



## KNOWLEDGE COMPANIES... Who are they?

### Background

MCS is set to revolutionize the world of work. People are the greatest asset for any organization. Right People with the Right Skills, Right Knowledge **upon** the Right Attitude on the Right Job is the essential ingredient for any successful organization. Show me a company who is successful and remains successful and I will show you a company that has **invested extraordinarily in his people**. (Notice the choice of word "invested" and not "expensed".) Empirical research shows that organizations that make extraordinary investment in their **people knowledge** often enjoy extraordinary performance on a variety of indicators including shareholder return.

An organization's success in today's Knowledge Economy depends on its intangible assets and its continued investment on these assets - particularly **human capital** defined as the **collective skills and knowledge of its workforce**. If this is true, is it not time for companies' investment in developing their human capital to be made public?

Despite the increasing frequency with which CEOs repeat the mantra that "people are our most important asset," the market pressures on them to maximize quarterly and annual earnings almost certainly reduce firms' incentives to invest in human capital, leading to an under-investment by most firms. It is therefore no wonder that once quarterly earnings are below analysts' predictions, the training budget is always the first to be frozen.

While this strategy may increase earnings in the short term, it is myopic, as research shows that treating employees like the assets they really are- by investing in their development - boost returns over the long term.

### Accounting Treatment of HC Investments

The current accounting treatment of firms' investment in human capital development (buried as costs in the balance sheet) is based on the premise that "**People (their knowledge and skills)**" are the only organizational asset that cannot be owned. Unlike other assets, employees can permanently walk out the door whenever they chose. Consequently, the future revenue streams attributable to investments in people are **not** guaranteed to accrue to the firm that made the investment.

A reason why most firms now decide to sparingly train their people or some don't even train at all. They frequently say to me: "**What if I train my staff, and they move on?**" A question that I answer with a better question: "**What if I don't train my staff, and they stay on?**" Selah



But if People are truly an organization's greatest assets, then the training and education of those assets has to be viewed as **investment** in human capital and **not** just as another expense. Organizations that grow are those that obtain and manage knowledge the quickest and cheapest.

### **MCS findings....**

A research carried out by our foreign affiliates in the US, suggests that firms that make **unusually** large investments in human capital development appear to subsequently enjoy **excess (supernormal)** market returns. This is consistent with the idea that training investments have future benefits to the firm which the market capitalizes even though they do not immediately appear in accounting profits. The existence of this supernormal return suggests that most firms may be under-investing in their workers' human capital development (even without considering the social benefits). It is also clear that portfolio investors guided by training expenditures (that are properly aligned to business goals) would be expected to outperform the market.

An analysis of 157 Michigan manufacturing firms that applied state subsidies to support private training (Holzer et al... 1993) shows that the receipt of these subsidies increases the firms' training hours by a factor of two to three in the short term, and reduces output "scrap rates" by around 13 percent earning them dollar savings of between \$30,000 and \$50,000 per year. Also, another research showed that footwear manufacturers were experiencing a very large boost in value-added per employee through their training activities, with returns to the firms of up to \$5,000 for every \$100 spent.

### **Findings Conclusions**

In a well-functioning economy, capital markets allocate resources to the most productive firms. The prospect of increasing shareholder value motivates firms to engage in productive activities, while the lure of above average returns leads investors to direct funds to the firms that undertake such activities.

Firms that engage in unusually high levels of training subsequently experience far higher gains in stock market valuation compared with those firms spending the least on employee training.

The findings reveal an UNEXPLOITED INVESTMENT OPPORTUNITY (*a hint for Capital Market Traders*): - the possibility of investing in those firms that engage in the highest levels of training.

This opportunity could have additional effect of motivating firms to document and publicly reveal their training investments, as well as encouraging them to undertake additional training investments. This later possibility could in turn create benefits not only for firms and their investors, but also for workers and society



The end result is that encouraging investors to begin to pay attention to how firms invest in the human capital of their employees could promote a process through which **firms begin to view their workers as assets rather than costs....**

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