The Importance of Understanding Human Capital in a Business

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Human Capital has been traditionally viewed as an operating expense (i.e., an income statement item) rather than a revenue-producing capital asset on the balance sheet. However, it is a key contributing factor to the long-term operating success of your business. This article discusses ideas, analytical views and considerations to help you better understand the importance of the Human Capital component of your business, as it relates to a "sale" or "generational transition," as well as other stages within the lifecycle of your business.

Analyze the roster

The first step in analyzing and understanding the importance of Human Capital in your business is an Employee Roster; a list of your company's current and past employees. This is often referred to as an Organizational Chart, but should also include additional details not typically found in an Organizational Chart such as: hire and termination date; role descriptions; compensation model (salaried or hourly); amount and date of prior compensation changes; commission and bonus structures; type of employment; professional designations; and related association dues.

This insight into your Employee Roster is important when transitioning or selling a business, as well as performing regular maintenance and strategic business planning, because it allows you to better understand any Human Capital gaps that should be addressed.

Compensation and other employee-related costs

In addition to maintaining a record of employee compensation, business owners should consider tracking these additional employee benefits:

- sales commissions and bonus structures;
- allowances granted (e.g., automobile, meals and entertainment, travel, sundry);
- access to business assets (e.g., company vehicles, mobile devices);
- association and professional fees paid by the company; and
- travel for conferences and any other employment perks or out of pocket costs.

These benefits may be essential for retaining employees, and you should frequently compare employee and other related costs to industry standards to foresee any changes in expectations from your labour force.

A thorough understanding of your company's compensation arrangements and other employee related costs will help in your decision making – especially in the sale of your business – and is a key consideration when budgeting or forecasting.

Analyzing employee efforts, productivity and capacity

Understanding your business' employee productivity and capacity should also be considered when budgeting and forecasting, especially when anticipating different scenarios (e.g., shortage of labour, loss of a key employee, reduced operating hours, etc.). Assessing the average dollars associated with the efforts expended by employees – i.e., billed hours, sales generated by each salesperson, hours worked versus hours billed – are just a few of the metrics that should be analyzed, as they will help you to understand potential areas for improvement.

Employee agreements and other considerations

You may consider updating employee agreements to reflect actual business arrangements, as well as alternative compensation arrangements for employees identified as key and critical to the success of your business, in order to motivate and retain them. These may include granting non-voting shares or other alternative employee share option plans.

Vesting (when the options or share ownership is eligible to be exercised) can be conditional upon the employee and business achieving specific financial metrics (for example, sales, profitability or efficiency of your business).

In circumstances where you are considering a management buyout, the aforementioned will facilitate this transition as employees begin to think and act as both owners and employees.

Seek advice

The topics discussed herein are not exhaustive and are dependent on your specific business. Speak with your BMO financial professional to connect with a local BMO Business Advisory and Transition Planning Specialist to discuss this topic further.

For more information, speak with your BMO financial professional.

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