**Human Capital White Paper**
**Version 1.1**

## What is Human Capital?

Human capital is just one of an organisation's intangible assets. It is basically all of the competencies and commitment of the people within an organisation i.e. their skills, experience, potential and capacity. Other examples of intangible assets include: brand, software, design, working methods and customer relationships. The human capital asset captures all the people oriented capabilities we need for a business to be successful.

It's important to remember, however, that individuals are only an asset insofar as they choose to invest their human capital in an organisation.

Some people find the term Human Capital somewhat mechanistic, but human capital is not about describing people as economic units, rather it is a way of viewing people as critical contributors to an organisation's success. This then throws the spotlight on how businesses invest in their human capital asset, in order for it to add value. For any commercial organisation, this is an important component to understand. If a company understands how its human capital contributes to their business success, it can then be measured and managed more effectively.

Human capital management is a reciprocal relationship between supply and demand: employees, contractors and consultants invest their own human capital into business enterprises and the business enterprises need to manage the supplier. Any organisation interested in its performance will naturally ask how well they are managing this asset to ensure maximum return on their investment. In the same way, all employees, contractors, consultants and providers of human capital want to ensure they are getting the appropriate return for their own human capital investing through salary, bonuses, benefits, and so on.

Understanding how and why people add value or not to an organisation is an important, and difficult, management skill for the 21$^{st}$ century.

## Why is Human Capital an increasingly important issue?

Human capital has never been more critical to competitiveness, because the world has changed. Over the last 15 years we have witnessed a revolution in the workforce, as well as in the workplace.

*The Workplace*

Increasingly the developed world has evolved into a service and information economy. In an information economy, people are the critical asset and in a service economy many more outputs are intangible, as much as 80 per cent of a company's worth is now tied to its people. Access to financial capital is no longer a source of competitive advantage; our competitiveness increasingly derives from know-how, or people's abilities, skills and competence.

People, the human capital asset, with the right profile and capability provide an advantage, which is not easily replicated by competitors.

*The Workforce*

At the same time, the labour force has also changed dramatically. Organisations know they need people to deliver value in new and different ways, and that those people they depend on have changed. For example, we see an aging, more diverse population, with more women entering the workforce, more dual-earner couples. However businesses can still struggle with a general shortage of the skills required in a service and information economy.

The war for talent in the human capital market place means businesses can't take for granted that individuals will want to invest their own human capital in an organisation. Elements, other than traditional pay and job security, need to be put in place to attract and retain top talent.

These changes have culminated to ensure that human capital is becoming a major driver for organisational performance.

Forty-six per cent of Chief Executives say that finding good people and keeping them is their single biggest worry and most fear their employees are ill-equipped in terms of skills. The investment community is now probing human capital issues, yet most Chief Finance Officers say they have only a moderate understanding of the returns they get from what is often their largest single investment – people. Human capital then is a critical contributor to competitive advantage.

**What is the challenge for organisations?**

Human capital may well now be the most critical source of competitive advantage, but it is also the most difficult to measure. If people are a company's greatest asset, how do we quantify the value of this asset?

The phrase 'our people are our greatest asset' has become a tired cliché around which real cynicism has justifiably been created. The cynicism is based on the gap between what a business says and what it does. If an organisation can't prove that its people are its greatest asset, then it isn't being measured and it can't really be managed.

The quantifiable evaluation of human capital is a challenge and there is currently no accepted way of doing this. There is no single measure, independent of context, which can describe the impact of employee competencies and commitment on business performance. There are reliable methods for measuring the return on investment on physical capital, but not for human capital; it's a new and evolving science.

Causality is the issue; it is very difficult to prove links between 'cause' and 'effect' in a complex working and social environment. Assigning causality is a challenge because a business context is a very different social environment, e.g. is customer satisfaction *really* improved because employee retention has improved, or is it because that business invested in better technology and improved their product? Is an organisation getting discretionary effort from its people because they have been allowed flexible working, or because they are being paid more than competitors' offers, or even a mixture of both?

Correlations are not the same as causality either. The challenge for most organisations is that if the value of human capital can't be quantified, where and how do they make the best investment in their asset, and how do they know what the return on that investment will be?

**What does this mean for HR?**

The pressure on HR functions to perform is greater than ever because of the critical role human capital plays in an organisation's wealth, success and competitiveness today. If the role of HR is to optimise 'people performance' then businesses need to ask what 'good' HR looks like for their organisation.

Increasingly it's understood that a good HR function can add significant value and make a real contribution to an organisation's performance, however looking at HR through a human capital lens puts further demands on the function. HR needs to make causal connections clear between their practices and business value. This means moving from *describing* good HR practice to *proving* it.

For decades HR has wanted greater legitimacy for their role; often without a seat at the top table. With human capital now being such a source of competitive advantage, the door is open for HR to bring to the table the value they have for many years been espousing.

But how do they do this?

*The HR paradigm shift*

If we accept human capital is one of the key assets driving creation of value, then HR is not a cost centre but an asset provider. It is a function that enables businesses to manage people better than other companies, but to prove this, HR needs to change its approach quite fundamentally.

Most HR functions are on this route, in some form or other, already:

- Moving from efficiency to effectiveness
- Moving from cost to value-add
- Moving from inputs to outputs
- Moving from data collection to data analysis
- Moving from traditional HR data to linking it to operational performance

Having this intelligence informs our answer to the question of what HR should be doing in order to deliver business impact.

Linking HR practice and individual or organisational performance is therefore at the heart of what HR needs to do so it can identify how HR policies translate into performance. As a minimum, HR should have reliable data in conventional areas, such as churn, absence, labour costs, time and costs of recruiting, etc but they must also have access to performance measures, such as production figures, sales targets, service level agreements and be able to make links between the two.

Increasing the capability of HR to deliver more commercially will be the key to demonstrating how HR can really add-value to an organisation.

**What does this mean for Finance Directors and the CEO?**

The gap between a company's tangible assets and its stock market value is growing. For many businesses the tangible assets on the balance sheet represent a small part of their stock market valuation or the value to a potential acquirer. In most organisations, reporting and evaluation of human capital is non-existent. As the world has changed and human capital has become more critical to competitiveness, it has exposed the limitations of traditional accounting practices in being able to identify the real value-adding components of an organisation. The issue is, if we don't know how to measure intangible assets, how do we know whether to invest, or how much?

How do we link investment in the following areas to business performance?

- Induction
- Skills and technical training
- Management training
- Organisational roles
- Process design
- Workforce planning
- Reward management
- Retention management
- Employee feedback
- Performance management, etc

We know the evaluation and measurement of human capital is difficult and that it's an evolving science, but for most Finance Directors, understanding the performance of their human capital investments is extremely weak compared to their understanding of any other asset in their business.

Many finance professionals see people as an operating cost, not as a source of value creation. They also then treat all expenditure on human capital as a cost to be minimised, as opposed to a cost that can be optimised. Without the measures and links, however, it is hard to know how to do the latter and who in the business is responsible for that: HR; Finance; or both?

There is also a difference between internal and external reporting. Increasingly, externally a company will be assessed on the basis of the amount of information it can provide about its internal labour market and how well that market serves its business objectives. External human capital reporting required of organisations today is still limited and is largely narrative, but this may well change.

The real challenge is how to move along the continuum, using HR analytics, to deliver a picture of how human capital investments create business value. To move from generating HR information, to reporting human capital and then measuring that asset, so it can be managed.