HUMAN RESOURCE MANAGEMENT AS VALUE DRIVER IN THE MODERN COMPANY

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Abstract: Today, one of the most critical skills any professional can possess is the ability to show and explain the accountability of various processes and functions that take place within the company. More and more, senior executives, shareholders and other stakeholders are questioning the value created by the variety of activities that companies develop, including non-traditional sources of value creation, such as human resources. Senior executives that are able to perceive the human resource learning activities as investments, as opposed to expenses, and to understand and use innovative criteria to assess their business impact dispose of an instrument that can effectively create a competitive advantage that will generate growth and value for shareholders. Our paper analyses the shift in the manner human resources programs are considered within a business, from "cost centres" to "value generators" and the efficiency of using assessment criteria to evaluate the business impact of such programs, contrasted against the traditional assessment of human resource programmes through participants' satisfaction with the program and captured planned actions, or changes in participants' knowledge, skills, and attitudes.

1. Introduction

For any company, primary activities like: sales, operations, production, service, are directly concerned with the value creation linked to an offered product or service. Other activities like human resources, IT and administration are traditionally considered support activities and are seen as helping to the improvement of effectiveness or efficiency of primary activities, by adding indirectly value to the company's products or services. In most of the cases, these support activities, including human resources, are considered "cost centres", due to the manner most senior executives consider them. Since attaching specific values to these activities in terms of tangible benefits is a difficult endeavour, the majority of senior executives are not using measurement criteria such as a simple return on investment (ROI) to assess the effectiveness of various human resources activities.

Today, one of the most critical skills any professional can possess is the ability to show and explain the accountability of various processes and functions that take place within the company. More than any time in the past, senior executives, shareholders and other stakeholders are questioning the value created by the variety of programs, projects, and processes that companies develop. Hence, human resources professionals are forced to show to all these interested groups how the value generated by HR programs can be measured and reported in a credible, coherent and methodical way.

Under these circumstances, senior executives that are able to perceive the human resource learning activities as investments, as opposed to expenses, and to understand and use such innovative assessment criteria for a non-standard framework will dispose

of an instrument that can effectively create a competitive advantage and will innovatively generate growth and value for all stakeholders.

Our paper is developed on three coordinates: first, we analyse the sources of competitive advantage in the modern corporation and their link with the value creation process in the company; second, we make the case for a new manner of understanding human resource management activities in terms of competitive advantages; third, we discuss possible assessment criteria that companies may use in order to evaluate the business impact of human resources programmes and their potential in terms of value adding. The paper is structured as follows: Section 2 analyses the traditional sources of value creation employed by companies, Section 3 examines the potential of human resource activities as an innovative value driver in the modern corporation, while Section 4 presents a framework that may be employed by companies to assess the impact that human resource programmes have on their ability to create value for shareholders. Section 5 concludes.

2. Sources of value creation

During the 1980s, an influential work of Rappaport (1986) gave birth to a new approach to firm's valuation called shareholder value analysis, based on a different new way of looking at value forged into the net present value approach. The key assumption of shareholder value analysis is that a business is worth the net present value of its future cash flows, discounted at the appropriate cost of capital that reflects the business level of risk. This new approach provides a framework for linking management decisions and strategies to value-creation and focuses the executives' attention on how to plan and manage firm's activities to increase value for shareholders and, at the same time, to benefit other stakeholders. Figure 1 shows the relationship between decision-making and shareholder value, by linking the strategic focus to the value drivers and, finally, to the corporate objective. The managers' role, in this framework, is to make decisions that are able to influence the value drivers that can have the greatest impact on shareholder value. As identified by Rappaport (1986, 1987) these value drivers include sales growth and margin, working capital and fixed capital investment, the cost of capital and the tax rate. The shareholder value analysis requires the specification of a planning horizon and forecasting the cash flows and discount rates based on the underlying plans and strategies, with various strategies possible to be considered to evaluate their implications for shareholders' value. In a very simple manner, this new framework assists managers focus on value-creating activities and helps them consider long-term activities as being more productive in value-creation terms as compared to sort-term profit-related activities.

This apparent contradiction between investing for the long-run and showing to the interested groups good short-term results has been for many years the battle camp for financial managers, interested in short-term results, and business strategists, which formulate action plans for the long-term. One way of exploring this disagreement is to observe whether the stock market reacts better to firm's actions that foster long-term results at the expense, sometimes, of short-term results, as the capital budgeting process in any company is under the scrutiny of the stock market, with or without the conscious understanding or the firm's management. If a firm invests in a project that is worth more than its cost, the project will generate a positive net present value and the firm's stock price should consequently increase. However, the popular financial press frequently suggests that the best way to boost stock prices is to report high short-term

earnings. But the existing evidence shows that this assumption might not be true. Johnson and Pazderka (1993) used Canadian stock market data and corporate financial data to test the market's reaction to research and development spending on firms and their empirical results showed a positive statistically significant relationship between R&D activities and market value. For the United States, McConnell and Muscarella (1985) investigated the effects of corporate investment on the market value of equity and found that, for most industrial firms, announcements on increases in planned capital spending were associated with significant increases in the market value of the common stock, while announcements of decreases in capital spending had the opposite effect. In another study on American companies, Wooldridge (1988) looked at firms' announcements of joint ventures, research and development spending, new product strategies, and capital spending for expansion and modernization and found a strong positive stock market reaction to these types of announcements. Another interesting study, conducted by Chan, Martin and Kensinger (1990), reports that share price responses to announcements of increased research and development spending are significantly positive, even when the firm's short-term earnings are decreasing. These findings provide a strong support for the belief that the stock market encourages long-term strategic investment decisions made by managers and aimed at increasing shareholders' value, even at the expense of lower short-term earnings.

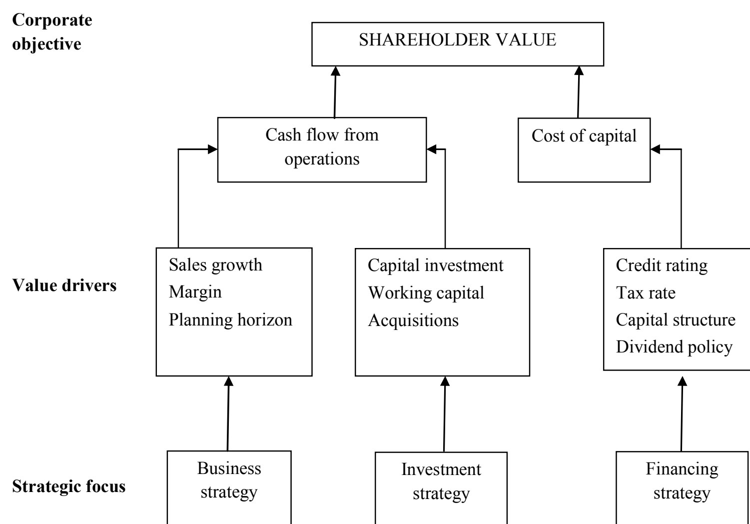

Fig.1: Shareholder value analysis framework

Source: Based on Rappaport (1986) and Pike and Neale (1996)

The other approach that we may take is supported by Rappaport (1992) that transforms the long versus short-term horizon of a business into a debate followed by reconciliation between shareholder value and competitive advantage. Indeed, these two dominant business objectives are based on a common concept: long-term productivity. According to Rappaport, productivity – the value of the output produced by a unit of labour or capital – is the foundation for creating competitive advantage in the marketplace and the factor that the stock market reacts to when pricing company's stock – as long as we agree that share prices include a long-term forecast about a company's ability to create value in excess of the cost of producing it. Under these circumstances,

if the competitive advantage that a company enjoys is incorporated in the stock price, there is no reason to expect that the shareholder will earn a greater than normal market-required return. At the same time, unexpected changes in investors' perceptions of a company's future prospects will generate excess returns through increases in stock prices. As a result, even if a company increases shareholder value by investing at above the risk-adjusted cost of capital, shareholders will earn more than the market-required rate of return only if the company's performance was not fully anticipated in the stock price at the moment of their purchase. Rappaport makes very strongly the case against the myth that managers must depart from the standard shareholder value model in order to make investments that ultimately lead to competitive advantage. This myth is, in his view, rooted in the incorrect assumption that the market reacts negatively to long-term investments that might represent a short-term drain on both earnings and cash flows. As presented above, empirical evidences support this view and lead us to consider that any strategy that is designed to promote the firm's competitive advantages must, eventually, pass the test of sustainable value creation. In turn, the value-creation process depends on the company's ability to translate these competitive advantages into sustainable cash flows.

Traditional financial analysis operates with criteria such as net present value and internal rate of return in order to identify the so-called „good projects", which create value for the shareholders by earning a return greater than that obtained on investments of similar risk. While these criteria are valid from a measurement point of view, they are not able to address the true fundamental question about the good projects, referring to the economic conditions that lead to the existence of projects that are able to create value. In a competitive market for real investments, the presence of excess returns attached to investment projects attracts competitors to undertake similar projects, but in the process these excess returns will disappear, sooner or later, depending on the easiness of market entry and of development of substitute products or services. But these depends, on their turn, on the magnitude of differential advantages that the company that undertakes such good projects disposes of and is capable to maintain in time: in case the business that identifies good projects has no differential advantage attached to cost or project quality over its competitors and new competitors can enter rather easily the market, there is no reason to assume that the business can obtain superior returns over time; under these circumstances, the abnormal returns initially forecasted by the business will disappear very quickly, leading to the transformation of a good project in a project that destroys value.

Damodaran (1999) sees the creation and maintenance of barriers to new or existing competitors taking on equivalent or similar projects as the basis for the existence of good projects, in the form of economies of scale – in such cases, large companies may be able to continue to earn superior returns on their projects because smaller scale competitors will not be able to replicate them, cost advantages – either in the form of higher efficiency or by taking advantage of arrangements that its competitors cannot use, capital requirements – referring to the large investments required to enter in some businesses, which can discourage competition from entering, even though projects in these businesses may earn above-market returns, product differentiation – can be created in a number of ways through advertising and promotion, technical expertise, better service and responsiveness to customer needs, access to distribution channels – this takes the form of a better access to the distribution channels than their competitors, or the restricted access to outsiders due to tradition or loyalty to existing competitors, or

the ownership of a distribution channel and the inability of competitors to develop their own channel due to prohibitive costs, and even legal and government barriers that set restrictions on competitive entry. It is interesting to note that the management of the firm holds different degrees of control over these factors: while some of them, such as government restrictions, may be largely out of management's control, there are others that can be visibly influenced by management. For example, a good managerial team may exploit these market barriers by undertaking projects that use the economies of scale that the firm may dispose of, by establishing and fostering cost advantages over its competitors, by consolidating brand recognition by aggressive advertising campaigns and/or by delivering superior products to customers, by improving the firm's reputation for customer service and product delivery, by developing distribution channels that are difficult to be accesses by competitors, or by obtaining patents that keep the competition at distance and generate high returns.

3. Human resource management as value driver

Nowadays, most managers recognise the strategic implications of the knowledge-based economy and understand that skilled and motivated people are critical for the success of firm's operations that wishes to remain competitive in the new type of economy that is currently emerging. In the late 1980s, the search for more dynamic and sustainable advantages led the managers towards a supplement of their analysis of external competition with an internal competency assessment. Pfeffer (1994) describes how changing market conditions have reduced the importance of traditional sources of competitive advantage, such as patents, economies of scale, access to capital and market regulations. Although this does not mean that such assets are not valuable anymore, but that they are not able to offer to the company the needed differentiation, in a global economy driven by innovation, speed, adaptability and low costs. This came with the understanding that resources and competencies will be more and more difficult to imitate and, in this framework, the core-competency perspective focused attention on the importance of knowledge creation and learning processes for the building and maintaining of competitive advantages. In such an economy, the core competencies and capabilities of employees that help the development of new products, provide world class customer service and implement organizational strategy become relatively more influential (Becker, Huselid, Pickus, Spratt, 1997).

Regrettably, at the time companies acknowledged the fact that their employees, no matter the level within the hierarchy, were not prepared for the new knowledge-intensive tasks. By definition, competency-based strategies are dependent on people, since scarce knowledge and expertise drive the development of new products and personal relationships with customers are central to a flexible market response to firm's actions. Consequently, people started to be seen as a key strategic resource and strategy was increasingly directed towards a human resource approach. The implications for top management are profound: first, human resources issues should be moved upper in the company's hierarchy and in the agenda of company's strategic priorities; second, and even more significant, traditional strategic planning processes will have to suffer a transformation that includes financially calibrated performance measurement and reward systems in order to recognise the strategic importance of human resources, apart from financial resources.

As more and more companies understood the decisive importance of human resources the so-called "War for talent" began. The concept was pioneered by

McKinsey researchers, which conducted in 1997 a yearlong survey entitled "The War for Talent" and published an updated research in 2001 (see Michaels, Handfield-Jones and Axelrod, 2001). Also, Bartlett and Ghoshal (2002) make the case for the evolving role of human resources and see human resource professionals as key players in the design, development and delivery of company's strategy (see Table 1).

Table 1

The evolving role of human resources

	Competition for products and markets	**Competition for resources and competencies**	**Competition for talent and dreams**
Perspective on employees	People viewed as factors of production	People viewed as valuable resources	People viewed as "talent investors"
HR's role in strategy	Implementation, support	Contributory	Central
Key HR activity	Administering of recruitment, training and benefits	Aligning resources and capabilities to achieve strategic intent	Building human capital as a core source of competi-tive advantage

Source: Bartlett, Ghoshal (2002)

Surprisingly enough, ten years after the research conducted by McKinsey, the problems remains acute, as companies are faced with issues such as a demographic landscape dominated by the retirement of baby boomers and the reluctance of young people to enter the workforce in the developed world, on one hand, and doubts over the appropriateness of the talent in many emerging markets. Judging by the most recent McKinsey Quarterly global executives surveys, business leaders are deeply concerned. The 2006 survey indicated that respondents considered finding talented people the single most important managerial concern for the rest of the decade, while the 2007 survey revealed that nearly half of the respondents expect the amplification of competition for talent and the increasingly global nature of that competition to have a major impact on their companies over the next five years, with no other global trend being considered nearly as significant. Guthridge, Komm and Lawson (2008) discuss three external factors that are forcing organizations to take talent more seriously: demographic changes, globalization and the rise of the knowledge worker. At the same time, they see managers not ready to give up on the reactive manner they have employed so far - for example, by hiring additional sales and marketing people only when new products are launched. In their view, the "short-termism" fostered by shareholders and investment analysts diverts management attention from longer-term issues such as talent sourcing and career development. They state their case very well (Guthridge, Komm and Lawson, 2008, p. 53): "Since investments in talent intangibles are expensed rather than capitalized, managers may try to raise short-term earnings by cutting discretionary expenditures on people development. This tendency may turn into a vicious circle: a lack of talent blocks corporate growth, creating additional performance pressures that further divert the attention and thinking of executives toward the short term."

4. Measuring the business impact of human resource management

Despite its increasingly recognised importance, human resource management is seldom analysed when the company's performance or its competitive positions are assessed. Traditionally, the performance of companies and of their business units is measured by financial indicators such as return on investment, earnings per share and net profits. Unfortunately for the human resource department, they are not the right measures to encourage the empowerment of employees and the proper use of people's capacities. Bühner (1997) identifies three major reasons why traditional financial and accounting indicators are not appropriated for the performance measurement in the case of human resources: (1) The performance of people is shown in financial and accounting statements in terms of costs only, as employees are too often regarded as costly liabilities rather than valuable assets; (2) Traditional financial measures, such as return on investment or earnings per share, foster short-sighted action in a company, and neglecting employees training is, unfortunately, one of the best examples that can be given; (3) Traditional accounting data are an instrument for remote control, which provide highly aggregated financial reflection of the real business processes, but do not provide real-time feedback for corrective action or a stimuli for continuous improvement or preventive action programmes needed in the case of employees' management.

Based on these hypotheses, Bühner proposes a system of human resource management indicators that avoids these shortcomings and focus management's attention towards human resources. This system represents a translation of the well-known DuPont model, designed by an electrical engineer of Du Pont Chemical, after the chemical giant bought a 23 percent stake in General Motors and was interested in understanding the new company's performance. Ensuing success of the model made it a first choice for major US corporations in their endeavor to improve performance and it remained the dominant form of financial analysis until the 1970s. Nevertheless, the model offers insight into a company's performance even today, almost 100 years after its design due, on one hand, to its simplicity, and, on the other hand, to its ability to precisely point out the weak and strong points of a business, both in time and by comparing it to the industry or the economy as a whole. The Du Pont model explains the return on assets (ROA), by linking it to the company's efficiency and profitability, as follows:

$$\text{ROA} = \frac{\text{Net profit}}{\text{Total assets}} = \frac{\text{Net profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Total assets}} = \text{Net profit margin} \times \text{Total asset turnover} \quad (1)$$

The first component of ROA, net profit margin, offers insight into company's profitability and ability to control costs, while the second component, total asset turnover, indicates how efficiently is the firm using its assets in order to generate sales. This decomposition of ROA shows that as net profit margin increases – profitability increases – and total asset turnover increases – efficiency of using assets increases - the return generated by the use of company's assets increases.

Besides this basic interpretation of ROA, there is much more insight one can gain by analyzing the root causes of the ROA level and changes in time. The two components of ROA – asset turnover and profit margin – find themselves into a trade-off type of relation, depending on the industry. As such, ROA can be achieved with various combinations of profit margin and asset turnover, with firms ranging along so-called "ROA lines": each line shows the combinations of the two, with high turnover

accompanies by low profit margin and inversely. In an economy, one can find companies aligned along a different ROA level, with different efficiency and profitability levels. Also, when a dynamic analysis is performed at a company level, one can observe that the company remained under the same ROA line, but with changing components – the firm might have been forced to undergo through such changes due to the business environment characteristics -, or that it moved on another ROA line, by changing one and/or another of ROA components. Figure 2 below depicts graphically the relation between profit margin and asset turnover using iso-ROA curves.

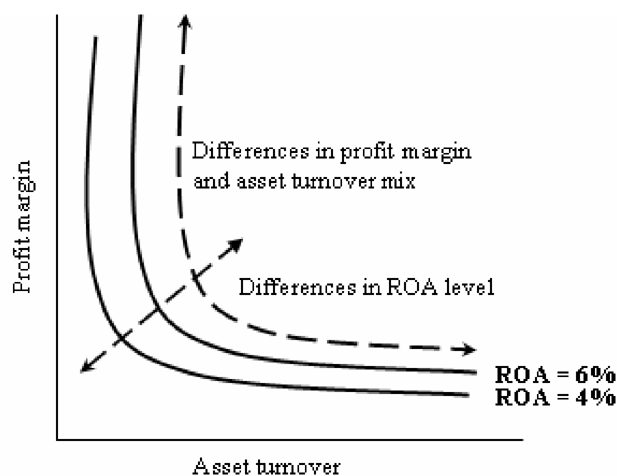

Fig. 2: Iso-ROA curves

The system proposed by Bühner (1997) uses the ratio "cash flow per employee" – as absolute figures or as growth rates – as the ultimate measure of a company's or a business unit's success. Figure 3 presents the formation of the "cash flow per employee" ratio and points to the fundamental driving forces for increasing it through human resource management: on one hand, a company may undertake strategic investment in intellectual capital, addressed by the system's upper branch by the ratio "cash flow per sales"; on the other hand, a firm may use its intellectual capital more efficiently, as indicated by the ratio "sales per employee" in the system's lower branch. In a similar manner as illustrated in Figure 2 above, a company that wants to achieve a high cash flow per employee need to control both measures. The system's upper branch shows how investment in training is related to the ratio "cash flow per sales" and, eventually, to the firm's performance: to sustain a desired growth of cash flow, incremental investment in fixed and working capital is needed, but also incremental investment in human resources. This incremental investment in human capital that can be achieved by raising training expenses per employee or by hiring new employees is typically not explicitly included in the standard shareholder value analysis. The lower branch system measures how efficiently is the company in managing its investments in personnel through the use of the ratio "sales per employee". As can be noted, the driving forces for these measures of human resource efficiency are availability, performance and quality, more specifically the work-time during which the employee is physically available, the speed at which the employee performs the work and the rate of no-defect work. Thus, at the departmental or individual level, human efficiency measures the avoidance of losses with respect to time, speed and quality.

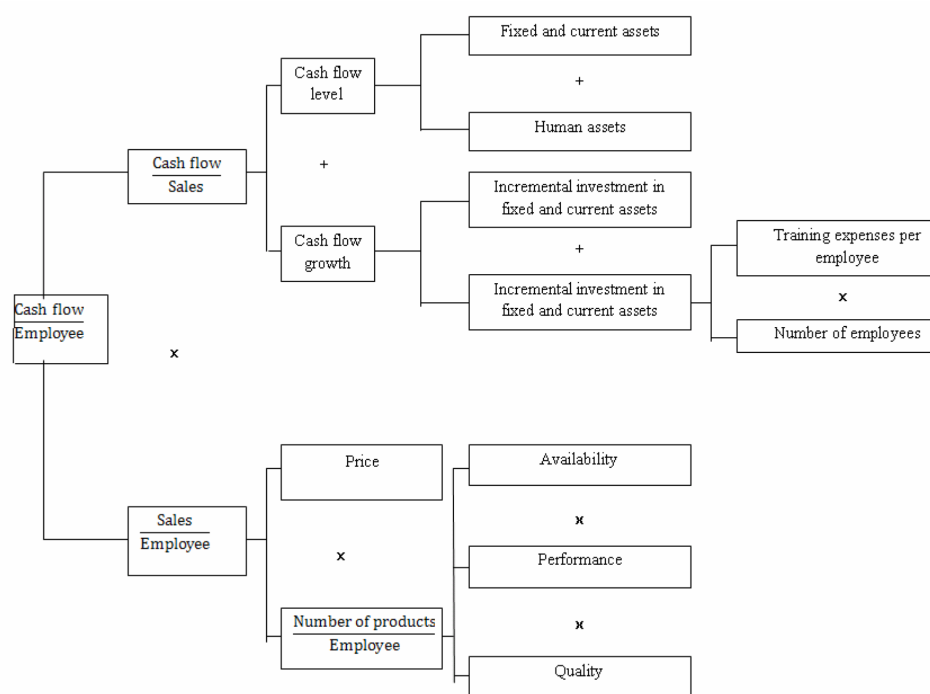

Fig. 3: Human resource management system of indicators
Source: Brühner (1997)

5. Conclusions

In a world dominated by highly competitive pressures and defined by demographic changes, globalization and the rise of the knowledge worker, companies aiming at remaining competitive in their markets or attempting to penetrate new ones are forced to look internally rather than externally in order to identify new sources of competitive advantages that lay the foundation for shareholder value creation. Human resources activities may represent such an innovative source competitive advantage, as long as executives will think about them not in terms of expenses, but in terms of long-term investments. For this to happen, a new framework for the assessment of human resources programmes' performance is needed, where both the profitability such programmes and their efficiency is taken into account, in a similar manner to the well-known DuPont model of financial analysis.

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