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Human Resources & Valuation of Intangible Assets

Patrick Kelsey

Nyack College, Nyack, New York

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Dr. Ralph T. Grant

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Companies consist of a variety of components such as machinery, real estate, financial resources, and other such "tangible assets." According to researchers Dave Ulrich and Norm Smallwood (2004), companies also possess other abilities, beyond the these tangible assets, to create, innovate, and persuade consumers to buy from them instead of a competitor in the same industry. These "organizational capabilities," Ulrich and Smallwood clarify, are frequently labeled as *intangible asset*. These, intangible assets are what actually contributes much of the value and wealth for the company. These intangible assets are, for example, the company's "distinctive competencies," skills, and abilities which differentiates itself from its competitors. The increase in the value of intangible assets is also the direct beneficiary of the company's investment in such functional areas as human resources, infrastructure, intellectual property, communications, etc.

According to a study published in the Harvard Business Review, companies possess eleven identifiable traits when they place high value in their intangible assets. They are:

1. Talent - Companies are good at attracting, motivating, and retaining competent and committed people.
2. Speed - Companies are good at making important changes rapidly.

3. Shared Mind-Set & Coherent Brand Identity - Companies are good at ensuring that employees and customers have positive and consistent images of and experiences with our organization.
4. Accountability - Companies are good at obtaining high performances from employees.
5. Collaboration - Companies are good at working across boundaries to ensure both efficiency and leverage.
6. Learning - Companies are good at generating and generalizing ideas with impact.
7. Leadership - Companies are good at embedding leaders throughout the organization.
8. Customer Connectivity - Companies are good at building enduring relationships of trust with targeted customers.
9. Strategic Unity - Companies are good at articulating and sharing a strategic point of view.
10. Innovation - Companies are good at doing something new in both content and process.
11. Efficiency - Companies are good at managing costs (Ulrich 2004).

Intangible assets are frequently overlooked by management and its shareholders. According to Baruch Lev (2004), author of Intangibles: Management, Measurement, and Reporting, over half

the market capitalization of public companies is attributable to these intangible assets. In his research Lev points out "investors systematically misprice the shares of intangible-intensive companies."

Besides infrastructure, communications, patents, brands, and other intellectual property, human resources, is in fact, the core component of the intangible asset equation. Human resources encompass customer relations, the working environment, turnover rates, training and development of staff, etc. In a study of over 750 publicly traded companies, Drs. Bruce Pfau and Ira Kay, were able to quantify the impact that poor human resources policies and procedures have on the intangible assets, which in turn directly affects shareholder wealth and the return on their investment (2002). Furthermore, they were able to determine a "clear relationship between the effectiveness of a company's human capital management and shareholder value creation." In companies that managed their human resources very well, there was a 64% total return to shareholders over a 5-year period. In contrast, for companies not managing their human resources well, they experienced only a 21% return during the same time frame (Pfau 2002).

Human resources factors affecting the shareholder return are numerous. A few factors affecting overall market value are having a low voluntary turnover of managers/professionals,

systematic new-hire orientation programs, a high percentage of company stock is owned by employees, the company helps poor performers improve, avoiding varying the office space based on position, and high percentage of workforce participates in opinion surveys. Drs. Pfau and Kay (2002) summarized that these and many other factors fell into the following categories shown together with their aggregate affect upon a company's market value:

Recruiting and Retention Excellence	7.9%
Rewards and Accountability	16.5%
Collegial, Flexible Workplace	9.0%
Communications Integrity	7.1%
Focused Human Resources Service Technologies	6.5%

By not managing intangible assets well, such as human resources, it has an obvious adverse affect upon the company and its overall value. In order to begin to fix the problem and to maximize overall shareholder value, management must first, "decide where to compete and to invest, how to allocate resources among many alternatives, and how to share the proceeds among the people who put up the money and do the work." Secondly, management must do a better job of leading, monitoring, and improving performance (Stewart). As these managerial tasks pertain specifically to human resources, management must:

1. Achieve recruiting and retention excellence
2. Create a total rewards and accountability orientation
3. Establish a collegial, flexible workplace
4. Open up communications between management and employees
5. Implement focused human resources technology

(Pfau 2002)

Like the challenge of motivating employees, in order to properly motivate management, "companies need to generate better information about their investments in intangibles and the benefits that flow from them" (Lev). By improving the amount of available information, managers can make better decisions and investors will have a clearer picture of the company's overall performance, all of which will lead to a more accurate valuation of the company and lower the cost of the company's cost of capital (Lev). Currently, researchers have already determined the correlation of high uncertainty discount shareholders apply to intangible asset-intensive research and development (R & D) companies because such analytical information is already required on the company's financials. However, when it comes to human resources and other intangible assets, such investment information is not widely tracked and reported, and, subsequently, unlike bona fide research and development companies, investment in human resources is frequently

undervalued because companies have not agreed on a way or means to actually track the positive or negative outcomes.

The under reporting of intangible assets, such as human resources, effectively leaves behind a significant amount of shareholder wealth and contributes to the company's higher cost of capital. Both of which, can be remedied if company's focused on their greatest assets, the intangible assets, studied them, monitored them, and invested in them for the maximum shareholder return. Furthermore, companies need to establish the way or means to actually account for the investment in their intangible assets where an industry could agree upon much like the Generally Accepted Accounting Procedures as it pertains to financial reporting.

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