Establishing Financial Rationale of HR Decisions

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M/S Novel Kitchen Utensils Private Limited manufactures a variety of kitchen equipment and accessories for household use and their product portfolio is reasonably well reputed enjoying widespread use in the Indian domestic circuit. During the financial year 2012–13, the said company started manufacturing a new product, namely, a novel variety of storage utensil meant for bulk kitchen storage facility and the said product was officially launched by the company during the month of April 2012. The actual launching of this product in the market was preceded by a chain of events as explained hereunder.

Before the said product was officially launched in the market, the company management had undertaken a detail planning and budgeting exercise which encompassed activities like market survey (for assessing the potential market demand and evaluating various pricing options in view of ruling prices of similar products manufactured by various competitors), detail cost estimation, assessing incremental working capital needs (if any), assessing the capital expenditure required for augmenting plant facilities (if any), evaluating cheap sources of finance to meet the estimated fund requirement etc. The planning and budgeting exercise undertaken (and executed) revealed that launching this new product would definitely prove to be a very high positive NPV investment option and would promise very attractive return on investment on a yearly basis as well. In view of the same, (naturally) it made excellent business sense to launch this product in the market at the first available opportunity especially because the concerned company had every intention to leverage on the "first mover advantage" which was actually viewed as one of the key considerations so far the anticipated success of this product launch was concerned.

However, this particular product belonged to that category of kitchen utensils which calls for a somewhat labour intensive production process. Thus, while undergoing the cost estimation exercise of the said product, due care was adopted in estimating the direct labour cost attributable to the manufacture of this particular product. Therefore, the HR Department of the company was involved at the very inception stage (of the planning exercise) and they were requested to develop a detail estimate of direct labour cost that would be attracted in case the company manufactures this particular product. While developing the said budget, the HR Department of the company had actually planned to meet their direct labour requirement (for manufacture of this product) by employing a number of contract labourers (only) who may strictly be paid on an hourly basis. This decision was actually taken by the HR Department in order to optimize (rather minimize) the direct labour cost by avoiding all (direct labour related) fixed cost exposure and any possible long term contractual obligations which might had arisen had the company recruited workers on a permanent basis. The HR Department of the company was of the opinion that as their company is reasonably well reputed in the market and since their plant is strategically well located, such contract labourers would always be available in abundance to cater to the specific needs i.e. the anticipated labour intensive production process.

The HR Department of the company estimated that the manufacturing process would call for involvement of essentially two categories of contract labourers, namely, a group of semi-skilled workforce who may be compensated by paying relatively low hourly remuneration and another group of reasonably skilled workforce who would invariably demand a much higher hourly compensation. Now, the applicable law of the land had actually prescribed the minimum hourly remuneration for these two categories of the workforce. As the supply of such workforce far outstrips the demand in the market, the HR Department was pretty confident that they would be in a position to source contract labourers belonging to the above two categories by paying the minimum hourly remuneration as the law of the land actually prescribes. The HR Department had estimated (in consultation with the Production Department) that manufacture of one unit of this new product would actually consume 30 hours time of the semi-skilled labourers and 20 hours time of the skilled labourers. It may also be noted that the minimum prescribed hourly remuneration happens to be Rs 20 per hour and Rs 30 per hour for the semi-skilled worker and the skilled worker respectively. In view of the same the total direct labour cost for manufacture of one unit of the new product was estimated at Rs 1,200 (i.e. 30 * 20 + 20 * 30 = 600 + 600 = 1200).

The company completed the entire exercise of planning and budgeting by the end of the first week of March 2012 and they were all set to start the manufacture of the product and launch the same during April 2012. However, the regulatory authorities issued a notification by the end of second week of March 2012 wherein it was clarified that the minimum hourly remuneration payable to skilled labourers (grouped under the above noted category) would have to be raised from Rs 30 per hour to Rs 40 per hour. The concerned regulatory authority made this particular notification effective from the 1st of April 2012. Naturally, the HR Department of the company immediately realized that such a notification would have material (rather significant) adverse impact on the product launch as it would result into a substantial increase in direct labour cost, which in turn would erode the profits and cash flows of the company. In view of the same the HR Department of the company was compelled to work out an alternative plan of action which may counter the adverse impact of the notification in terms of protecting the profits and cash flows of the company that was being expected to be generated through the new product. Early third week of March 2012 a meeting was convened wherein the HR Department had initiated/proposed the following actions (refer point nos. A & B given below). These proposals were discussed in detail in a Board meeting conducted by the end of third week of March 2012 and were cleared for immediate implementation. Pursuant to the final decision taken by the Board, the HR Department implemented the same effective - first week of April 2012.

A) The contractual employment was to be provided to a group of un-skilled labourers instead of semi-skilled workforce proposed earlier. The minimum hourly remuneration for such un-skilled labourers as prescribed by the law of the land is Rs 15 per hour (only) as compared to Rs 20 per hour payable in case of semi-skilled labourers.

B) It was proposed that a high quality (but, expensive) training programme may be organized for the skilled workforce. Such a training programme (although very costly) was expected to substantially increase the overall efficiency of the skilled labourers. The anticipated total cost of such a training programme was estimated in the region of Rs 75 to 85 Lakhs approximately (during the financial year 2012–13). Although the HR Department was not in a position to exactly quantify (in monetary terms) the increase in efficiency factor pursuant to such a training programme so far the skilled workforce is concerned, they were of the opinion that the benefits would actually outweigh the costs.

Finally, the company actually started manufacturing the new product from the very first week of April 2012.

The overall market response to the new product launch was highly encouraging and the concerned company managed to actually manufacture and sell one million units of the new product during the financial year 2012–13.

Sometime during the first week of April 2013, the Head of the HR Department of the company received a letter issued by the CEO of the company wherein he was requested to create and submit a report (addressed to the senior management) which would clarify the final outcome of the two crucial decisions implemented by the HR Department as a response to counter the impact of the notification issued by the regulatory authority. The CEO was specifically interested to know as to how these two decisions had actually impacted the bottom line of the company and as to whether such decisions had made good business sense.

On receipt of the above letter from the CEO of the company, the Head (HR Department) tried his level best to obtain and collate certain information that relates to the direct labour costs pertaining to the manufacture of the new product. The information collected by him (given below) pertained to the manufacture of the new product only and revealed that during the financial year ended 31st March 2013, the company had actually paid Rs 48 Crores to the un-skilled contract labourers at the rate of Rs 15 per hour and paid another Rs 76 Crores to the skilled contract labourers at the rate of Rs 40 per hour. He also came to know that the high quality training programme that was organized for the skilled workforce (as planned) had proved to be a costly affair for the company and it involved a total cash outlay of Rs 80 Lakhs during the financial year 2012–13.

The Head (HR Department) was sitting in his chamber sipping a cup of coffee having the financial information obtained and collated by him jotted down in a piece of paper lying in front of him. He was wondering how such information would aid in answering the specific queries raised by the CEO and how he may actually proceed to justify the "financial correctness" of the two crucial decisions his department had actually implemented at the commencement of the financial year 2012–13. At a personal level he was pretty sure that those decisions actually made good business sense and hence, it must have boosted the bottom line of the company in more ways than one. In other words, he was quite certain that had his company stuck to the original plan of employing semi-skilled contract labourers instead of un-skilled workforce and avoided investing in the high quality training programme it would have affected the bottom line of the company adversely. But, how would he actually quantify the impact in monetary terms that may establish the financial rationale of the decisions?

List of Review Questions

a) Can you suggest a common "cost based reporting model" which may be effectively applied by the Head (HR Department) for establishing the "financial correctness" of the decisions implemented?

b) Conduct a comparative study, namely, the original plan vis-à-vis the final outcome pursuant to the decisions taken and make an attempt to justify the "financial correctness" of such decisions by capturing the overall bottom line impact.

c) Create a meaningful management report (as specifically requested by the CEO) analyzing the overall impact in terms of their various contributors so far the direct labour cost pertaining to the manufacture of the new product was concerned.