

Strategic HRM

An Investment Perspective of HRM

Chapter One

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Human Resources: From Cost to Asset

A Shift in Perspective

Traditionally, employees were seen as a cost (salaries, benefits).

Successful organizations now view them as valuable assets, like buildings or equipment.

The Employee Performance Impact

- Employee decisions and actions directly affect your business (bottom line).
- A motivated, skilled workforce leads to:
 - Higher productivity
 - Better customer service
 - Increased innovation

Adopting an Investment Perspective

Employees Drive Performance

- Employees are the most important asset.
- Employee decisions and actions directly impact an organization's success.
- Skilled workforce especially important in today's knowledge-based economy.

The Strategic Shift

- Traditionally, competitive advantages came from factors like product design or marketing.
- Today, the most strategic advantage comes from how well you manage your workforce.

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Sources of Employees Values

- **Technical Knowledge**
 - Markets, processes, customers, environment
- **Ability to Learn and Grow**
 - Openness to new ideas
 - Acquisition of knowledge & skills
- **Decision Making Capabilities**
- **Motivation & Commitment**
- **Teamwork**
 - Interpersonal skills, leadership ability



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Investing in Human Resources: Risk, Return, Cost & Benefit

Just like any investment, developing your workforce involves risk and reward, with costs and benefits to consider. Here's how it works:

Example: Training & Development

Cost: There's the direct cost of the training program itself (instructor fees, materials) and indirect costs like lost work time during training.

Benefit: Employees gain new skills and knowledge, leading to increased productivity, reduced errors, and the ability to take on more complex tasks. This translates to higher output and potentially higher revenue.

Risk: The training may not be effective, or employees might leave the company after being trained, taking their newfound skills elsewhere.

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An Investment Dilemma

Investing in employees is tricky. Companies need skilled workers to succeed, but training them makes them more valuable to competitors.

The key is finding a balance.

- Companies should invest in their employees, but also develop strategies to keep them happy and loyal.
- This might involve offering competitive salaries, good benefits, and opportunities for advancement.

By valuing their employees, companies can ensure they get a good return on their investment.

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Lets Apply: Green Tech Giant's Innovation Challenge

GreenVolt, a leading solar panel manufacturer, faces disruption due to new battery technology. To stay competitive, they need to develop next-gen solar panels with integrated storage. Their R&D team has the expertise, but high employee turnover threatens the project.

Key Challenge: Retain Top Talent in R&D

Engineers are leaving for competitors with better salaries and career opportunities.

HR Strategies for Retention and Innovation

- Option 1: Training & Development
- Option 2: Enhanced Compensation
- Option 3: Culture of Innovation

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Lets Apply: Green Tech Giant's Innovation Challenge

Discussion Points:

1. Weigh the risks and benefits of each option.
2. Considering GreenVolt's situation, which option is most suitable? Why?
3. Explore alternative HR strategies (e.g., flexible work arrangements, mentorship programs).
4. How can GreenVolt measure the success of their chosen HR strategy?

Note: The full case study is uploaded on the SharePoint, and will be discussed during the next workshop. Be prepared!

The 5 Pillars of Organizational Performance

Organizations rely on five main assets to function well and create value:

- **Financial Assets:** Cash, investments, and receivables.
- **Physical Assets:** Buildings, equipment, and materials.
- **Market Assets:** Brand reputation, customer loyalty, and patents.
- **Operational Assets:** Management practices, organizational structures, and technology use.
- **Human Assets:** Employee skills, knowledge, and relationships.

The Challenge of Human Capital

While the first four assets are easier to measure financially, human assets are more challenging to quantify.



Understanding and Measuring Human Capital

Employees: Value Measurement

Employees' skills, knowledge, and abilities represent a significant asset for organizations. Measuring this value and its contribution to profitability becomes a critical issue.

Strategic HR: The Key to Success

Alignment with Goals: HR activities aligned with organizational goals lead to higher profits and market value.

Effective Management: Retaining talent through fair rewards and active management is crucial.

Quantifiable Impact: Studies show positive impacts of good HR practices, with up to a 47% market value increase.

HR Value Chain: Investing in People, Building Value

The Cause-and-Effect Chain

The HR value chain demonstrates a clear connection between:

HR Practices: How you manage your workforce (hiring, training, development)

Employee Performance: How well your employees do their jobs

Financial Results: The profitability of your organization

Market Value: The overall worth of your company



HR Value Chain Example: Training & Development



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The Measurement Challenge

Despite its importance, measuring the value of HR practices can be difficult.

Many companies rely on basic metrics like:

- **Employee Turnover:** How many employees leave the company
- **Employee Satisfaction:** How happy employees are at work

These metrics don't directly show the financial impact of HR activities.



Lets Apply: Measuring Human Capital at Dow Chemical

Dow Chemical is pioneering a method to measure the value of its employees (human capital). They're piloting a program that uses two metrics:

Expected Human Capital Return (EHCR): This calculates the point where an employee's contribution outweighs the company's investment (salary, training, etc.).

Actual Human Capital Return (AHCR): This measures the value an employee creates on projects based on their skills and the project's profitability.

These metrics aim to help managers:

- Match employee skills to project needs.
- Identify areas for employee development.
- Staff projects more efficiently and effectively.

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Lets Apply: Measuring Human Capital at Dow Chemical

Equilibrium Point= Total cost of employee investment- Net profit (Contribution) of employee

Example:

Basic salary = \$5000 + additional benefits \$2000= \$7000

Employment cost= \$5000

Training Cost= \$2000

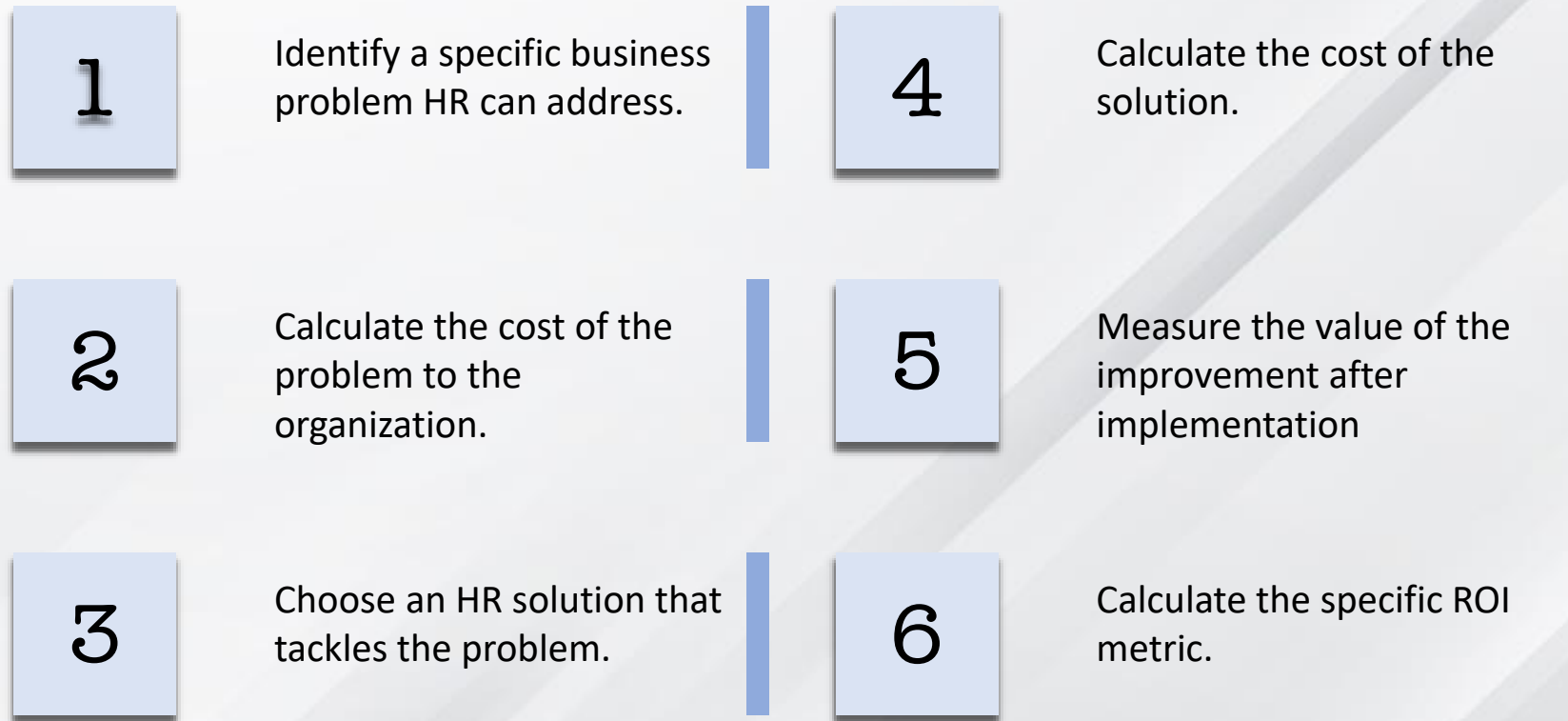
Employees contribution of revenues = \$15000

Net profit by employees = **Employees contribution of revenues** – **Direct employee Cost**= \$15000-7000= \$8000

Total cost of employee investment= Basic Salary +Additional Cost (Benefits+ employment cost+ training cost)
= 7000+5000+2000= 14000

Equilibrium Point= 14000/8000=1.75 month.

Mercer Model for Measuring Human Capital



Mercer Model Example

Problem:

The customer service department at XYZ Company is experiencing high employee turnover, which is leading to high training costs and decreased customer service quality.

Solution:

XYZ Company implements a new customer service skills training program for both new and existing employees.

ROI Measurement Steps

Determine the Actual Cost of the Problem:

- Costs of hiring and training new employees to replace those who have left.
- Decreased productivity due to staff shortages and training periods.
- Decreased customer satisfaction due to poor service quality.

Calculate the Cost of the Solution:

- Cost of developing and implementing the training program.
- Salaries of trainers.
- Cost of training materials.

ROI Measurement Steps

Calculate the Value of Improvement:

- Reduced employee turnover rate.
- Increased productivity.
- Improved customer satisfaction.

Calculate the ROI: $\text{ROI} = (\text{Value of Improvement} - \text{Cost of Solution}) / \text{Cost of Solution}$

ROI Example

Value of Improvement:

- Reducing employee turnover by 10% saves \$100,000 in annual hiring and training costs.
- Increasing productivity by 5% increases revenue by \$50,000 annually.
- Improving customer satisfaction by 5% increases customer retention by 2%, which leads to increased revenue of \$20,000 annually.
- Total Value of Improvement = \$170,000 annually.

ROI Example

Cost of Solution:

- Cost of developing and implementing the training program: \$50,000.
- Salaries of trainers: \$20,000 annually.
- Cost of training materials: \$10,000 annually.
- Total Cost of Solution: \$80,000 annually.

➤ **ROI:** $\text{ROI} = (\$170,000 - \$80,000) / \$80,000 = 112.5\%$

HR Metrics & Challenges

HR's Importance Recognized, But Not Valued by Wall Street

- CEOs acknowledge the importance of HR, but Wall Street analysts often disregard human capital's impact on a company's value.
- Analysts prioritize talking to finance and operations, areas they understand better, instead of HR.

Lack of Standard Metrics Hinders Reporting

- There's no universally accepted way to measure and report human capital value, unlike financial metrics.
- HR has identified common metrics (Exhibit 1.4) that translate to financial performance and compare with industry benchmarks .

Factors Influencing How “Investment Oriented” an Organization Is

Leadership Viewpoint:

Companies with leaders who see employees as valuable assets will invest more in retaining and developing them.

Risk Tolerance:

Organizations willing to take risks are more likely to invest heavily in employee training and development.

Factors Influencing How “Investment Oriented” an Organization Is

Employee Skills:

- Investment decisions are influenced by the skills employees possess.
- Companies offering training in highly marketable skills may need stronger retention strategies to prevent employee loss.

Focus on Measurable Returns:

Organizations that prioritize a clear return on investment may struggle to justify investment in HR programs with less tangible benefits, like improved morale.

Factors Influencing How “Investment Oriented” an Organization Is

Outsourcing Options:

The availability of cost-effective outsourcing can influence investment decisions. Some functions may be outsourced if specialists are readily available elsewhere.

HR Professionals' Role:

HR professionals play a crucial role in convincing leadership to understand the value of their workforce. They have an ethical responsibility to advocate for strategic HR practices that benefit everyone involved.

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Watch This Video: Moneyball Winning with Stats in Baseball



[Video Link: https://www.youtube.com/watch?v=Xk6hBkOzCzQ](https://www.youtube.com/watch?v=Xk6hBkOzCzQ)

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Moneyball* Winning with Stats in Baseball*The Challenge:**

Billy Beane, general manager of the Oakland Athletics (small-market team), couldn't compete financially with big spenders like New York and Boston.

The Solution:

Beane looked beyond traditional player evaluation methods (batting average, home runs for hitters, wins for pitchers) He used new metrics like on-base percentage and pitch count, which were more predictive of team success.

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Moneyball* Winning with Stats in Baseball*The Result:**

Oakland, with a low payroll, made the playoffs four years straight (2000-2003) despite having fewer stars. Other teams copied Beane's approach, reducing Oakland's advantage.

The Lesson:

Smart use of data and metrics can lead to success, even for organizations with fewer resources. Choosing the right metrics and analysis techniques is crucial.

HR Metrics

HR Metrics: Quantitative measures used to track and assess the efficiency and effectiveness of human resource management practices.

Choosing the Right Metrics Matters

"Perfect" metrics don't exist. The most suitable ones depend on the organization's strategy:

- Cost-focused companies might track turnover and revenue per employee.
- Growth-oriented companies might look at time-to-fill vacancies.
- Innovation-driven companies might monitor training costs per employee.
- Different divisions within the same organization might use different metrics based on their unique goals.



Key HR Metrics- Reading Only

Absence Rate

1

Absence Rate = (Total number of absence days) / (Total number of scheduled workdays) x 100

Cost per Hire

2

Cost per Hire = (Total hiring costs) / (Number of new hires)

Medical Costs per Employee

3

= (Total health care costs) / (Number of employees)

HR Expense Factor

4

= (Total HR expenses) / (Total operating expenses) x 100

Labor Costs as % Sales / Revenues

5

= (Total labor costs) / (Total sales or revenue) x 100

Profit per Employee

6

= (Total company profit) / (Number of employees)

Absence Rate

XYZ Programming Company

The HR department want to measure Absence rate in Q1 2024.

- Total absence days= 100
- Number of employees = 50
- Number of calendar days = 5 days/week* 12 weeks= 60 weeks *50 employees = 3000

Absence rate= $100/3000=3\%$

- Its important to compare this ratio to the industry average
- Its also important to monitor the impact of this ratio on employees productivity, financial measures, or employees satisfaction.

HR Expenses Factor

A manufacturing middle size Company that have 200 employees

The company want to measure HR department expenses

- Total HR department expenses= \$1000000
- Total operating expenses=\$10000

HR expenses factor= $10000/1000000 = \%10$

This means that total HR expenses represent 10% of the total operating expenses

Medical cost per employee

XYZ Programming Company

The HR department want to measure medical cost per employee

- Total medical cost= \$25000
- Number of employees = 50

Medical cost per employee= $25000/50 = \$50/\text{employee}$

Labor cost as % of sales/revenue

A manufacturing middle size Company that have 200 employees

The company want to measure Labor cost as % of sales/revenue

- Total cost of employees= \$3000000
- Total Sales=\$20000000

Labor cost as % of Sales= $3000000 / 20000000 * 100 = 15\%$

- This means that employees cost represent 15% of total company sales

Profit per employee

A manufacturing middle size Company that have 200 employees

The company want to measure Profit per employee

Total Company Profit=\$5000000

Profit per employee = $5000000/200=\$25000$

- This means that each employee contribute on average \$25000 profit to the company.

Key HR Metrics- Reading Only

Revenue per
Employee

7

= (Total company revenue) / (Number of employees)

Time to Fill

8

= (Average time from job posting to offer acceptance)

Turnover
Rate

9

= (# of separations in a specific period) / (Average number of employees during that period) x 100

Workers'
Compensation Cost
per employee

10

= (Total workers' compensation costs) / (Number of employees)

Vacancy Rate

11

= (Number of open positions) / (Total number of positions) x 100

Yield Ratio

12

= (Number of hires from a pool of applicants) / (Number of applicants in the pool)

Revenue per employee

A multinational manufacturing Company that has 1000 employees

Total company revenue = \$100,000,000

Revenue per employee = $\$100,000,000 / 1000 = \$100,000$

➤ This means that each employee contribute on average \$25000 revenue to the company.

Turnover rate

A multinational manufacturing Company that has 1000 employees

Total turnover in a year= 50

Turnover= $(50/1000)*100= 5\%$

This means that on average 5% of total employees workforce leave the company.

Time to fill

A multinational manufacturing Company that has 1000 employees

Time to hire new employees from advertising job till employees join takes on average **90 days**.

- High ratio might indicate shortage of skills in a competitive market or a complicated recruitment process.
- It is important to compare this ratio with the market

Vacancy rate

A multinational manufacturing Company that has 1000 employees

- No. of open positions= 20
- Total no. of jobs = 100

Vacancy rate = $(20/100) \times 100 = 20\%$

➤ **A high vacancy ratio might indicate high turnover rate or difficulty to recruit qualified staff.**

Yield Ratio

A multinational manufacturing Company that has 1000 employees

- No. of hire from applicant pool=10
- Total number of applicants=100

Yield ratio = $10/100=0.10$

➤ **This ratio could be used to measure recruitment efficiency**

Other Metrics- Human Capital ROI

Human Capital ROI- a valuable metric that allows companies to determine ROI in human resources relative to productivity and profitability.

Human Capital ROI = (Profit before tax – (Employee Compensation + Benefits Costs)) / (Employee Compensation + Benefits Costs)

Example:

- Profit before tax= \$10,000,000
- Compensation cost=\$5000000
- Other Benefits cost=\$2000000

ROI=(\$10,000,000 – \$7000000) / (7000000)

= \$0.43 (This means that the company achieved ROI = 43% of each dollar invested in employees).

Other Metrics- Workers' Compensation Cost per Employee

Workers' Compensation Cost per Employee: Shows the average amount spent on workers' compensation claims per employee.

Workers' Compensation Cost per Employee = (Total workers' compensation costs) / (Number of employees)

Example: Total compensation claims= 100,000

No. of employees=1000

Workers' Compensation Cost per Employee= $100000/1000 = \$100$

This means on average \$100 is spent a year of compensation claim for each employee.

Other Metrics: Workers' Compensation Incident Rate

Workers' Compensation Incident Rate: Measures the frequency of work-related injuries or illnesses per 100,000 work hours.

Workers' Compensation Incident Rate = (Number of recordable incidents) / (Total number of work hours) x 100,000

Example: If a company has **100 employees** who work **40 hours per week** for **52 weeks**

the total annual working hours would be 280000 (100 employees * 40 hours/week * 52 weeks)

Rate = (Number of Injuries * 100,000) / Total Hours Worked Rate = (5 injuries * 100,000) / 280000 hours Rate = 2.40 incidents per 100,000 hours.

Note: The 100,000 hours act as a standard denominator to ensure consistent comparison of incident rates across various timeframes and company sizes (recommended by Bureau of Labor Statistics (BLS) in the US).

Other Metrics: Workers' Compensation Severity rate

Workers' Compensation Severity rate: Indicates the average cost of a work-related injury or illness claim.
= (Total workers' compensation costs) / (Number of recordable incidents).

Example:

- Total compensation claims= 100,000
- No. of recorded incidents=10

Workers' Compensation Severity rate= \$100000/10= \$10000

- This means that the average cost of workers compensation claim is \$10000
- This ratio could be used to determine the type of injuries that are most costly to the organization.

Conclusion

- ❑ Organizations rely on five main types of assets to perform well and create value: **Financial Assets, Physical Assets, Market Assets, Operational Assets, and Human Assets**
- ❑ Traditionally, competitive advantages came from factors like product design or marketing. Today, the most strategic advantage comes from how well an organization attracts, motivates, and manages its workforce.
- ❑ By considering the risks and returns, costs and benefits, you can make informed decisions to develop your human capital and gain a lasting competitive advantage.
- ❑ By valuing their employees, companies can ensure they get a good return on their investment.

Conclusion

- ❑ Treating employees well and strategically managing their skills and contributions leads to a more profitable and valuable company. However, accurately measuring the impact of HR practices on the bottom line is still a work in progress.
- ❑ Dyer and Reeves attempted to define what can be called the HR “value chain.” They argued that performance could be measured via four different sets of outcomes: employee, organizational, financial and accounting, and market-based, they proposed that these sets of outcomes had a sequential cause-and-effect relationship,

Conclusion

- ❑ The Mercer Human Capital ROI Model can be used to measure the effectiveness of human capital investments. By following the steps outlined, organizations can determine the return on investment of their training programs and other human capital initiatives.
- ❑ HR Metrics can be used to track and assess the efficiency and effectiveness of human resource management practices. Perfect" metrics don't exist. The most suitable ones depend on the organization's strategy:

Thank You