Human Assets

By Jack J. Phillips, Ph.D.

Human capital expert Jack Phillips explains how return on investment can be applied to the people side of your business.

Although the term “human capital” is commonplace in organizations (the number of documents produced containing the term increased from almost 700 in 1993 to more than 8,000 in 2003), management’s role in this important resource is often unclear. This lack of clarity adds to the mystery of human capital investment.

Imagine this scenario: the CEO of a $5 billion company proposes to its board of directors that the company make an investment of $1.8 billion for the coming year. In describing the investment, the CEO is optimistic that returns will follow, although he does not know how much of a return will be realized and cannot estimate it reliably. He says he’s confident that the investment is needed and that it will pay off for the company. The executive explains that this investment, which represents almost 40% of its revenues, is based on benchmarked data that shows other firms are making similar levels of investments.

The investment in question is, of course, human capital. As extreme as it seems, this scenario plays out in organizations each year as they invest in their workforce. Budget approvals are granted on faith, with the assumption that the requested investment will pay off.

There is far too much mystery about the connection between the investment in employees and the success that follows. This mystery causes some organizations to invest too much or too little—either of which can bring disaster. However, executives can develop an optimum investment in human capital by considering five possible strategies:

1. Let others do it. Avoid much of the investment altogether by using contract employees and/or outsourcing.

2. Invest the minimum. Invest only the minimum required, and expect a huge turnover rate.

3. Invest with the rest. Use benchmarking to determine proper investment levels.

4. Invest until it hurts. Over-invest, either intentionally or unintentionally.

5. Invest when there is a payoff. Use ROI to determine if the investment provides the appropriate return.

These strategies define the range of possibilities. Unfortunately, many executives do not examine all the options before deciding on a specific strategy.

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Macro vs. micro

As executives continue to try to understand the importance of investing in human capital, they have developed both intuitive and empirical reasons for investing in human capital. Three approaches have evolved.

The first approach is to use logical deductions, intuition, and common sense—in other words, it's easy to see the value of employees. Employees are necessary; they add to the market value and are the last source of competitive advantage. This approach is based on intangibles. The second approach is empirical, examining the connection between investment in human capital and organizational performance (macro analysis). More than 100 studies have been conducted to show this linkage. The important areas are (1) the positive correlation between the human capital investment and the productivity of the firm and (2) the positive correlation between the human capital investment and profitability. The research base is comprehensive and significant.

The third approach presents data on the impact of specific human capital programs, using return on investment as a measure (micro analysis). The use of ROI has become an important management tool for placing a value on human capital initiatives, programs, and solutions.

Show us the money

The ROI methodology can be used to show executives the monetary benefits directly connected to human capital expenditures (compensation, benefits, and training), particularly for programs that are highly visible, strategic, and expensive. This systematic, comprehensive measurement and evaluation process generates seven types of measures:

1. Reaction and satisfaction. This data is generated from participants (HR stakeholders) and used to measure nearly all HR functions and programs, usually through generic questionnaires and surveys. Although this level of evaluation is important as a customer satisfaction measure from program participants, a favorable reaction does not ensure that participants have learned to implement the HR program.

2. Acquisition of knowledge and skills needed to implement plan or program. These measurements focus on what participants learned during the HR program. A learning check is helpful to ensure that participants absorb new skills, knowledge, and know-how to make the HR program successful. However, a positive measure at this level is no guarantee that the program will be implemented successfully.

3. Application and implementation. Measuring application and implementation is necessary to determine if participants implement the HR program successfully. The frequency and use of skills are important measures at this level. This measure includes all the steps, actions, tasks, and processes involved in the implementation of the program. Although the evaluation is important for gauging the success of the program's implementation, it still does not guarantee a positive business impact on the organization.

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4. Business impact related to the human capital expenditure or program. This measurement focuses on the actual business results achieved directly from the HR program. Typical business measures include output, quality, costs, time, and customer satisfaction.

5. Costs. Although the HR program may produce a measurable business impact, there still is a concern that the costs for the program may be too high. A fully loaded cost profile is recommended, involving a tabulation of all direct and indirect costs.

6. Return on investment in the expenditure or program. The ROI measurement is the ultimate level of evaluation, comparing the HR program's monetary benefits with the costs, usually presented as a percentage or benefit/cost ratio.

7. Intangible measures not converted to monetary values. In addition to tangible, monetary benefits, most HR programs drive intangible, non-monetary benefits. Intangibles are defined as benefits to the business or organization that are not converted to monetary values.
This balanced approach to measurement includes techniques for isolating the impact of the human capital investment, such as the use of control groups, trend-line analysis, forecasting methods, and end-user estimates of impact. However, selecting the most appropriate techniques for specific programs can be difficult. Accuracy, feasibility, cost, workflow disruption, and staff time required are among the factors that should be considered when choosing which techniques to employ.

ROI is measured with the same type of formula the finance staff would use to measure any type of investment—the ROI on investing in building equipment, for example. This methodology, created by the ROI Institute (www.roiinstitute.net), is based on a comprehensive measurement and evaluation process that has been implemented by more than 2,000 leading organizations in 44 countries worldwide.

The first step in the process is selecting an evaluation framework, which is essentially a categorization of data. The next step involves drawing up a process model detailing how data will be collected, processed, analyzed, and reported to various target audiences. The third step is the development of operating standards, ensuring that the results of the study are stable and free of influence from the individual conducting the study. Implementation is the fourth step, in which the ROI process becomes a routine part of training and performance. Finally, the impact the specific program evaluated had on the organization should be communicated to the entire organization.

As interest in human capital investment continues to grow, executives will seek strategies to guide decisionmaking about this critical investment. Calculating the ROI on human capital expenditures will play a substantial role in shaping decisions about an organization's human capital investments.

***Jack Phillips** is the author of **Investing in Your Company's Human Capital: Strategies to Avoid Spending Too Little—or Too Much.** (Amacom, 2005).*

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