MEASURING Human Capital Part 2

Why do we need to consider a valuation for Human Capital?

As per GAAP, "an asset can be defined as "a resource with economic value that an individual, corporation, or country owns or controls with the expectation that it will provide a future benefit."

Therefore, by definition, human capital is an asset. As mentioned earlier, over 52% of the value of the average entity is intangible assets, including human capital. To present the value of an entity and not reflect or identify the majority of its asset bases generates ambiguous results at best. Measuring human capital can serve a number of purposes, including:

- For many enterprises including service organizations, technology entities, start-ups, and distressed entities, human capital is the most material asset.
- As a core concept of economics, for each dollar you spend or invest, the enterprise recognizes the value of the amount plus an additional rate of return.
- Each enterprise has a considerable number of tangible and intangible characteristics that comprise its value. The proportional value that human capital plays in small mid-size businesses is greater than larger public entities. According to numerous research, for public entities, there is no positive correlation between how a company's stock fares upon the announcement of a new CEO and the share price over that CEO's tenure[1]. Could it be that there is an inverse value with management and the size of the entity[2]?

FROM THE US

BY MICHAEL R. KOEPPEL

Managing Director of Lakelet Advisory Group

WHAT MUST HUMAN CAPITAL VALUATION ADDRESS?

In Section VII, there is an extensive list of alternative means of placing a quantitative value on the human capital. Before addressing these alternative methodologies, the following prerequisites should be achieved for any methodology to be acceptable:

- The economic value of human capital measures not only an individual worker's human capital value; it should also include the value of the aggregated team. The value of the team should be greater than the sum of its individual components.

Identifying the human capital value of a single employee can be somewhat challenging but quantifying the value of the total team adds a degree of significant complexity.

At the base level, an employee's value is generally a function of the salary paid on an annual basis. However, beyond that, employees may have some extraordinary value assigned to them – possibly their reputation or some special training that they have received, either within an organization or on their own[3]. "An individual can make a difference, but a team can make a miracle."[4] What a team can accomplish together is greater than what can be accomplished individually.

- The concept of human capital recognizes that not all labor is equal. Employers can improve the quality of that capital by investing in employees. This can be done through the education, experience, and abilities of employees. All of this has great economic value for employers and for the economy as a whole.
- Against the background of numerous capital theories and the resources, HC must be regarded as a dominant factor behind organizations' competitiveness. However, apart from its role as a means of production and providing of services and products, its value is not disclosed on the assets side of the classical balance sheet[5].

"AN INDIVIDUAL CAN MAKE A DIFFERENCE, BUT A TEAM CAN MAKE A MIRACLE."4 WHAT A TEAM CAN ACCOMPLISH TOGETHER IS GREATER THAN WHAT CAN BE ACCOMPLISHED INDIVIDUALLY.

Traditional perception of human capital stems from the belief that employees are not company assets. According to the classical model, an element can be treated as an asset only when there is a possibility that the presence of this element in a business process is associated with economic benefits.

The future stream of economic benefits associated with the value of employees does not appear to be linear. Each year, the value of an employee to the enterprise needs to improve.

Nevertheless, in this process over the duration of the employee's tenure, one needs to account for the changes in the life cycle of the company, advances in technology, roles for said employee, and so on.

This further means that their presence in a business process is associated with the achievement of economic benefits. Human resource accounting approach is defined as "the process of identifying, measuring, and communicating information about human resources to decision makers"[6]. It is the limited identification, measurement and communication that is the core challenge with HC.

1. Political environment. It is essential that the workforce be viewed as an asset rather than as an expense or liability, with investments in the workforce (such as learning and development) being captured and reflected in the overall change in workforce value. This is an issue, especially in the US, where labour has traditionally been treated as a short-term expense and not the long-term commitment of the EU.
2. The resulting quantified value of the HC must have some degree of objectivity. Granted, subjectivity is a hallmark of the valuation process, but said subjectivity must have a consistent set of parameters to curtail the degree of subjectivity.
3. Adding to the complexity of the quantification of the human capital is the basic fact that, on average, a US employee has over 12 jobs during their career.[7] This fact alone creates a myriad of challenges in the quantification processes. For example, if one were to utilize Discounted Cash Flow or Present Value methodologies, how could one account for this continuous fluctuation in the employees?

REFERENCES

1 When Naming a CEO, Ignore the Market Reaction, by James M. Citrin, From the Harvard Business Review – (January–February 2012).
2 This is a remarkably interesting area associated with valuations, but beyond the scope of this specific paper.
3 Jac Fitz-Enz. The ROI of human capital: Measuring the economic value of employee performance. AMACOM Division of the American Management Association, 2000.
4 Quote by Doug Pederson.
5 Several authors consider the importance of human capital (Chadwick & Dabu, 2009; Snell, Youndt, & Wright, 1996; Wright, Dunford, & Snell, 2001). Gamerschlag (2013, p. 327).
6 Eric Flamholtz, 1974, p. 44. According to this model the ultimate measure of an individual's value to an organization is his expected realizable value. Also referred to as Reward Valuation Method
7 Average Number of Jobs in A Lifetime [2022]: All Statistics by Chris Kolmar Apr. 5, 2022. https://www.zippia.com/advice/average-number-jobs-inlifetime/#:~:text=On%20average%2C%20men%20hold%2012.5,the%20same%20as%20in%202018. ■

MICHAEL R. KOEPPEL, CPA, ABV, CFF, CITP, CTP, CGMA, is Managing Director of Lakelet Advisory Group, LLC in New York, US. The firm focuses on complex Business Valuations, Quality of Earnings Reporting, and working with challenged entities. In his experience, Michael has been exposed to a host of industries, but his primary focus is on technology, manufacturing, and service organizations. This experience includes both national and international clients. Assistance in Research was provided by Ms. Jamie O'Malley, with Lakelet Advisory Group, LLC.