

## CHAPTER 5 PROPOSED FRAMEWORK

*“A discovery is said to be an accident meeting a prepared mind.”*

*- Albert von Szent-Gyorgyi, US biochemist (1893 - 1986)*

### 5.1 Introduction

From the previous chapter and the results of the surveys, it becomes clear that HR reporting is generally focused and reported on internally. This does not allow stakeholders (especially investors or shareholders) the ability to view or have insight into the Human Assets (value or risks) or even the Human Capital employed by the organisation.

This chapter consists of the framework developed by the researcher based on the empirical study. The chapter is divided into three categories:

1. Framework for the Human Resources function to enable a clear understanding of the components within Human Resources which affect the Human Capital Asset.
2. Human Capital reporting (internal measures).
3. Metrics to manage the value of Human Assets.

It concludes with proposed principles for reporting Human Capital as part of Company Annual Reports.

The proposed framework will provide companies and their stakeholders (employees, management, shareholders, government etc) insight as to the value of the Human Capital and the methods to manage the Human Resources employed by a specific organisation. Should the framework be adopted, the information can be trusted by investors and other stakeholders and available for auditing. The Human Resources function will understand which components of the discipline forms

a basis for comparative external reporting on Human Capital Assets. This will also provide HR with a framework of related value propositions against which measurements can take place and against which HR development policies, procedures, guidelines and/or initiatives can ultimately be aligned.

## **5.2 Methodology for the Framework**

The researcher used the Enterprise Value Map (EVM) methodology from Deloitte as a basis for the framework for Human Capital Reporting. This methodology is used to evaluate processes or identify opportunity improvement levers that positively effect shareholder value (refer Chapter 2).

The framework proposes to look at the following improvement levers for Human Capital Management:

- Reduction in Total Cost of Employee Interactions.
- Increase in Employee Efficiency.
- Improvement of the Employee's Impact on Customers.
- Improvement of Employee Performance.
- Improvement of Asset Profitability.
- External Factors that influence the view of stakeholders in their value / perception of the organisation.

## **5.3 Framework for HR**

Based on the findings and aims, the following components are included in a salient manner in the framework:

### **1. Human Resources strategy**

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Reporting on Human Capital begins with an account of the firm's Human Resources strategy. This highlights the company's overall approach to the acquisition, development, management and performance of Human Capital. The strategy statement outlines the company's vision for the contribution of human assets in relation to future opportunities and challenges, and outlines the role of its HR policies in securing that contribution.

## **2. Sections on recruitment (acquisition) and retention, learning and development and Human Capital management**

This is supported by evidence on how organisations acquire, develop, manage and retain Human Capital. The evidence that organisations are able to provide and what is appropriate will depend on the organisations' individual circumstances. The evidence should be a balance of both quantitative and qualitative data. Quantitative data in particular can be misunderstood / interpreted, and therefore adequate explanation is required.

## **3. Information on performance**

The organisation should provide details of the effectiveness and performance of their Human Capital and Human Capital management policies and practices, using a mix of quantitative and qualitative data to indicate how well their strategic objectives are being achieved.

## **4. Information on asset productivity**

The organisation should provide details of the productivity and effectiveness of its Human Assets as well as the technology which enables the accurate accounting of such assets and the improvement of these assets, using a mix of quantitative and qualitative data to indicate how well the assets are enabled to increase their productivity.

This will highlight the company's ability to utilise their investment in technology to increase the capacity and effectiveness of the employees and highlight the level of automation a company may have invested in and leverage off. This dimension needs to be future-orientated to ensure that the value of the contribution of Human Assets to future performance is clear. The trade-off between

employing more Human Resources vs. the value (benefit) of deploying technologies is important; not only from an invested cash perspective, but also from a value generation perspective.

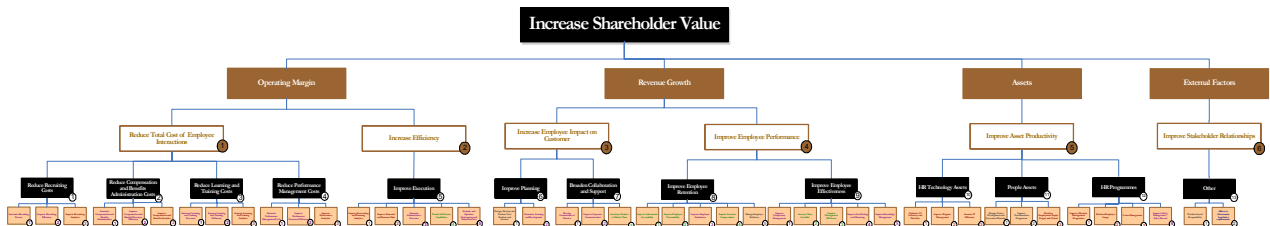
**5. Information which may relate to the considerations of the external environment**

The impact of the political and social environment on organisations is especially prevalent in South Africa. Reporting the status of the company’s employment equity policy and achievements as well as social investments provides an indicator of the organisation’s impact on the South African social and political policies and the economy of the country.

This is very important for non-profit or government organisations where questions such as “what is the value of a hospital that saves the lives of thousands of people?” or “what is the value of a university that educates the new leaders of tomorrow?” cannot be answered by looking purely at the revenue growth or operating margin, or even the assets of the organisation.

In order to facilitate this, a Human Capital Reporting Framework based on the EVM as described in Chapter 2 was developed as illustrated below.

**5.4 Proposed Framework**



**Figure 27: Proposed Framework**

The framework is based on the principles of accounting as specified in GAAP (refer to Chapter 2) and consists of the following components (please refer to the full framework print included in cover of report):

- **Reduce Operating Margins** – Lower transaction costs and increase knowledge dissemination.

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- **Increase Revenue** – Leveraging increased employee satisfaction and improved performance management.
  - **Improve Asset Productivity** – Optimal alignment and management of Human Capital resources including enabling technology.
  - **Improve Stakeholder Relationship** - Investment in social responsibility programmes and adherence to legislation.

Under each of these categories a distinct section on management and leadership is required. Information on Human Capital utilisation for this category of employees, with the greatest scope to affect the strategic performance of the organisation, will often be most readily available in organisations. It also has particular value to financial analysts and investors, as evidenced by the fact that the remuneration of company directors is already an important component of annual reports.

To read the model (large copy included in cover pocket of dissertation), the following approach should be taken:

### **Top-Down/Bottom-up**

The brown boxes (value drivers) marked A 1 - 4, are the metrics by which shareholders, analysts, and potential investors assess company performance - in absolute terms and relative to that of competitors. The four main value drivers of shareholder value are Revenue Growth (A1), Operating Margin (A2), Asset Efficiency (A3), and Expectations (A4). Starting at the top level and tracking downward, the successive layers of the model help answer the question, "How can we improve this?" The colour-coded items in the lower section of the model are specific actions you can take and have been linked to the HR strategic themes. Reading bottom to top, you can reverse the process and answer the question, "Why are we improving this?"

### **Left to Right**

The left side of the model, including the Revenue Growth and Operating Margin sections, represents the Income Statement portion of the model. These two sections combine to describe current operational performance. The Asset Efficiency section is a subset of the Balance Sheet, showing how efficiently assets are utilised in delivering operational performance. The External Factors section addresses factors that influence future Income Statement and Balance Sheet performance, and focuses on factors that influence shareholder confidence in the organisation and its leadership.

### **White Boxes - Improvement Levers**

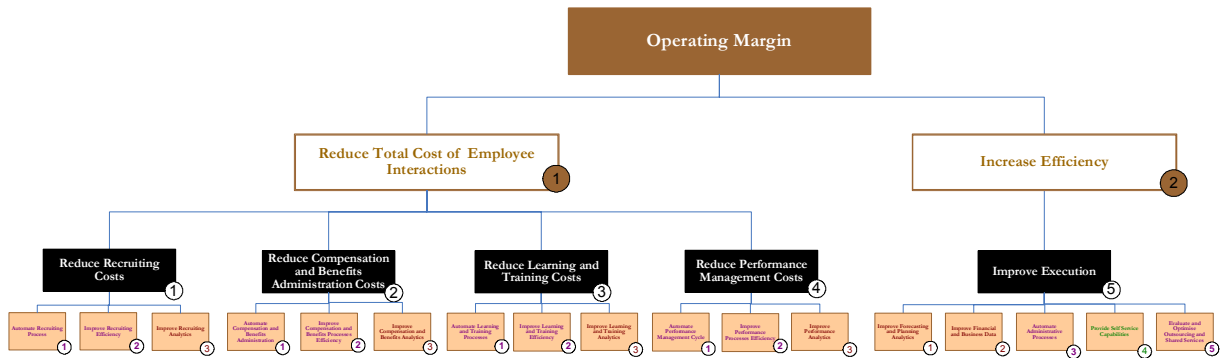
The first level of white boxes (B 1-6) defines actions organisations can take to improve revenue, operating margin, asset efficiency, and forward-looking performance. The next level (C 1-13) defines those areas on which the activities for improvement for maximum value may be focused on.

### **Colour coded text**

The text within the blocks described above is colour coded to highlight the link to the HR themes.

- Improve Employee Productivity.
- Develop a Continuous Performance Culture.
- Strengthen Knowledge Sharing and Learning.
- Elevate People Management to a Strategic Level.
- Increase Value to Customers through Employees.

### 5.4.1 Operating Margin (A1)



**Figure 28: Operating Margin**

There are two main factors that influence the operating margin:

- Reducing costs (B1) - Total cost of employee's interactions.
- Increasing efficiency (B2) - through improvement of execution capabilities.

#### 5.4.1.1 Reduce total cost of employee interactions (B1)

This area refers to ways in which Human Resource Management can reduce the costs of employee interactions to reduce the costs of the programmes for which they are responsible that directly impact the employee. Costs present a negative (-) effect on the Income Statement and thus the control of this is very important.

These include areas where HR is able to influence and control the costs directly:

- Reducing Recruitment costs (C1).
- Reducing HR administration costs (C2) - compensation and benefits administration.

- Reducing Learning / Training costs (C3).
- Reducing Performance Management costs (C4).

This management of costs is predominantly focused on the administration side and a balance between this focus and the value which may be extracted by applying HR initiatives needs to be maintained. An example of such a balance for consideration is in training and development. A study by Bassi Investments (Phillips, 2005) where the results shows that portfolio firms that made unusually large investments in employee education, training and development outperformed the S&P 500 by a factor of two (113% versus 55%). This may encourage an increase in the cost for Learning / Training and the reduction in cost focused purely on the administration of the function. Using metrics such as training ROI can help to ensure time, effort, focus and funds are spent on the right programmes that indeed deliver the increase in value for the organisation.

#### **5.4.1.2 Increase efficiency (B2)**

This area refers to increasing efficiency of the Human Resources function to provide the services and expertise to add value to the Human Capital of the organisation.

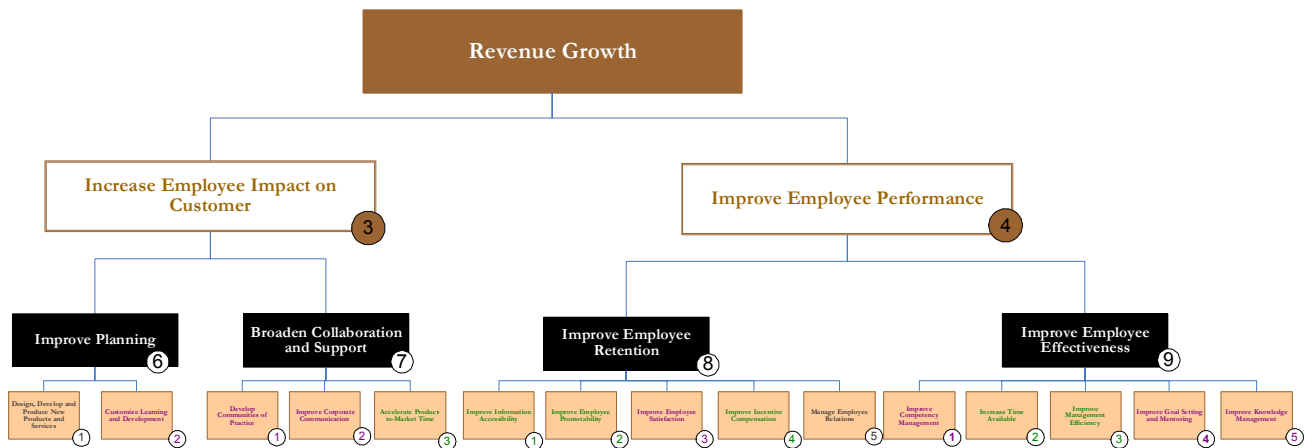
This includes:

- Improvement of Execution (C5) - of HR programmes.

These programmes need to be monitored and tested for Return on Investment (ROI) to ensure value is not destroyed, but added.



### 5.4.2 Revenue Growth (A2)



**Figure 29: Revenue Growth**

There are two main factors that influence revenue growth:

- Customers (B3) - increasing the positive impact that employees have on customers.
- Employee performance (B4) - improvement of the effectiveness and efficiency of the employee.

#### 5.4.2.1 Increase employee's impact on customer

In order to maintain a positive impact on customers and the interaction of the organisation's employees with customers, planning to increase the services and products that are offered and the "customisation" of such services and products as well as the training of employees in these products and services, needs to be addressed. The time to market of such products is crucial for revenue growth and ensuring that the relationship with customers is maintained, and customer loyalty build even more so.

The impact of employee satisfaction, loyalty, and productivity is linked to customer satisfaction and growth of customer loyalty (Heskett, Sasser & Schlesinger, 1994). The service-profit chain clarifies the links between the following:



**Figure 30: Service Profit Chain – adapted from Heskett et al., (1994)**

A study by Watson Wyatt (2004), Communication ROI Study™, demonstrated that there is a correlation between communication effectiveness, organisational turnover and financial performance. Some of the findings include evidence that:

- Companies that communicate effectively have a 19.4% higher market premium than companies that do not.
- Shareholder returns for organisations with the most effective communication were over 57% higher over the last five years (2000-2004) than returns for firms with less effective communication.

Based on the above, this dimension includes:

- Improve planning (C4).
- Broaden collaboration and support (C5).

#### 5.4.2.2 Improve employee performance (B4)

This area refers to the improvement of employee effectiveness. Retaining effective employees has a direct impact on both the operating margin and revenue growth. As the improvement and management of the efficiency of employees has been categorised to be influenced predominantly by the Human Resources function, the direct effectiveness of employees will have a larger impact on revenue growth than on the operating margin. This category is placed under the improvement of employee performance with the retention of employees which includes:

- Improve employee retention (C8).
- Improve employee effectiveness (C9).

#### Assets

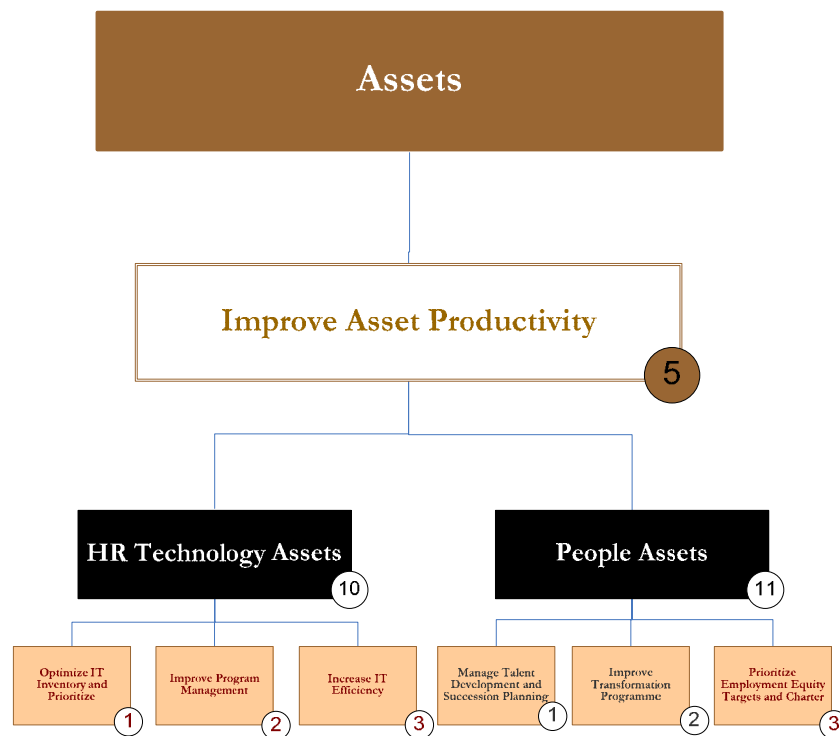


Figure 31: Assets

There is only one main factor that influences the assets value of an organisation:

- Improving asset productivity (B5).

Assets are depreciated over time, however Human Capital and intangibles are amortised due to their increase in value.

#### **5.4.2.3 Improve asset productivity (B5)**

In order to improve the productivity of your HR assets, an organisation may focus on two aspects:

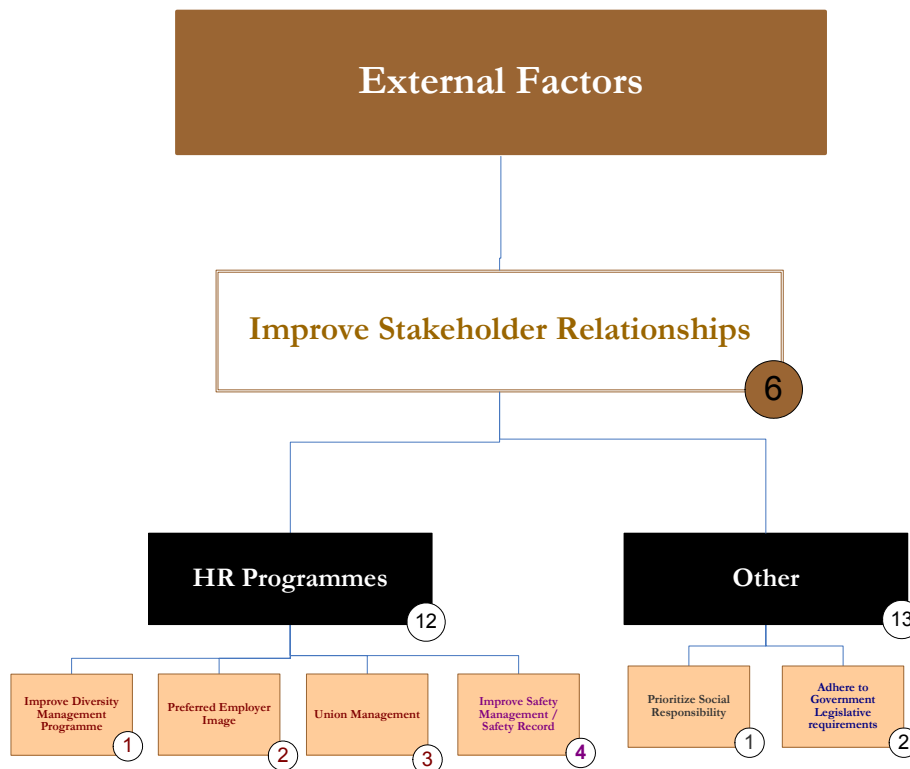
- Technology Assets (C10).
- People Assets (C11).

#### **5.4.2.4 Technology Assets (C10)**

HR technology, for example online benefits enrolment, retirement planning, compensation and pension administration, Employee / Manager self-service tools, e-recruiting tools, etc., can play a huge role in helping HR play a more value added strategic role. This technology must be implemented with the fundamentals in mind—improving accuracy, service, and cost-effectiveness to pay off in higher shareholder value. However, care must be taken to not implement the technology for the sake of it and to drive the value extraction from the technology - something which HR may not be skilled in yet.

As this technology is used to enable the HR efficiency and effectiveness, the cost of the technology is traded off against the reduction in Human Resources and the costs related to the latter. Taking this into consideration, the value generated from this method contributes to the value of the Human Resources function only.

### 5.4.3 External Factors



**Figure 32: External Factors**

This area refers to those factors that may influence the value of the company in the eyes of stakeholders (including government) and potential shareholders, external to the organisation. This varies by company and industry.

Certain HR programmes may well influence the external factors or react to the external factors, however, most of these are factors that need to be watched and proactively and reactively addressed.

- For this framework, HR Programmes (C12) is listed under this category. These programmes need to be considered as having an impact on the operating margin (costs) as well.

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- A category for Other (C13) is listed for consideration that needs to be given to market and external environment factors. These considerations are specific to the organisation and/or industry and cannot be listed in the model, but rather need to be identified by those using the model.

## 5.5 Using the Framework

To use the framework effectively, an understanding of the levers and what can be done is required.

### Actions You Can Take

To address the Improvement Levers, there are two basic categories of actions you can take:

*Change What You Do (Change your strategy / Refocus your resources)*

To maximise shareholder value, companies need to focus on activities that provide the best possible return on the resources they utilise. Focusing and refocusing can happen at many levels - from reducing costs spent on impact areas, to the discontinuation or outsourcing of services with little value add, to a diminished focus on lower-value employees. The first horizontal band of colour-coded actions addresses actions that can be taken from a strategy and focus viewpoint to improve the value of Human Assets in the organisation.

*Do What You Do Better (Improve your execution)*

There are two paths to better business process execution: improve the business processes themselves, and raise the efficiency and effectiveness of the people and technologies executing and managing the processes. Improving the performance of people and technologies means improving their respective capabilities, productivities and capacities.

The high interdependency of value drivers requires careful consideration of initiatives undertaken to improve a value driver. This will almost always have an impact on another value driver. The challenge is to recognise and account for these effects and balance the trade-offs in ways that align with the company's direction and priorities.