# A FIRM'S WORKERS ARE AN ASSET

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In the late 1990s, mergers and acquisitions took place at a rate of more than one a day. Some turned out successful, most faltered. Size was not significant, nor was location or field of enterprise. In spite of high priced professional talent at the disposal of many organizations, a major problem was that most companies did not know exactly what they were getting for their money.

The purchase price, one of the most important criteria in such a transaction, is normally based on earnings, future cash flows and the benefits of syzygies (union of two related things). However, in all cases, a rigorous analysis of what the buyer actually receives is essential. After all, cash flows do not arise on their own; they come from the prudent utilization of assets: financial, physical, intangible and, last but not least in our knowledge oriented times, human.

**Human Assets**

In this uncertain economic period, much attention is paid to "hard" topics, such as cost efficiency and profitability; the immediate reaction after an acquisition may be to cut staff. For example, in a November 2000 transaction an Acquirer paid $36.4 million for the net operating assets of the Target, $5.2 million for employee bonuses and severance pay; after the transaction, a further $2.7 million was provided for additional terminations, which was capitalized in the "related costs and expenses".

Managers must exercise caution; too close a focus on the bottom line can prove short-sighted, as, to repeat an old truism, "good help is hard to get", especially highly skilled workers; all-too-ambitious attempts to "trim the fat" and instantly lower costs may eliminate vital muscle. Simply studying financial statements, even though an essential step in an acquisition, will not reveal which human assets are the factors behind the financial success. Was it the R&D team? the sales force? the systems staff? the factory workers? middle managers? senior executives? or even a local representative. All of those, plus many more individuals and groups, make up a firm's human assets.

Many valuation manuals and courses deal with financial and physical assets, a handful with intangibles, but very few mention human assets, the trained workers and management teams. Since 2001, according to FASB's Statement of Financial Accounting Standards 141, an "assembled workforce" is no longer an Intangible Asset, even though it used to be so considered under APB 16; it is now to form part of Goodwill. FASB's reasoning, in effect, was that its Fair Value could not accurately be measured. However, most investment bankers and valuation analysts would agree that a firm's human assets, even though they go home at night, contribute mightily to its

Return on Investment ("ROI"), and that poor management or "bolshie" employees can make even an excellent business fail.

## Planning

ROI is one of the most important measurements in business; its improvement must be one of management's major goals. To this end, most executives instinctively look to financial, technological or operational solutions and incorporate them into their planning process.

Every successful business has an operating plan for the month, quarter, year, even a product lifetime; it may be as simple as an annual budget, or as complex as a full blown five year business plan with monthly figures and milestones. In any case, it will contain explicit, or more probably, implicit goals and plans how the business would have to change to meet them.

Normally such documents concentrate on factual matters, as for instance freeing up working capital, purchasing new technology or speeding up production capabilities; however, some firm's "exotic accounting arrangements" should not be imitated..... Plans will almost always include investments to improve operating processes and the creation of new products and services. Other items will cover increased expenditures on R&D, brand building, staff training, establish customer relationships and enhanced information systems. All of these are reported as costs, but their investment characteristic helps generate value. The intangible and human assets they create do not appear on the balance sheet, but investors and potential acquirers pay considerable attention to them.

By concentrating on the financial aspects of planning while ignoring the human assets, managements may be missing a cornucopia of opportunities, especially if the plan does not adequately articulate the firm's Unique Competitive Advantage. This is an essential factor in not only establishing the type of individuals desirable to be on staff, but also how they should be compensated.

## Relating to Employees

A Unique Competitive Advantage may be something simple - such as a firm's ability to find competitors not known to the client; in one case, when an executive proudly told us they had none and that their product was unique, without much difficulty, our firm located 43 around the world. Other cases may be more complex, such as elaborate customer care systems that aim to ensure complete buyer satisfaction, extensive R&D programs to continue product leadership, or intensive procedures to improve operational efficiency.

The biggest expense for almost every company is payroll, yet many executives don't see the close link between better management of their staff and a higher ROI. This is confirmed by several major consulting firms:

- •Deloitte & Touche established that effective human capital management could result in up to a 43% higher market capitalization than that of comparables;
- •Watson Wyatt determined that companies with better human capital practices returned 64% higher shareholder value;
- •Accenture found that companies with vice presidents or directors responsible for human resources (HR) activities enjoyed median annual growth, in earnings per share, of 13% over a five year period (1994 to 1999), compared to 5% for companies without such HR representation in senior management.

While much depends on the quality of the HR department and spirit, the common conclusion is that a good HR department can be of considerable assistance in improving ROI.

### Unifying Force

Irrespective of what management believes to be the firm's Unique Competitive Advantage, it cannot act as a unifying force and bring about the desired results unless it permeates all levels. Key questions to ask employees are:

- •What are their perceptions of the business?
- •Where do they think it is going?
- •Do they agree with management as to the firm's Unique Competitive Advantage?

Surveys and other techniques, including off-site focus groups run by an independent organization, can give management the information necessary to explain to the staff the organization's ability to apply its Unique Competitive Advantage as well as the employees' role in doing so successfully. Communicate! Communicate! Communicate! is the essential mantra.

Part of the planning process immediately after the acquisition should be an analysis of all HR activities: hiring, retention, motivation and risk management, and identifying places that can be improved. One such area where a change in the cost/benefit ratio can give a high ROI is employment risk management. This includes everything related to legislation or government policy, such as: workplace safety, workers compensation insurance, employment standards litigation and unionization.

### Costs of Poor Safety Standards

While expenses brought on by poor safety standards vary a lot from state to state, one estimate is that while the average direct cost of a lost-time injury is around $12,000, the total cost is nearly five times higher, about $59,000. That includes all related items, such as property damage, lost production, managers' and supervisors' time, legal fees, compliance costs associated with regulatory decisions and lowered employee productivity while assigned lighter duties. Therefore a typical manufacturing business with a 10% pre-tax profit margin needs about $600,000 in additional sales just to recover from the effect of a single lost-time injury; if the pre-tax margin is only 6%, the required sales rise to $1 million.

In addition, accidents can have longer term implications. Many workers' compensation carriers use actual experience in setting rates; they add surcharges to already escalating premiums for companies with poor health and safety records. Smart, safety-tough firms can reduce such costs by maintaining and enforcing appropriate health and safety rules. Other savings can be obtained from effective management of workers' compensation claims and appeals. Manufacturing companies are often placed in specific state rate groups according to accident frequency and severity; a favourable rate group reclassification can result in considerable savings.

## Improving Efficiency

With the help of the HR department, management should know which "human capital drivers", such as reduced employee turnover or improved workplace safety, are appropriate to measure the application of the Unique Competitive Advantage. At the same time, realistic measures of success must be established for the drivers; these might be "reduce turnover from 15% to 10%", or "lower accidents from 10 per 1,000 hours worked to 4", thereby reverse the workers' compensation premium surcharge to a rebate in two years.

There are numerous other ways of improving the efficiency of a firm's human assets. One, ISO 9000, is widely employed, but many companies may find greater value by introducing processes such as "lean manufacturing", "kaizen" and "six sigma", which provide structured methodologies for achieving results.

Such techniques often seem to be nothing more than "the flavour of the month" and can be upsetting and disruptive. It is therefore often preferable to first apply them to one department or activity rather than instantly to a whole facility. In either case, it is essential to engage all concerned people from square one throughout the whole process. This takes time and effort, but the results are likely to be longer lasting than if the workforce is kept in the dark.

## Training

Training must be planned and considered an integral part of operations; if not organized correctly, it can result in minimal returns on enormous expenditures. Satisfactory approaches need skills inventories, focussed objectives and links to on-the-job activities; for management training, targeted, specific goals are required. If the organization needs to develop problem-solving skills, for example, pick ten problem situations and use the training to help develop solutions for them.

In some states, colleges are a good source of skilled workers in co-op programs; these can provide a business with enthusiastic students who are aware of the latest techniques, and for very little cost.

 

In the best of all worlds, some of this may even rub off on "the older guys". The object of training is to increase the value of a firm's human assets.

**Valuing Human Assets**

Our approach to establishing the value of human assets is to determine their Replacement Cost; this, we believe, consists of three items: hiring (head hunter) charges, salaries and wages for time spent on the learning curve, and related risk and benefit expenditures.

Senior executives, middle management, supervisors, even sometimes foremen, should be considered individually, while the remaining staff are grouped by department or functional activity, generally according to the skills and experience required. Hiring charges vary geographically; for many industries, they are between 10% and 20% of payroll, which shows the high cost of turnover; they may go as high as 25% for senior executives.

Learning curve pay depends on the time it takes an individual or a group to become both effective and efficient in their function; this will normally vary from nine months for a senior manager to as little as two weeks for an unskilled labourer. Risk and benefit expenditures depend on a firm's medical, pension and other plans, also on the nature of its activity, but are around 25% of payroll.

Once the Replacement Costs have been developed for the various human assets, such as "assembled workforce", "R&D group" and "management team", their contribution to the business can be assessed.

For this, it is helpful to determine past, present and predicted labour productivity (output per average working hour); in some industries, this may be expressed as the number of hours involved to assemble an automobile, generate a megawatt-hour of electricity or produce a ton of steel; it may become more difficult when abstract activities are to be measured. Changes over time in this factor reflect not only capital expenditures on plant and equipment, but also on staff training, better production scheduling and supply chain planning.

In any period, the revenue is equal to the output per working hour multiplied by the total hours worked. From this amount must be deducted all operating costs other than those related to staff and equipment, to give a figure for Operating Value Added. This has to be divided between the contributions from the staff and from the equipment. A simple way to do this is to use the relationship between staff costs (salaries, benefits etc. including amounts relating to retirees) and equipment costs (depreciation, repairs, maintenance not expansion capital expenditures etc.).

The portion of the Operating Value Added that relates to the staff less the total of staff costs gives the return to the business from its human assets; a similar process gives the return from the equipment.

As an example, look at Tiger Manufacturing Co., whose conventional Operating Statements for 2002 are set out below:

| | **$'000** | |
|---|---|---|
| *Revenues* | 68,200 | 100.0% |
| *Costs* | | |
| Operating | (32,095) | -47.1% |
| Staff | (25,350) | -37.2% |
| Equipment | (2,480) | -3.6% |
| Financial | (295) | -0.4% |
| Pre-Tax Profit | 7,980 | 11.7% |
| Income Tax (50%) | (4,307) | -6.3% |
| Net Income | 3,673 | 5.4% |

These amounts, when restated, give the following:

| | **$'000** | |
|---|---|---|
| *Revenues* | 68,200 | |
| *Costs* | | |
| Operating | (32,095) | |
| Financial | (295) | |
| Operating Value Added | 35,810 | |
| *Allocated to:* | | |
| Human Assets | 32,623 | 91.1% |
| Equipment | 3,187 | 8.9% |
| | 35,810 | 100.0% |

From these figures, the human assets have an ROI of 11.1%, and the equipment one of 15%, as shown below:

| | **$'000** |
|---|---|
| *Human Assets* | |
| Operating Value Added | 32,623 |
| Costs | (25,350) |
| Contribution | 7,273 |
| Replacement Costs | 65,350 |
| Return On Investment | 11.1% |
| *Equipment* | |
| Operating Value Added | 3,187 |
| Costs | (2,480) |
| Contribution | 707 |
| Replacement Costs | 4,710 |
| Return On Investment | 15.0% |