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Human Capital Management

Key concepts and terms

- Balanced scorecard
- Human capital
- Human capital advantage
- Human capital index – Watson Wyatt
- Human capital management
- Human capital measurement
- Human capital monitor – Andrew Mayo
- Human process advantage
- Intangible resources
- Intellectual capital
- Metrics
- Organizational capital
- Organizational performance model – Mercer HR Consulting
- Social capital

Learning outcomes

On completing this chapter you should be able to define these key concepts. You should also understand:

- The meaning of human capital management
- The concept of human capital
- The significance of human capital theory
- The approaches to human capital measurement
- Human capital reporting

Introduction

Human capital management (HCM) informs decisions on the issues critical to the organization's success by systematically analysing, measuring and evaluating how people policies and practices create value. This chapter first defines HCM in more detail and then examines the underpinning concept of human capital and the significance of HCM. The rest of the chapter focuses on human capital measurement.

Human capital management defined

As defined by Baron and Armstrong (2007), HCM is concerned with obtaining, analysing and reporting on data which informs the direction of value-adding people management strategic, investment and operational decisions at corporate level and at the level of front-line management. It is, as Paul Kearns (2005) emphasized, ultimately about value.

The defining characteristic of HCM is the use of measurements (metrics) to guide an approach to managing people which regards them as assets and emphasizes that competitive advantage is achieved by strategic investments in those assets through employee engagement and retention, talent management and learning and development programmes. HCM provides a bridge between HR and business strategy. It is based on the concept of human capital.

The concept of human capital

Individuals generate, retain and use knowledge and skill (human capital) and create intellectual capital. Their knowledge is enhanced by the interactions between them (social capital), and generates the institutionalized knowledge possessed by an organization (organizational capital).

Human capital consists of the knowledge, skills and abilities of the people employed in an organization. HCM is about generating and analysing the information needed to develop and manage these people.

The term 'human capital' was originated by Schultz (1961), who elaborated his notion in 1981 as follows:

> *Consider all human abilities to be either innate or acquired. Attributes… which are valuable and can be augmented by appropriate investment will be human capital.*

A more detailed definition was put forward by Bontis *et al* (1999):

> *Human capital represents the human factor in the organization; the combined intelligence, skills and expertise that gives the organization its distinctive character. The*

> *human elements of the organization are those that are capable of learning, changing, innovating and providing the creative thrust which if properly motivated can ensure the long-term survival of the organization.*

Scarborough and Elias (2002) believe that 'The concept of human capital is most usefully viewed as a bridging concept – that is, it defines the link between HR practices and business performance in terms of assets rather than business processes.' They point out that human capital is to a large extent 'non-standardized, tacit, dynamic, context dependent and embodied in people'. These characteristics make it difficult to evaluate human capital, bearing in mind that the 'features of human capital that are so crucial to firm performance are the flexibility and creativity of individuals, their ability to develop skills over time and to respond in a motivated way to different contexts'.

Intellectual capital

The concept of human capital is associated with the overarching notion of intellectual capital. This is defined as the stocks and flows of knowledge available to an organization. These can be regarded as the intangible resources associated with people which, together with tangible resources (money and physical assets), comprise the market or total value of a business. Bontis (1998) defined intangible resources as the factors other than financial and physical assets that contribute to the value-generating processes of a firm and are under its control.

Social capital

Social capital is another element of intellectual capital. It consists of the knowledge derived from networks of relationships within and outside the organization. The concept of social capital was defined by Putnam (1996) as 'the features of social life – networks, norms and trust – that enable participants to act together more effectively to pursue shared objectives'. It is important to take into account social capital considerations, that is, the ways in which knowledge is developed through interaction between people. Bontis *et al* (1999) pointed out that it is flows as well as stocks that matter. Intellectual capital develops and changes over time, and a significant part is played in these processes by people acting together.

Organizational capital

Organizational capital is the institutionalized knowledge possessed by an organization which is stored in databases, manuals and so on (Youndt, 2000). It is often called structural capital (Edvinson and Malone, 1997), but the term organizational capital is preferred by Youndt because, he argues, it conveys more clearly that this is the knowledge that the organization actually owns.

The significance of human capital theory

The added value that people can contribute to an organization is emphasized by human capital theory. It regards people as assets, and stresses that investment by organizations in people will generate worthwhile returns. Human capital theory is associated with the resource-based view of the firm as described in Chapter 2 and also with knowledge management (see Chapter 5).

An approach to people management based on human capital theory involves obtaining answers to the following questions:

- What are the key performance drivers that create value?
- What skills have we got?
- What skills de we need now and in the future to meet our strategic aims?
- How are we going to attract, develop and retain these skills?
- How can we develop a culture and environment in which organizational and individual learning takes place which meets both our needs and the needs of our employees?
- How can we provide for both the explicit and tacit knowledge created in our organization to be captured, recorded and used effectively?

Human capital theory provides the conceptual framework for human capital management, which is based on human capital measurement as discussed below.

Human capital measurement

Human capital measurement has been defined by IDS (2004) as being 'about finding links, correlations and, ideally, causation, between different sets of (HR) data, using statistical techniques'.

As Becker *et al* (2001) emphasized, 'The most potent action HR managers can take to ensure their strategic contribution is to develop a measurement system that convincingly showcases HR's impact on business performance.' They must 'understand how the firm creates value and how to measure the value creation process'.

The primary aim of HCM is to assess the impact of human resource management practices and the contribution made by people to organizational performance. Methods of measuring impact and contribution based upon human capital data have therefore to be developed.

The need for human capital measurement

There is an overwhelming case for evolving methods of valuing human capital as an aid to people management decision making. This may mean identifying the key people management drivers and modelling the effect of varying them. The need is to develop a framework within which reliable information can be collected and analysed, such as added value per employee, productivity and measures of employee behaviour (attrition and absenteeism rates, the frequency/severity rate of accidents, and cost savings resulting from suggestion schemes).

Becker *et al* (2001) refer to the need to develop a 'high-performance perspective' in which HR and other executives view HR as a system embedded within the larger system of the firm's strategy implementation. They state that 'The firm manages and measures the relationship between these two systems and firm performance.'

Reasons for the interest in measurement

The recognized importance of achieving human capital advantage has led to an interest in the development of methods of measuring the value and impact of that capital:

- Human capital constitutes a key element of the market worth of a company. A research study conducted in 2003 (CFO Research Services) estimated that the value of human capital represented over 36 per cent of total revenue in a typical organization.
- People in organizations add value, and there is a case for assessing this value to provide a basis for HR planning and for monitoring the effectiveness and impact of HR policies and practices.
- The process of identifying measures and collecting and analysing information relating to them will focus the attention of the organization on what needs to be done to find, keep, develop and make the best use of its human capital.
- Measurements can be used to monitor progress in achieving strategic HR goals and generally to evaluate the effectiveness of HR practices.
- You cannot manage unless you measure.

Critical evaluation of human capital measurement

The case for human capital measurement seems to be overwhelming, but a number of voices have advised caution about measurement. Leadbeater (2000) observed: that measuring can 'result in cumbersome inventories which allow managers to manipulate perceptions of intangible values to the detriment of investors. The fact is that too few of these measures are focused on the way companies create value and make money.' The Institute for Employment Studies (Hartley, 2005) emphasized that reporting on human capital is not simply about measurement. Measures on their own such as those resulting from benchmarking are not enough; they must be clearly linked to business performance.

Research carried out by Scarborough and Elias (2002) found that it is not what organizations decide to measure that is important, but the process of measurement itself. As they noted:

> *In short, measures are less important that the activity of measuring – of continuously developing and refining our understanding of the productive role of human capital within particular settings, by embedding such activities in management practices, and linking them to the business strategy of the firm.*

This sentiment was echoed by Richard Donkin (2005), when he wrote 'It is not the measuring itself that is the key to successful human capital management but the intentions behind the measuring and the resulting practices that emerge.'

In a lecture to commemorate the Institute for Employment Studies' 40th anniversary, Professor Mick Marchington (2008) commented that the HR function is 'obsessed with measuring its way to credibility'. His arguments were that HR measurement and benchmarking are often concerned with the most measurable rather than the most meaningful, and that we are in some cases in danger of abandoning 'the heart and the soul of people management'.

Notwithstanding these comments, the growing sophistication of HR information systems, particularly in larger organizations, means that a lot more data on employees and HR practices is now often available. A reasonable and balanced use of measurement provides the information required to guide HR decisions and to evaluate the effectiveness of HRM practices.

Approaches to measurement

Three approaches to measurement are described below.

The human capital index: Watson Wyatt

On the basis of a survey of companies that have linked together HR management practices and market value, Watson Wyatt (2002) identified four major categories of HR practice which could be linked to a 30 per cent increase in shareholder value creation. These are:

Practice	**Percentage impact on market value**
Total rewards and accountability	16.5
Collegial, flexible workforce	9.0
Recruiting and retention excellence	7.9
Communication integrity	7.1

The organizational performance model: Mercer HR Consulting

As described by Nalbantian *et al* (2004), the Organizational Performance Model developed by Mercer HR Consulting is based on the following elements:

- people;
- work processes;
- management structure;

- information and knowledge;
- decision making;
- rewards.

Each of the above elements plays out differently within the context of the organization to create a unique DNA. If these elements have been developed piecemeal, as often happens, the potential for misalignment is strong, and it is likely that human capital is not being optimized, creating opportunities for substantial improvement in returns. Identifying these opportunities requires disciplined measurement of the organization's human capital assets and the management practices that affect their performance. The statistical tool 'Internal Labour Market Analysis' used by Mercer draws on the running record of employee and labour market data to analyse the actual experience of employees rather than stated HR programmes and policies. Thus gaps can be identified between what is required in the workforce to support business goals and what is actually being delivered.

The human capital monitor: Andrew Mayo

Andrew Mayo (2001) has developed the 'human capital monitor' to identify the human value of the enterprise, or 'human asset worth', which is equal to 'employment cost × individual asset multiplier'. The latter is a weighted average assessment of capability, potential to grow, personal performance (contribution) and alignment to the organization's values set in the context of the workforce environment (that is, how leadership, culture, motivation and learning are driving success). The absolute figure is not important. What does matter is that the process of measurement leads you to consider whether human capital is sufficient, increasing or decreasing, and highlights issues to address. Mayo advises against using too many measures: instead, it is best to concentrate on a few organization-wide measures that are critical in creating shareholder value or achieving current and future organizational goals.

A number of other areas for measurement and methods of doing so have been identified by Mayo (1999, 2001). He believes that value added per person is a good measure of the effectiveness of human capital, especially for making inter-firm comparisons. But he considers that the most critical indicator for the value of human capital is the level of expertise possessed by an organization. He suggests that this could be analysed under the headings of identified organizational core competencies. The other criteria he mentions are measures of satisfaction derived from employee opinion surveys and levels of attrition and absenteeism.

Measurement data

Main HCM data used for measurement

- Basic workforce data: demographic data (numbers by job category, gender, race, age, disability, working arrangements, absence and sickness, turnover and pay).

- People development and performance data: learning and development programmes, performance management/potential assessments, skills and qualifications.
- Perceptual data: attitude/opinion surveys, focus groups, exit interviews.
- Performance data: financial, operational and customer.

A summary of human capital measures and their possible uses is given in Table 4.1.

Table 4.1 A summary of human capital measures and their possible uses

Measures	Possible use – analysis leading to action
Workforce composition – gender, race, age, full time, part time	• Analyse the extent of diversity. • Assess the implications of a preponderance of employees in different age groups, such as the extent of losses through retirement. • Assess the extent to which the organization is relying on part-time staff.
Length of service distribution	• Indicate level of success in retaining employees. • Indicate preponderance of long- or short-serving employees. • Enable performance of more experienced employees to be assessed.
Skills analysis/assessment – graduates, professionally/technically qualified, skilled workers	• Assess skill levels against requirements. • Indicate where steps have to be taken to deal with shortfalls.
Attrition – employee turnover rates for different categories of management and employees	• Indicate areas where steps have to be taken to increase retention rates. • Provide a basis for assessing levels of commitment.
Attrition – cost of	• Support business case for taking steps to reduce attrition.
Absenteeism/sickness rates	• Identify problems and need for more effective attendance management policies.
Average number of vacancies as a percentage of total workforce	• Identify potential shortfall problem areas.
Total payroll costs (pay and benefits)	• Provide data for productivity analysis.

Table 4.1 *continued*

Measures	Possible use – analysis leading to action
Compa-ratio – actual rates of pay as a percentage of policy rates	● Enable control to be exercised over management of pay structure.
Percentage of employees in different categories of contingent pay or payment-by-result schemes	● Demonstrate the extent to which the organization believes that pay should be related to contribution.
Total pay review increases for different categories of employees as a percentage of pay	● Compare actual with budgeted payroll increase costs. ● Benchmark pay increases.
Average bonuses or contingent pay awards as a percentage of base pay for different categories of managers and employees	● Analyse cost of contingent pay. ● Compare actual and budgeted increases. ● Benchmark increases.
Outcome of equal pay reviews	● Reveal pay gap between male and female employees.
Personal development plans completed as a percentage of employees	● Indicate level of learning and development activity.
Training hours per employee	● Indicate actual amount of training activity (note that this does not reveal the quality of training achieved or its impact).
Percentage of managers taking part in formal management development programmes	● Indicate level of learning and development activity.
Internal promotion rate (percentage of promotions filled from within)	● Indicate extent to which talent management programmes are successful.
Succession planning coverage (percentage of managerial jobs for which successors have been identified)	● Indicate extent to which talent management programmes are successful.
Percentage of employees taking part in formal performance reviews	● Indicate level of performance management activity.
Distribution of performance ratings by category of staff and department	● Indicate inconsistencies, questionable distributions and trends in assessments.
Accident severity and frequency rates	● Assess health and safety programmes.
Cost savings/revenue increases resulting from employee suggestion schemes	● Measure the value created by employees.

Human capital reporting

Analysing and reporting human capital data to top management and line managers will lead to better-informed decision making about what kind of actions or practices will improve business results. The ability to recognize problems and take rapid action to deal with them will be increased, and the scope to demonstrate the effectiveness of HR solutions and thus support the business case for greater investment in HR practices will be enhanced.

The processes of reporting the data internally and obtaining inferences from them are therefore vital parts of HCM. It is necessary to be clear about what data is required, and how it will be communicated and used.

The factors affecting the choice of what should be reported in the form of metrics are:

- the type of organization – measures are context-dependent;
- the business goals of the organization;
- the business drivers of the organization, that is, the factors that contribute to the achievement of business;
- existing key performance indicators (KPIs) used in the organization;
- the use of a balanced scorecard which enables a comprehensive view of performance to be taken by reference to four perspectives: financial, customer, innovation, and learning and internal processes;
- the availability of data;
- the use of data – measures should only be selected that can be put to good use in guiding strategy and reporting on performance;
- the manageability of data – there may be a wide choice of metrics and it is essential to be selective in the light of the above analysis so that the burden of collecting, analysing and evaluating the data is not too great and people do not suffer from information overload (remember that the cost of perfection is prohibitive, the cost of sensible approximation is less).

Human capital information is usually reported internally in the form of management reports providing information for managers, often through the intranet and on dashboards. However this information will not be valued by managers unless:

- it is credible, accurate and trustworthy;
- they understand what it means for them personally and how it will help them to manage their team;
- it is accompanied by guidance as to what action can be taken;
- they have the skills and abilities to understand and act upon it.

It is not enough simply to give managers and other stakeholders information on human capital. It must be accompanied by effective analysis and explanation if they are going to understand and act upon it in the interests of maximizing organizational performance.

Human capital management: key learning points

The concept of human capital

Individuals generate, retain and use knowledge and skill (human capital) and create intellectual capital. Human capital 'defines the link between HR practices and business performance in terms of assets rather than business processes' (Scarborough and Elias, 2002).

Characteristics of human capital

Human capital is non-standardized, tacit, dynamic, context dependent and embodied in people (Scarborough and Elias, 2002).

Constituents of human capital

Human capital consists of intellectual capital, social capital and organizational capital.

Significance of human capital

Human capital theory regards people as assets and stresses that investment by organizations in people will generate worthwhile returns.

Importance of human capital measurement

Measuring and valuing human capital is an aid to people management decision making.

Reasons for interest in human capital measurement

- Human capital constitutes a key element of the market worth of a company.
- People in organizations add value.
- Focus attention on what needs to be done to make the best use of a company's human capital.
- Monitor progress in achieving strategic HR goals and evaluate HR practices.
- You cannot manage unless you measure.

Approaches to measurement

- The human capital index: Watson Wyatt.
- The organizational performance model: Mercer HR Consulting.
- The human capital monitor: Andrew Mayo.

Measurement elements

Workforce data, people development data, perceptual data and performance data.

Factors affecting choice of measurement

- Type of organization; its business goals and drivers.
- The existing key performance indicators (KPIs).
- Use of a balanced scorecard.
- The availability, use and manageability of data.

Human capital reporting

Analysing and reporting human capital data to top management and line managers will lead to better-informed decision making about what kind of actions or practices will improve business results.

Criteria for HCM data as a guide to managers

Data will only be useful for managers if:

- it is credible, accurate and trustworthy;
- they understand what it means for them;
- it is accompanied by guidance as to what action can be taken;
- they have the skills and abilities to understand and act upon it.

Questions

1. Your finance director has asked you 'What is the difference between human resource management and human capital management? And if they are different, why should we bother with the latter?' Formulate your response.
2. What is social capital and why is it significant?
3. You have given a presentation on human capital management at a local conference. At question time a member of the audience gets up and says 'This is all very well, but it sounds as if we will have to do an awful lot of work in getting a full programme of HCM off the ground (collecting, analysing and reporting on performance statistics). I don't think that we have the resources to do it and even if we had, that it would be a cost-effective use of people's time.' Respond.

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