
Human Resources Strategy and Change: Essentials of Labor Cost Reductions and Crisis Management

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Abstract

The following chapter provides some key insights and different perspectives on labor cost and how HR could proactively influence this substantial component and therewith-important factor of a company's result, and also what to do if there is no other option than reducing labor cost and at the final end causing layoffs of employees.

When many organizations are faced with the need to cut labor costs, the approaches taken are generally very reactive and not really creative or underlying with real proven figures to provide a proper business case. Based on this the decision-making process is also very driven by the one and only synonym: labor cost reduction = layoff of active staff.

Also there is no global catchall solution that can solve the issue of cost cutting, especially when it comes to labor cost but some general perspectives that could be taken into account.

Keywords

Labor cost reduction • Strategic HR business partner • Works council • Stakeholder

Overview**What Is Meant with Labor Cost Reductions?**

A set of intense and growing business forces – including globalization, digitization, and evolving customer preferences – is pressuring companies in virtually all industries of the developed markets to reduce costs. In many cases, organizations have already lowered their material and other nonpersonnel expenses and optimized prices. Yet if they are to preserve margins and remain competitive in the long term, they will also need to analyze in depth their personnel costs.

But when starting on thinking of labor cost reductions, HR, as a strategic business partner, should go a little bit more into the definitions to understand and proactively start analyzing what could influence companies' labor cost and also what is exactly meant when talking on reducing labor cost.

The Organization for Economic Co-operation and Development (OECD) is providing a large glossary of statistical terms. Also the terms are not mandatory set globally; there is a strong willingness for cooperation and understanding also with the BRIC states.

>>So **Labor cost** is defined as the total expenditure borne by employers in order to employ workers, a concept which has been adopted in the Community framework and complies broadly with the international definition of the International Conference of Labor Statisticians (Geneva, 1966). The reference period needs to be defined by the employer; usually the accounting period on daily, weekly, monthly or fiscal year basis (OECD)<<.

Labor costs include the direct costs linked to remuneration for work carried out such as direct remuneration, bonuses, and ex gratia payments not paid at each pay period, payments for days not worked, severance pay, and benefits in kind. They also include indirect costs linked to employees, independently of the remuneration paid by the employer, such as collectively agreed, contractual, and voluntary social security contributions, direct social benefits, vocational training costs, other social expenditure (cultural and medical services, transport costs, etc.), and taxes relating to employment regarded as labor costs, less any subsidies received.

Labor cost could either be fixed, because they are based on a legal or contractual agreement, or variable because of terms and conditions. Some of them can be controlled, but others cannot because of market or other circumstances. Being aware of the costs and monitoring them on a regular basis will help to increase or decrease the company's bottom line. Companies usually focus a lot on purchasing/cost of materials, but in many cases do not differentiate the labor cost or either monitor them.

The questions which always come to my mind when a company is asked to reduce labor cost are the following: How many of their annual costs are related to personnel? Do you have an idea on your company's ratio of labor cost to overall sales? Do you know the ratio of your major competitors or at least the overall figure of the industry? A lot of HR departments are actually not aware of the ratios and even benchmark whether they are good or bad compared to their competitors.

Definitions (Based on Saratoga Human Capital Effectiveness Report)

Total Labor Cost

Regular Compensation Cost: The total compensation costs incurred during the calendar year for non-contingent employees. This includes base and overtime pay, pay premiums, commissions, cash performance-related bonuses, sign-on and referral bonuses, profit sharing, payments for time not worked, and severance pay. This excludes any stock or employee stock purchase plan (ESPP) payouts and deferred compensation.

Total Benefit Costs: The total employer amount paid during the calendar year for regular employees for legally required payments, retirement and savings plan payments, life insurance and death benefit payments, healthcare benefit payments, and miscellaneous benefits.

Contingent Labor Cost: The total compensation and benefit costs for contingent employees during the calendar year. This includes base and overtime pay, pay premiums, commissions, performance-related bonuses, sign-on and referral bonuses, profit sharing, payments for time not worked (including vacation, sick, and holiday pay), severance pay, employee health and welfare, legally required payments (e.g., Social Security, FICA, FUTA, etc.), retirement and savings plan payments, and life insurance premiums.

Revenue: The total sales and service earnings (pretax) for the calendar year. This number is available on your organization's income statement.

The structure of labor cost is also very much dependent on the industry the company is in, and so there is a huge variability across industries. This will highlight the importance of benchmarking against the right peer group. Organizations should make the labor-costs-as-a-percentage-of-revenue metric part of their executive dashboard and use it to drive conversations about employee productivity.

For the US market, but also on a global base, one of the best sources for HR benchmarks is the Saratoga Institute in Santa Clara, California, founded by Jac Fitzenz and actually belonging to PWC group.

The Saratoga Institute-Workforce Diagnostic System Report Executive Summary presents financial results alongside employee productivity to reveal organization and operation trends and highlights. Between 2001 and 2003, Saratoga Institute has observed a 13 % increase in the human capital ROI calculated using its Workforce Diagnostic System. The revenue factor, income factor, and human capital ROI, along with other metrics, contribute to the diagnosis that improvements of these measures illustrate, for example, a recovery in the US economy.

If numbers are released, they usually start “walking around” and being interpreted, so please be aware that HR not only has to provide the numbers but also to explain and make recommendations on how to deal with, and if the number is good or bad related to benchmarks or individual, company internal targets.

But with all upfront controlling and monitoring under some circumstances, the need for intense labor cost reduction or at least layoff of employees in some cases could not be avoided. But doing all these in advance, it will be much easier to explain the need and therewith-storyline behind. And the major part in crisis management is communication following a “recurrent theme” to stay reliable to the impacted audience.

What Could Affect Labor Cost

Besides understanding the cost factor itself, it is worth to spend some thoughts on “what affects labor cost in a positive or negative way.”

- (A) **The level of difficulty to get the right talent.** The higher the supply and demand, also known as the “war for talent,” the more intense the company's effort in getting the right talent on board, and the higher the educational degree, usually the higher are the salary structure in that area and therewith also the labor cost.
- (B) **The location.** If the company is based in an area where the war for talents is low, you would pay less in other areas. But if there are less skilled employees in the area as needed by the companies, you would even have to pay more to get the right talent.
- (C) **The balance of employee structure.** Try to keep the age of your employees at the average between the age you usually recruit juniors/apprentices and the age

employees tend to retire. Usually wages tend to increase most in the mid-career years. So the higher the average age of your workforce, the higher your average labor cost.

- (D) **The efficiency in (production) processes.** The more efficient your processes might be, the less people you need.
- (E) **The complexity pay structure.** If the compensation components are contractually fixed, reducing wages or cost per head would either be exorbitantly expensive or take too long. This might be the result of existing compensation structures within a company, such as a high number of monthly salaries and bonuses that are regulated on an individual or collective basis.
- (F) **The overall economic situation.** If the economy of the company you're in is in a good shape, this would usually lead the unions to demand for higher wages or increase of other benefits that will drive the labor cost base as well.

The next step is to understand “where does the problem really come from.” Is there a causal relationship because of an overall economic crisis leading to a drop in orders – so solutions to reduce capacity/hours of work are the tools of choice – or are the orders and solutions still the same to reduce cost but keeping capacity at appropriate levels?

You could probably also think on discussing a range of alternative solutions before it really comes to the bitter end. The possible alternative short-/midterm approaches to think about that allow companies to keep the same number of employees but still cut cost are as follows:

- Altering work time components such as overtime, flexible scheduling, day off, and break times or even remaining holidays to reduce the accruals.
- Reducing available capacity by using flexible, temporary workers, limited contracts, hiring freeze, reducing paid working hours, or even implementing flextime wage records to store a certain amount of hours for better times.
- Working short time.
- Eliminating optional benefits or revisiting contract components based on operational agreements that may no longer be appropriate in difficult times.
- Outsourcing of cost-intensive but noncritical tasks.
- Finding and eliminating hidden costs by analyzing the different cost categories related to personnel.
- Offering sabbaticals could be a win-win solution to reduce capacity on a short term.

These measures effectively reduce costs for the company without in any case directly reducing an employee's contracted monthly salary, so it is a less irritating change for employees. But be careful to discuss these options up front if you have unions or works councils to be consulted. And it is important to note that these approaches will only succeed if the company implements them effectively. The fear of hurting the morale of the remaining employees and weakening the organization is understandable, but such concerns can be eased by

communicating in a targeted, open, and fair manner. It is equally critical that the reduction should take place quickly and professionally so that employees do not become distracted or lose motivation because of lingering uncertainty. Early in the process, business leaders and HR should approach company's top performers personally to explain the need for change and make sure not to lose their know-how.

And also if you have to reduce the number of your workforce, you could even think of early-retirement offers or specifically designed programs for voluntary leavers which could be a very effective reduction instrument, but it needs to be well designed. Otherwise you will lose your best-skilled people first as they are the ones with the best chances to find new jobs and so probably have less risk to take the money and start somewhere else and leave the company short of know-how and experience.

But even if companies are being proactive and safety conscious, it could happen that reducing workforce by closing production sites or departments might be the only way to survive. So we now take a look on the different perspectives and related core HR topics that need to be taken into account to support the layoff and crisis management in a very professional way.

Economic Perspective

The following core HR topics are essential to manage the economic perspective, considering value drivers and project cost of labor cost reduction.

Accurate HR Business-Case Calculations for the Options Identified

It seems there is a general belief in "cutting cost by cutting people," but going this way to reduce overcapacity, you have always to take the "transaction cost" into account.

On a structural level, companies can utilize more innovative solutions. Employee representatives are constantly aware of economic trends, and executives can make the company's situation more clearly by conducting a structured analysis and evaluation of possible options. So from a cost perspective, it is important not to focus purely on legal boundaries but also to do a proper calculation of the business case and, on the one hand, the impact on the tangibles like financials, and, on the other hand, also try to calculate the intangibles like decreasing employee morale, effecting customer satisfaction, etc.. Companies need a clear analysis of contracts, regulatory constraints, and other factors, but they must also identify and assess options from the employees' point of view. Creative solutions may put the company on a more secure financial footing while not threatening the livelihood of employees, leading to an agreement in which the positives outweigh the negatives for both sides.

Clearly Defined Scope and Baseline

While the definition of a reduction target is relatively easy (e.g., “all budgets have to be cut by 10 %”), the definition of the scope and the baseline can be quite difficult.

What if certain parts of the budget are fixed by law? In some countries, for example, cost for employee representation cannot be reduced. Assume that costs for employee representation are part of HR’s budget. If HR now has to reduce its overall cost by 12 % but cannot reduce cost for employee representation, the effective savings in the remaining other cost of HR have to be higher. Hence, it should be considered to take cost of employee representation out of the scope.

Any definition of a baseline has its disadvantages because if the definition is the original budget plan, which usually has been created some time ago, it can be argued that reality has changed too much to build a good basis for the reduction target. As a consequence, discussions about corrections start which are nothing more than exceptions and hence endanger the achievement of the overall reduction target.

If the definition is based on actual spending, there will also be discussions about necessary correction (e.g., due to unplanned one-time costs) and who was how cost conscious in the past (“now we get penalized for always having been cost conscious”).

Long-Term Thinking

Usually a lot of problems occurring after a drastic labor cost reduction phase are based on short-term thinking and only managing the reduction instead of having in mind that at a minimum they have to take care of proper ideas and processes on how the company could be kept even on the same productivity level with less employees and even more important how to get the same quality or even better quality for their customers than before the layoff of employees. This always needs an even stronger set of leadership competencies than during the good times where it might be simpler to ensure motivation and loyalty of the employees. Usually employees start to think resigning not as a reaction on the layoff process at all but on how the management leads through the whole process. So for HR it is important to support the leadership team of the company and equip them with the necessary skills and competencies either by trainings or coaching and to give a platform for exchange on everything that is happening during the process. For a lot of managers, it might be the first time in their lives that they have to give notice to people from their team, and this is not an easy task.

No Tactic Games

Managers usually tend to worry about decreasing productivity if employees are informed early on their reduction plans. But this is short-term thinking. It has something to do with trust and appreciation, and if employees get the feeling that

they are part of a tactical maneuver, this will even decrease productivity more than an open and clear communication based on a good story.

Risk Perspective

The following core HR topics are essential to manage the risk perspective of labor cost reduction, taking legal and compliance risks into account:

Detailed Stakeholder Analysis and Identification of Measures That Benefit All Impacted Groups

Conduct a clear stakeholder analysis on whoever is deeply impacted by the labor cost reduction and derive individual communication packages to the different groups. This would mean the employees themselves, as well as works councils or unions, are either directly affected or not affected but remaining in the organization. Identification of and communication with all key employees and top performers might be one of the major success criteria or even possibilities for failure.

Stakeholder management, as well as the management of resistance, is a natural response of personal disruption. So it is important to know who is affected by the process and to what extent. Also there are several pitfalls in managing resistance; it will be important not to attempt to overuse “logical” arguments about why they should change. Because assuming what is “logical” to you is “logical” to them shouldn’t be the truth in any case. So take the time to talk to people, ask open questions, and try to understand the reasons for their resistance.

Usual Groups of Stakeholders

The definition of stakeholders (either internal or external) in the process is seen as a wider definition of any group of individual who can affect or are affected by the achievement of the company’s objectives. Identifying all stakeholders is crucial and could either be done by brainstorming, mind mapping, etc., and there are various tools in the market to identify the stakeholders and set up a proper stakeholder map including stakeholder management. Possible stakeholders in the process could be the following: employee; shareholders; executive management; managers; human resources; legal department/external lawyer; unions; works council; colleagues; family, spouse, and friends; customers; suppliers; public; and politicians.

Having a strong works council and an active trade union makes it even more necessary to do so we do not have any leeway for negotiation. Strong organized-labor participation within a company is not necessarily a drawback; in fact, it can be quite the opposite. It provides a solid foundation for dialogue between management and employee representatives. Strained relationships and misunderstandings between both parties are frequently responsible for the failure of such processes.

An atmosphere of mistrust can prevent some issues – such as employee reduction and outsourcing – from being openly discussed and addressed.

Strategic and Legal Assessment of the Feasibility of Contract Adjustment Options

Depending on the business the company is in, labor cost could be one of the important factors in a company's result. Especially people-driven industries (offering all parts of services) will face significant effects by clearly monitoring their labor costs and deducting the relevant actions as soon as ever possible.

So if you plan to reduce labor cost, it will be important to do a proper legal assessment of feasibility upfront. To local law or collective agreement, some employees could not be subject to notice because they have reached a certain age or have a clause in their contracts or even belonged to state-owned companies (civil servants) which makes it even difficult to reduce this kind of staff. Some organizations may have so-called permanent employees and contract workers, as well as special employment contracts from the public or semipublic sectors, which contain comprehensive protective mechanisms. This would lead to attempted soft measures first, such as reducing external employees and setting up a voluntary leavers program and should be considered in the strategy.

During the last economic crisis, for example, many companies implemented comprehensive reduction programs that focused on speed and not thoroughness. Executives did not often consider other solutions that may have been more effective – such as adapting collective-bargaining agreements that would match required skill sets with compensation levels – because collective protective rights made such ideas seem unfeasible. But at the final end, a lot of the programs failed or even was not very effective.

Redundancies can be challenging, particularly in more-regulated labor markets such as Europe, where social-criteria rules stipulate the order in which employees should be let go. These criteria put a heavy emphasis on employee tenure, along with issues such as age, marital status, and whether employees have children. Many employees and also manager might think that the criteria lead to layoffs of the “wrong” – that is, younger – employees, resulting in structural issues such as an unbalanced workforce not retaining the right profile of skills and qualifications.

Operational Perspective

The following core HR topics are essential to manage the operational perspective, considering administrative consequences of labor cost reduction:

Make Sure That an Appropriate Amount of People Is Dedicated to the Project

Very often the HR departments suffer from a lack of resources, and if the economic situation of a company is becoming worse, management usually starts with a reduction of positions in the so-called administrative or cross-divisional functions. So it might happen that the HR department has to manage the labor cost reduction with insufficient staff available to deal with all the add-on workload that will happen during such a process. But it is extremely important to manage such a process by reacting on any upcoming questions as soon as ever possible to keep rumors to a minimum.

So it is highly recommended to equip the team as best as possible to ensure precise coordination of reduction planning, data availability and accurateness, negotiations, and transformation within one central team. If HR is not fully equipped to support, it might be worth to invest in external support, either by experienced lawyers or interim managers, to manage this process in a professional manner and adequately enabling a coaching HR business partners in the implementation and change process. It is even more recommended to do so if it is not a complete closing of business.

Make Sure That All Personnel Files Are Properly Kept Up-to-Date So That Needed Information Is Available Shortly

Do not underestimate the workload coming up with such a process. To follow legal requirements, usually a lot of detailed information needs to be provided on a daily basis, even to fulfill the determined social criteria for redundancy. A lot of information might be available if your company has a solid HR IT solution in place, but usually this needs to be verified by having a look and review in each personnel file. So make sure that the filing is always up to date.

People Perspective

Finally do not forget the most important perspective in such a process which would mean to manage the change and cultural environment as important prerequisite for a good-managed process or even a new start, also considering effects on motivation, emotion, and culture.

“What you cannot measure, you cannot manage” is often used by managers even from a pure controlling perspective – but this is not the real truth. Very often the soft factors will make the important difference between the company’s choice as a great place to work, and even if you have to lay off people, make sure that you treat them with respect, taking their individual circumstances into account.

The following core HR topics are essential to manage the cultural and emotional perspective of labor cost reduction:

Communication Is Key

The top management is in key position when it comes to communication of reduction plans. So it is important to prepare a communications plan for the overall project. Open and honest communication is one key success criteria to keep respect and credibility of the management. The upfront development of a clear course and communication plan for employees and employee representatives is therewith highly recommended.

Also a bad news continues to be a bad news; it might be important to start the communication at an early stage. You cannot change the bad news but no communication is not tending to have a better situation at the final end of the process. How such a crisis is managed is even the most important criteria if the company is planning a comeback. Usually at some point of time, there will be a leakage and the bad news starts wafting and even tends to rumors and mistrust.

Consider the Impact on the Individual

Considering the effects on motivation, emotion, and culture is an important success factor if companies have to start programs affecting their workforce. And the most affecting one is a program which brings the environment of an individual into imbalance. This would mean that if there is a fear of losing or even failure, this would affect even more the balance of feelings of an individual as if there are positive messages like new tasks and responsibilities (Fig. 1).

Feelings in Balance

Negative mood in the workforce is usually affecting customer satisfaction as well. This could lead to a downward spiral. As part of a change management process, it is therewith important to actively monitor the employee morale and react short term on the results. For such surveys, new tools, like SurveyMonkey, would allow quick, easy, and confidential online feedback.

Do Not Forget About the Remaining Employees

Survivor sickness is a situation which typically appears with employees remaining when reductions affect the wrong employees by discouraging those who remain. This comes along with feelings of uncertainty, anger, guilt, and distrust. They are simultaneously glad to have a job and guilty that their workmates were displaced. In the meantime, the job pressures on them often increase dramatically as they try to

feelings in balance

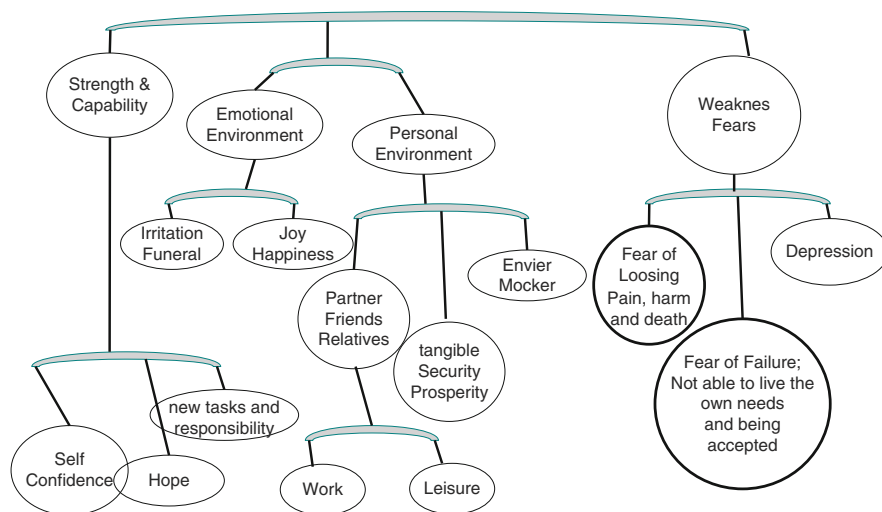


Fig. 1 Feelings in balance

shoulder the tasks of former colleagues. They also wonder, “will I be the next to be cut”? This negative effect could hurt companies in the long run.

Dos and Don'ts

In some countries/companies, the involvement of labor representation (unions, internal employee council) is demanded by law or union agreements. If this is the case, **do** consider involving labor representation as early as possible and negotiate a redundancy program in a professional and transparent manner.

If there is no legal need to **do** so, it should be discussed whether labor representatives should be involved in the discussion. The answer to this question depends on the level of trust between company leadership and labor representation and the acceptance of labor representatives as opinion leaders within the company. By involving labor representatives, the risk of strikes or forms of passive resistance of the workforce against the to-be-decided measures can be reduced.

Do always keeping an eye on your labor cost also in good times.

Do develop HR into a true business partner model that is closely involved in management discussions and strategic planning.

Do not underestimate the influence of labor representatives, works councils, or unions in either supporting or hindering the process.

Do not forget carefully balancing the burden between management and staff. In situations of drastic cost-saving measures, people look at fairness of the burden's

distribution. If, in addition to significant reductions of their income or benefits, staff feels that those above do not really join in with cuts in their income, resistance against the measures will increase, and long-term credibility of the company's management will be at risk.

Do not be liberal with exceptions. Exceptions to rules always bear the risk that they erode the rule itself. If you have a general labor cost reduction policy and you make one exception, it is a sure bet that this will stimulate others to also ask for exceptions. In the end, the company runs the risk of not achieving their saving target because many people are busy creating cases for exceptions instead of thinking about ways to save money.

Final Comments and Outlook

Initial pessimism is understandable, but companies can make improvements in their workforce in even the most complex situations. That is why open and honest communication is absolutely essential from the earliest phases of the effort. The management must sit down with employee representatives and chart a clear course. Success demands on an objective assessment of the situation in coordination with relevant committees in both the negotiation and implementation phases. Precise and reasonable simulations of specific cases can ensure that the discussion takes place on an equal footing.

A codetermination process when representatives from the management and the unions agree upon necessary actions together helps to clarify how planned changes will be received by employees and may identify less invasive cost reduction measures as well. With sufficient transparency and clarity, even "sacred cows" may become legitimate options in workforce improvements. Worth noting is that this process can have a positive secondary effect by creating a more pragmatic and trusting relationship among the participating committees and by giving the company a stronger foundation for the future but could even become a negative effect if it is not possible to come to a common solution. It may be also depending on a negative relationship from the past. So trustworthy behaviors and walk-the-talk principle from management and HR are required during the whole process.

This dynamic change in the enterprise environment means that HR departments also face completely new tasks. For example, it is no longer sufficient to support the enterprise strategy with cost-optimized personnel management and to provide qualified employees. The future of personnel management lies in a consistent strategic orientation. In particular, HR departments must analyze and consider what part they can play in reaching enterprise goals and how they can increase the value of the enterprise. By proactively participating in the implementation of the enterprise strategy, an HR department can develop into an important link in the value chain and position itself as a consultant and partner for management and employees.

Personnel cost reduction initiatives are difficult, so it is essential for management and HR to clearly identify and prioritize the challenges and to tailor a structured process that focuses on root causes. The result will be a company that is not only

more financially fit but one that more effectively communicates and collaborates, leaving it better equipped to meet the challenges of the future.

Business units and HR typically have different priorities, and it can feel as if representatives from each are speaking different languages. The focus of business leaders is to get the job done. They describe their needs in terms that only vaguely translate into specific personnel requests, and they believe that many HR processes are too complicated and that HR employees are too problem oriented. Conversely, the HR department believes that management will not simply accept an answer of “no” – rather, it wants to live in a world of exceptions. The result is a persistent misunderstanding, which gets exacerbated during complex projects such as a reduction program. However, these perceptions are simplistic, and companies can overcome them.

Many HR departments have already taken on new tasks and greater responsibilities, becoming a true partner to the business by maintaining an approach which HR assumes more of a strategic and management function in the company and expands its knowledge in the areas of realignment, codetermination, and collective labor law while maintaining expertise in the baseline HR functions.

But when leaders together with HR implement a reduction measure correctly, the company should emerge stronger and with a more aligned workforce one that understands the company’s situation and objectives and believes management is taking the right steps to reach those objectives. Structure and processes can be more efficient and professional, creating an improved work environment.

Humanity within the transformation, traceability of the reason for layoff or adjustment, and a clear vision of the future is the painful prerequisite for a new start in a more prosperous future.

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