CHAPTER 1 - THE PROBLEM AND ITS CONTEXT

Cliché: Our people are our greatest asset
Fact: People costs constitute up to 65% of company costs
Reality: Very little strategic reporting on people - Human Assets- in private or public sectors

1.1 Introduction

Very few of the important aspects of an organisation in the 21st century can be measured objectively. Industry information around products, services, distribution channels and even strategies are widely available and no longer considered a competitive advantage, leaving the "fuzzy" items such as culture and people. Traditional HR metrics, however fail to report on the level of performance, knowledgebase or value of their Human Capital, making it virtually impossible for stakeholders or valuators of companies to take this most important asset - Human Resources - into account in valuing the company against its competitors. In today's economy, an organisation's success is the product the competence of the people within the organisation. It is this value added by the people of the organisation which should be visible and available to all stakeholders.

Peter Drucker (1993:8) wrote "The basic economic resource - 'the means of production' to use the economist's term - is no longer capital, nor natural resources (the economist's 'land'), nor 'labour.' It is and will be knowledge". He also stated in another publication a few years later "The most valuable asset of a 21st century institution, whether business or non-business, will be its knowledge workers and their productivity" (Drucker, 1999:135).

A company's ability to support its business strategies with Human Capital is an important indication of the company's future business performance. It cannot be denied that human issues and their effect on the organisation provide useful information for stakeholders; however, no standard or framework to enable the inclusion of this information in company reporting currently exists in South Africa, or even globally.

Human Capital metrics as a construct not only embraces Human Capital performance-capacity factors that are immediately apparent to the short-term success of the organisation, but also the long-term strategic imperative issues critical to transcendental accomplishments of the enterprise (Gilley, Callahan & Bierema, 2003) The objective of company reports is "a method to communicate economic measurements and information about the performance of the organisation to the stakeholders of the organisation" (Le Clerc, Moynagh & Boisclair*,* 1996), yet this very important component - especially in today's knowledge economy - is not included in such reports.

Most executives would agree with the statement that Human Resource Management has an impact on the company's' bottom line and that Human Resources are the most valuable resource a company has. Many will even admit that measuring and reporting Human Capital can lead to the improvement of competitiveness of the organisation and add to the bottom line; however, when asked how or what needs to be measured or reported on, even HR Executives seem to be unclear. A view by Dr Greg Wang of Performtech LLC, confirms that investment in Human Capital will occur at two levels: "People cannot be treated as assets because assets will depreciate over time. But the value of people will appreciate with accumulated experience and organisation development strategies. Employees are the organisation's investors. Employees as investors are expecting an increased return from their investment. This is not only in the form of salary and benefits, but also in individual competency, development, and career growth" (Wang, 2002).

In their book, The HR Scorecard, (Becker, Huselid & Ulrich*,* 2001*)* states that, according to Lawrence R. Whitman, deputy CFO at GTE, "Once we are able to measure intangible assets more accurately, I think investors and finance professionals will begin to look at Human Capital metrics as another indicator of a company's value" (Becker et al., 2001). Accounting systems used today were developed for financial and physical assets, and considered the main source of company's value, thus access to money and equipment provides companies with the greatest competitive advantage whilst intangible assets are treated as expenses rather than investments, which in today's economy shouts out at inaccuracy.

1.2 Need for research in this field

There is increasing evidence from both consultants and academics that Human Capital practices are linked to competitiveness and performance, measured through shareholder value with a noticeable increase in international scientific research on this type of study (Becker et al., 2001; Fitz-end, 2000;

Drucker, 1999; and Becker, 1994). This study has been commissioned as an attempt to add new theory which would span further research with the objective to improve the reporting systems and/or methodologies to value Human Capital for South African industry.

The study touches on the broader topic of intangible assets, however, it focuses on the most important asset in the company of the 21st century: Human Assets. The study provides a framework that allows for the quantification and extraction of the value of Human Assets in an organisation. It should initiate further research in this field as many of the intangible assets which have an effect on the bottom line of companies are not accurately being reported.

The focus of this study is thus to create an innovative framework for reporting which, as it's outcome, should be viewed as an attempt to establish an improved, practical and theoretical approach and method relating to Human Capital and value creation for Human Assets in organisations.

1.3 Problem Statement and Objectives

Investors, partners and shareholders as well as the public require information regarding the long-term sustainability of a company's performance. Employees need to understand the company's sustainability to increase motivation and commitment to assist in developing their own careers. This requires that the value of Human Capital and the related value of Human Assets is reported accurately and fairly. More importantly, the information needs to be trusted to be relevant, reliable, consistent and complete.

The King II Report (2004) on Corporate Governance in South Africa recommends that management accounting should, as a matter of best management practice, reflect requirements of Human Capital development. This implies that companies should lay out, in publicly reported accounts, the principles, standards and goals adopted for the development of their Human Capital, making appropriate reference to the accounting policies adopted to support adherence to them. Furthermore, King II recognises that the development of Human Capital does not only serve the economic interests of the company, but also serves the requirements of the society within which the company operates.

The reporting of intangibles such as Human Capital is certainly no easy task. According to Huselid (1995), this is because of two major issues:

1. No common framework that goes beyond historical measures to provide more detailed information on workforce quality and;

2. Many companies lack the infrastructure and information that can give strong, relevant and audited information to stakeholders.

Reporting systems are limited in several ways (Walker, 1996), including:

- GAAP (Generally Accepted Accounting Principles) rules;
- Measurements expressed in monetary values;
- Categories included in the COA (chart of accounts);
- Lack of predictive power;
- Rewarding of the wrong behaviour; and
- High levels of aggregation of information.

Since the introduction of the first internal reporting model for Intellectual Capital, a number of methodologies have been developed to help organisations assess and monitor their Human Capital as part of a broader evaluation of Intellectual Capital or on their own. Examples of the more well-known approaches include HR Scorecard, Skandia Navigator/IC index, EFQM Excellence Model, and the Economic Value Added/Saratoga Institute approaches.

A study by Deloitte & Touche Human Capital ROI (Brown, 2002) answers this question by measuring Human Capital practices and linking them to corporate financial performance. The results suggest that Human Capital practices may account for as much as 43% of the difference between a company's market-to-book value and that of its competitors'. The survey showed that HR Benchmarking & HR metrics (used by 50% of respondents) and Balanced Scorecard methodologies (used by 32% of respondents) are the two main approaches used for measuring Human Capital.

Here 48% of respondents used more than one approach. Deloitte further showed that each type of approach was associated with a different profile of benefits, but that data accessibility/collection problems, doubts about the ability to locate Human Capital value in the organisation, and the level of resources required, were seen as key limitations across the approaches (Brown, 2002).

The results of the survey clearly show that, while the evaluation models can help organisations to identify key Human Capital issues, none is widely regarded as providing a complete answer. Each of the approaches is subject to continuing development, with some signs of convergence between those approaches whose original aim was to account for Human Capital as intangible assets and those developed originally to provide a strategic tool for management. Companies, however, do not report externally - the focus remains on internal reporting.

1.3.1 Problem Statement

No standard or framework to enable the inclusion of Human Capital information in company reporting to demonstrate the effect on performance currently exists. A company's ability to support its business strategy with Human Capital is an important indication of the company's future business performance. This means that a company's most significant asset (Human Capital) cannot be included in the valuation of the business.

1.3.2 Objectives of this research

The objective of this study is to provide an exploratory framework which can be used by Human Resource practitioners to identify and leverage activities, interventions and/or actions which will provide qualifiable results that demonstrate shareholder value for the organisation. This reporting framework with categories provides a holistic, future-orientated account of the Human Assets in a company.

The study includes an investigation into, and an attempt to answer, the following questions:

4. What insight should investors and other external stakeholders have into the Human Capital employed by a specific organisation?

5. How best to ensure that Human Capital is reported and the information is trusted by investors and other stakeholders as seen as relevant, reliable and consistent, adding value to shareholders?

6. Which Human Resource Management components can form a basis for comparative external reporting on Human Capital (if any)?

The impact of the report on companies has the potential to constitute further consequences (benefits) such as:

1 Strategic alignment of Human Capital development related initiatives.

2 Enhanced ability for companies to attract and retain talent.

3 Related value propositions for key stakeholder groups with a framework against which measurements can take place, and against which HR development policies, procedures, guidelines and/or initiatives can ultimately be aligned.

The study reviews various topics relating to Human Capital, measurement, value and Corporate Reporting.

1.4 Conclusion

Human Capital (people) comprise up to 65% of operating costs for most organisations. Nevertheless, many companies don't measure or manage this (their people) effectively. Unless they begin to treat employees as an investment - in a way that enables continual improvement - they will be unable to attain their optimum value. Shareholders need to have access to information regarding the methods deployed by companies to extract value from their Human Resources to enable them to make an informed decision that includes an understanding of the Human Assets of the organisation.

External reporting of Human Capital costs and benefits must be included in company reports.