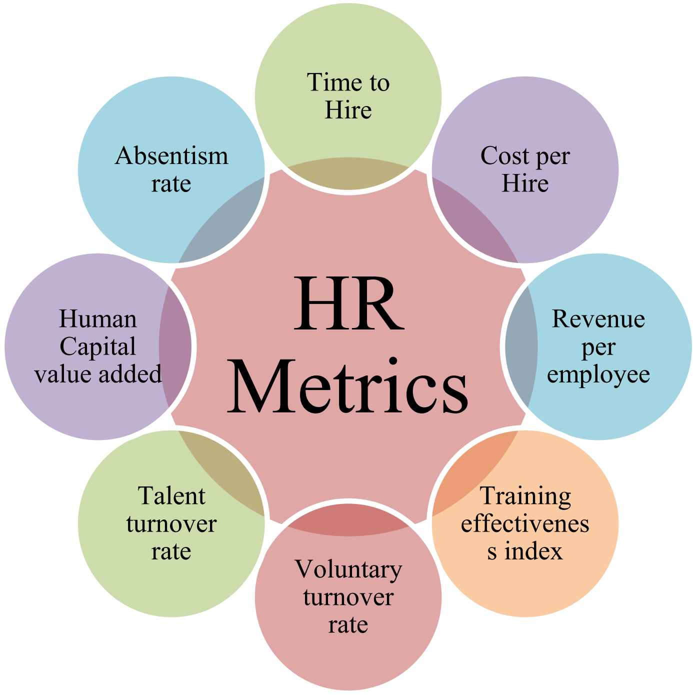


These metrics can help to understand how the human capital in an organization can be channelized to optimize the benefits for the various initiatives like hiring, employee retention, training, and labour costs, etc. The metrics will in turn help the HR department to improve their efficiency and demonstrate the value of their activities in quantifiable and objective terms to the upper management.

**4. Creating the HR value chain:**

Information is the key to performance management. The responsibility of the management in an organization is to combine people with information. In this regard, the Human Capital Metrics is a focused diagnostic tool consisting of leading and lagging indicators which can help to gauge the value of various activities undertaken. Once new strategies are identified and implemented, the cycle of measurement starts again. Building a value chain results is to undertake new initiatives and continuously measure them against the expected results as well as industry benchmarks. In case of deviations, the strategies are further developed to adapt to the current needs of the organization. Creating an HR value chain is a three-step process that starts with HRM activities, followed by HRM outcomes and organizational objectives. The value chain analyses the impact of various HR metrics on portrays their impact on organizational goals.

| Efficiency<br>HRM Activities & Processes | Effectiveness<br>HRM Outcomes | Impact<br>Organizational Objectives |
|---|---|---|
| •Recruitment & Selection<br>•Compensation and Benefits<br>•Training<br>•Talent management<br>•Industrial Relations<br>•Organiztional Design | •Employee Engagement<br>•Retention<br>•Performance Measurement<br>•Workforce Costs<br>•Talent metrics | •Profit<br>•Market share<br>•Customer satisfaction<br>•Brand Loyalty<br>•Productivity<br>•Market value |

The first category shows the HR metrics that measure the HR processes and give information about the efficiency of the various process undertaken by the HR function. The second category shows the outcomes of these activities which we also refer to as the end result in terms of Key Performance Indicators. Lastly, the 3rd level is the attainment of strategic organization's goals which are lagging indicators which are always in hindsight.

To summarize the importance of measuring the human capital ROI, it would be a far say to conclude that it is the only measure that we should rely on to measure the effectiveness of the HR activities and their alignment with the organizational objectives. As with all things, they need to be used alongside other data and metrics in to give a holistic view about the bottom-line impact of the HR activities on attainment of organizational goals. Though it isn't and end in itself, still it has a more holistic view. As with any organization, capital is a critical resource, so any function needs to effectively demonstrate the efficient use of the resources allotted to it. It is no longer enough to state that a certain program is believed to be beneficial -- we need to have verifiable and objective data to demonstrate the worth of the various HR initiatives. Most HR is mostly regarded to be a soft function because it does not typically create revenue directly, so it becomes even more important for HR professionals to show how HR services directly impact the bottom line, while identifying and eliminating programs that are not financially efficient.

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