OMS
Organizational Maturity Services LLP

'The Materiality of Human Capital to Corporate Financial Performance'

By Aaron Bernstein and Larry Beeferman, Harvard Law School, Labor and Worklife Program

A Maturity Institute (MI) and OMR perspective

Dear Aaron and Larry

Thank you again for your paper. Having now had a chance to read through it completely I can say that it is exactly what MI has been seeking from the academic community. You contacted me as a partner of OMS LLP because you can see that we are dealing directly with these issues of human capital materiality as a live, strategic, investment issue. You should also know that OMS was born out of MI and is the first embodiment of the application of its principles - the 'Ten Pillars'.

We think your paper can draw a line under the many 'false trails' and 'dead ends' that purport to show a material value in HR practice and, instead, build a seminal platform from which we can all start to move forward more decisively. I hope the comments below will enable us to commence our debate on 20th January from a higher base than that to be found in the majority of the research papers you surveyed.

A. Some general observations.

1. There are two sides to the coin of human capital materiality but the evidence is plain for those who can see it. When it is explicitly and consciously integrated into the boardroom/C-suite's thinking it makes a very significant, material difference to financial performance. MI's exemplar, Toyota, has a market cap of $171bn, which is nearly four times the market cap of GM/$45bn and 3 times that of Ford/$51bn - two very well established, but highly immature, corporations with respect to human capital utilisation. However, such exemplars are extremely rare; our research suggests possibly less than 3% of the corporate world. Therefore, the other side of the coin is negative materiality; both in terms of financial opportunities missed and increased risk, as with VW's emissions scandal, where the nature of human capital is not explicitly factored into strategic thinking.

2. If you stand back from your own systematic review you might conclude that conventional academic scholarship and research, thus far, has yet to provide unequivocal answers that have convinced the investment community. We believe the reason for this is very simple; human capital materiality is of such complexity that conventional thinking cannot deal with it satisfactorily. For example, as you recognise, conventional regression analysis (especially of highly questionable data - such as engagement and satisfaction surveys) fails to resolve the crucial issue of

causality. The solution has to be a fresh perspective and methodology. MI/OMS's intention is to resolve this, and the other issues, that have not been adequately addressed by HR practitioners and previous academic research.

3. There are many bodies and initiatives attempting to shine a light on the intersection of corporate performance, sustainability and societal impact. (GRI, ESG, SASB, Shared Value, <IR> etc.). Our view is that this conventional, 'deconstructive', approach suffers from two fatal flaws. First, vested interests, who hold on to their orthodoxies (IIRC's attempts at <IR> is a good case in point with accountants not willing to admit the limitations of their conventional reporting) prevent open and impartial enquiry. Second, they all seem to miss (or wilfully ignore?) the very obvious point that the problems we face are whole system problems and can only be addressed as such. This is MI/OMS's conceptual foundation and the basis for OMRs (organizational maturity ratings). We see the extent to which corporations openly acknowledge the whole system nature of the issues they face as a significant indicator of maturity (or lack of it) and thereby predict the likelihood of a higher probability of human capital materiality and company value.

4. The traditional, academic focus on HR (and training) practice is too narrow. Boards/Excos get the HR functions they deserve; they do not currently possess human governance or effective human capital management capabilities and their professional bodies (CIPD, SHRM, ASTD et al) are not developing such capabilities for the senior level posts required. MI was set up to do precisely this but it recognizes that such capability has to be a multi-disciplined, integrated and composite collection of insights and skills. This is the new management order we are aiming to build.

5. Management practice and business school education have failed to produce whole system management; partly because of a failure to articulate intangibles in terms of tangible value. For example we had already highlighted the relatively low operating margins at VW that stem directly from immature management attitudes. MI's definition of value is very clear, very simple and unequivocal - producing the best quality product/service at the best possible cost, without undue impact on the environment. ESG and 'triple bottom line' thinking has confused an already complicated field of study. Value has to be unambiguous if everyone in the organization, and working with it, is to be clear about their common purpose.

6. This simple formula is designed to produce the best financial returns by serving society in the best way possible. It is also, simultaneously, intended to produce the best long term returns for investors/shareholders; but individual shareholders do not hold primacy over society's needs. This definition makes corporate value and societal value one and the same; working as a whole system. This is our over-arching criterion for assessing the worth of corporations. It follows, that organizations cannot maximise their societal and corporate value unless and until they maximise the returns from their human capital. This places a responsibility on corporations to report that they are doing so; but they can only report if they know how to measure. Conventional HR/training measures have not been developed for this purpose. Stuart

sent you our Human Capital Reporting Template and hopefully this explains where it comes from and how it follows from this line of thinking.

B. Some specific points relating to your paper.

1. The systematic review up to page 38 is the best I have seen. It neatly sums up the 'state of the art' in conventional HR practice in the last line - "In sum the debate over causality remains a contested one". Our view is that this will always be the case when the research methodology is not up to the job. The reality of organizational complexity is such that any demonstrable proof of causality is impossible and proxies (and regression analyses that produce them) do not offer a satisfactory solution. At MI we accept this as a fact of life and it enables us to move forward.

2. The nature of any business is about managing risk and probabilities, experimenting with hypotheses and learning in the process; not seeking incontrovertible proof. This is not a weak stance but one of maturity. We use it to assess organizations and analyse how they manage themselves. For example, whenever an immature company spends money on training (mature organizations spend it on learning) the most valid question to the CEO (never mind the head of HR) is 'what is your hypothesis?' 'Are you expecting a financial return and, if so, what evidence will you use to demonstrate it?' CEOs currently struggle to provide a clear answer and their CFOs have no idea how to account for the impact of the training (and <IR> has not helped) whilst continuing to set arbitrary training budgets that have no connection with the business's value.

3. The first 38 pages of your paper bring all previous, pointless and interminable debates to a close, once and for all. We want to use your paper to draw a line under conventional thinking and make a decisive step to move on into whole system management; both conceptually and practically.

4. Page 39 onwards moves the debate onto the right level by focusing on human capital metrics in investment decisions. This is where we are today with MI/OMS; yet we are prepared to admit that we are only at the dawn of this brave new world. You hit the nail on the head with - *"One of the largest (challenges) is obtaining sufficient data on relevant corporate policies, which for the most part is not required by regulators or the listing standards of stock exchanges. That the data is unreported does not mean it does not exist."* Your diagnosis is right but the prescription is not for HR and training to produce the data; rather it is for corporate vision, strategic planning, business forecasting, budgeting and reporting to be constructed around a much fuller understanding of the potential materiality of human capital. Currently, as we have suggested above, such a role and the concomitant capability do not exist. This needs to be forged anew.

5. On page 40 you say - "*Clearly, even if the answers were forthcoming, comparability across companies would be difficult. Other HR policies present other challenges, including complexity, non-comparability, definitional fuzziness, etc.*" We disagree. We are very confident that once a whole system perspective is adopted (albeit following

a conventional construct such as vision, mission strategy, structure etc.) all organizations are the ‘same’ and benchmark comparisons can be made across sectors; whilst at the same time producing prescriptions for each individual company relevant to their own unique context. This is why we decided to work with an S&P agency to adapt their 22-point benchmarking scale to pick up all the complexity and variation along a single continuum with universal applicability.

6. In your conclusion on page 44 you state - “*It also may be the case that companies have not heard consistent requests from investors for such information. This may be somewhat circular: if investors do not see how the effects of human capital policies are reflected in stock prices, they have little reason to ask for data about such policies.*” We address this particular issue in an MI post “Overcoming the “impasse” in human capital reporting”. Again, in the light of the reaction we are receiving from the investment community, we are confident that we have started to overcome this apparent impasse and believe our joint efforts could drive this point home.

We would echo your final thoughts - “*Our analysis of the literature offers strong support for this call to action.”* We have already answered that call and have plans to produce an OMR index for the entire S&P 500. Maybe we can add this to our agenda on the 20th?

Stuart and I are very much looking forward to the debate.

best regards

Paul.

Paul

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