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## Flexibility in human resources management: a real options analysis

*Flexibilidade na gestão de recursos humanos: uma análise por opções reais*

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### Abstract

A private company has several options in the job market, such as hiring, outsourcing, or dismissing employees. The management flexibility of dismissing employees, even without just cause, provides an economic benefit for companies. By addressing real options, this study aims to measure the effects of this flexibility on the employer's decision to hire more employees as well as to invest in the more productive employees through graduate incentives. This article evaluates the adverse impacts of labor laws that restrict this flexibility, such as the Severance Indemnity Fund (FGTS) fine and the prior notice of termination of employment, in order to find out how much the employee adds value to the company and, consequently, to its salary. Using this methodology, this study also evaluates, from the employer's perspective, the relevance and value maximization of the company's financial support programs for employees taking graduate courses. Results show that severance costs reduce the net value of the employee to the employer. Should these costs be disregarded and the benefit in value transferred to the employee this could be equivalent in a 4.5% increase in salary. Likewise the possibility of investing in graduate course at the correct moment but only for the more productive employees can increase their net value significantly, doubling the net value of the employee to the employer.

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*Keywords:* Employee dismissal; Employee value; Real options; Flexibility in human resources

### Resumo

As empresas privadas têm diversas opções no mercado de trabalho tais como contratar, terceirizar ou dispensar empregados. A flexibilidade gerencial de poder demitir empregados, mesmo sem justa causa, gera um benefício econômico para as empresas. Usando a abordagem de Opções Reais, neste trabalho procurou-se mensurar os efeitos desta flexibilidade na decisão do empregador em contratar mais empregados, assim como, investir nos empregados mais produtivos por meio de programas de pós-graduação. Nesta pesquisa avaliou-se os efeitos adversos das leis trabalhistas que restringem essa flexibilidade, tais como a multa do FGTS e do aviso prévio, de forma a determinar o quanto o empregado adiciona de valor para a empresa e, conseqüentemente, ao seu salário. Utilizando essa abordagem procurou-se avaliar pela ótica do empregado, a relevância e maximização de valor criada pelos programas de incentivo a cursos de pós-graduação. Os resultados mostraram que os custos de demissão reduzem o valor

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do empregado para o empregador. Ao desconsiderar estes e transferindo os benefícios diretamente ao empregado, resultaria em incremento de 4,5% no salário deste. Outrossim, a possibilidade de investir numa pós-graduação no momento oportuno, mas somente para os empregados mais produtivos, pode aumentar valor do empregado de forma significativa, duplicando este para o empregador.

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*Palavras-chave:* Demissão; Flexibilidade em recursos humanos; Opções reais; Valor do empregado

## Introduction

Company decisions to hire, train, or dismiss employees are influenced by the employer's expectations about how much the employee will contribute in generating cash flow for the company, similar to the decision to invest in an asset. Hiring an employee may generate revenue for the company; however, it also comes with a cost. Similar to other investment decisions, the decision to hire an employee comes with some uncertainty related to the employee's performance (his labor supply) as well as the amount that his services are used (demand for labor). It is valid to investigate whether the decisions to hire or dismiss employees, in light of the volatility of the company's demand, are made considering the value of management flexibility of hiring or dismissing employees.

During an economic crisis, it is very common for mass layoffs to occur because the labor cost is higher than the value of its economic production. Since the social cost of unemployment is very high, especially the cost of maintaining the living conditions of unemployed people and their families, the labor laws of several countries impose costs when the work contract is terminated without just cause in order to discourage this action.

In Brazil, the main obligations are the prior notice of termination of employment and the Severance Indemnity Fund (FGTS) fine. The latter, paid by the company that decides to fire employees without just cause, is equivalent to about 4% of the sum of the salaries received by the employee (40% fine to the dismissed employee, plus 10% fine to the government, both on 8% of all salaries reviewed to date – FGTS accumulated value, amounting to around 4% of all salaries received). The former, when paid to the employee, has a value equal to the sum of the salaries and other labor rights proportional to the period of 30 days plus three days for each year of service to the company.

However, even if these costs are effective in reducing the number of dismissals, they also tend to negatively affect the decision to hire, as will be investigated in this study. Thus, in normal economic situations, both the level of employment as well as the salaries are smaller when there is not total flexibility to lay off employees. Furthermore, the costs for terminating the employment relationship increases the incentive for labor outsourcing.

The employers must understand the effects of management inflexibility when dismissing employees in order to make the correct decision when hiring. Furthermore, it is essential to analyze the cost–benefit of public policies that affect the flexibility to lay off employees without just cause. The costs imposed by

labor laws on companies when the work contract is terminated without just cause serve to protect workers against a dismissal not initiated by the employee. The receipt of 40% of the total deposits made to the employee's FGTS account during the work contract is a boost to the newly-unemployed person and his family. However, companies may lose interest in hiring employees due to these costs, and this is not as easy to observe or measure.

In order to investigate the adverse impacts of labor laws that restrict flexibility of dismissing employees, this article adopts the real options analysis methodology for two purposes, one main and a secondary objective. These are modeled as synthesized in [Table 1](#) and further explained in Chapter 4. As a main purpose, the dismissal option is analyzed in four different scenarios. Two of them, real cases in Brazil: dismissal with FGTS fine and indemnified proportional prior notice (in force since October 13, 2011) and dismissal with FGTS fine and indemnified 30-day prior notice (in force before October 13, 2011). The other two are theoretical scenarios: dismissal with FGTS fine only and unrestricted dismissal. This paper seeks to compare the results in order to measure the undesired effects of reduced employee value for the company, which may cause an adverse effect on hiring new employees or on the salary amount of each of these components.

Secondly, as a secondary purpose, this article also uses real options theory to analyzing the business option of funding graduate courses for their best-performing employees in order to encourage them to increase their performance. This option will be investigated under the assumption that it is an expensive investment and that it will raise the salary of the employee selected for the course. This study shows the difference between a program that offers financial support for graduate studies to all employees when they enter the company and a program that views the incentive as an option to be given only when the company expects that the chosen employee will bring a financial return on that investment and at a time that maximizes his net present value.

All major characteristics and approaches used in the article are listed in [Table 1](#).

This article is divided into six sections. The theoretical framework is presented after the introduction, giving a review of the existing literature on the real options theory and the labor laws related to dismissal without just cause. The third section analyzes hiring, training, and dismissal without just cause generically as well as with a focus on Brazil. The fourth section describes the methodology used to estimate the value of the dismissal options and the support for graduate studies as well as to calculate the

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