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Human Capital Reporting – seizing the opportunity

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From "Where is the workforce in corporate reporting?" (NAPF, 2015)

"Now companies will commonly retort that they would provide more information if their investors were asking for it. ... On the other hand, investors suggest that they would take these matters into account were there useful information to digest and comparisons to make. This chicken and egg situation has resulted in an unsatisfactory impasse."

Joanne Segars, Chief Executive, National Association of Pension Funds (NAPF)

"'People are our greatest assets' is rhetoric .... with little evidence supporting this claim in business performance indicators and reporting. .... the arrival of stewardship and corporate governance codes has signalled a new era for business, investor and stakeholder interaction. Much more than just understanding the finances of a business, it is now about understanding their strategy and business model. A reassessment of our understanding of value – its parameters and its effects - is taking place.... a value creation model fit for the 21st century."

Paul Druckman, Chief Executive Officer, International Integrated Reporting Council

Executive overview

The recently published NAPF report - "Where is the workforce in corporate reporting?" (NAPF, June 2015) - has successfully summarised and crystallised the current debate on human capital management (HCM) reporting. It acknowledges a present impasse (see side bar) but has re-ignited the debate around how best to report on human capital and its link to sustained value creation.

This now presents all interested parties with a fresh opportunity to make significant progress in this area. However, we must move beyond the current, conceptual framing of the dialogue, which is founded on the notion that rudimentary people metrics will offer a way forward. We argue here that human capital measurement is particularly problematic and requires skilful use of insightful indicators if HCM reporting is to become established as an integral part of mainstream company reporting.

Beyond basic metrics

Joanne Segars acknowledges that the whole topic has reached an impasse. It is clear that companies do not know how to report on human capital; researchers and analysts do not know the questions they need to ask; and investors are not convinced existing metrics (e.g. employee engagement scores) are telling them anything valuable. Against this backdrop is a hope that the market can, and will, naturally lead us forward. In our view, this approach poses a significant risk as most companies are either ill-equipped or lack any appetite to produce meaningful insights. Those that have both expertise and appetite see that effective HCM offers a significant competitive advantage and tend to guard their information and insights for internal use only.

The approach to HCM reporting that appears to be emerging as documented in the NAPF report is one based on conventional HR metrics. Its roots can be found in previous, abortive, attempts to develop HCM reports (e.g. the Accounting for People Report 2003), which shed little insight for stakeholders and ultimately failed to capture interest in the markets. This is best exemplified by metrics such as measuring investment in training and development, average hours spent on training per employee, and the number of courses taken. These are statements of activity that offer no insight or indications of actual, financial value for calculating returns. This is equivalent to viewing the amount spent in pharma R&D as an accurate indicator of future drug success. Input and activity measures are not meaningful in value terms. Instead of measuring training days, companies should be reporting on learning output and outcomes and connecting them directly to financial returns on the investment.

The Maturity Institute (MI) was established as a dedicated professional management institute to move away from this fragmented thinking and towards a whole system approach to management that integrates all the capitals that organizations should utilise to full advantage. This approach has already been subjected to rigorous academic scrutiny and is research-tested. It views the role of Human Capital Management as both crucial and integral to any total value management system and offers a consistent, objective and comparative methodology for analysing and measuring corporate effectiveness. It also considers human capital from a much wider perspective than that of the workforce and specifically integrates the role of external human systems, such as supply/value chains. This makes it a highly and mutually attractive proposition for business leaders, investors and other stakeholders.

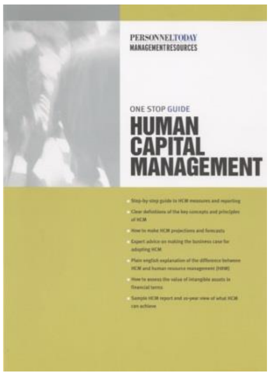
The opportunity

Well-established accounting and auditing conventions were never designed to be capable of attributing specific and credible value to human capital. Nevertheless, these conventions are difficult to shake off and that makes them resistant to integration with new paradigms. A reluctance to accept the limitations of the present system and acknowledge that a new 'accounting technology' is necessary has already unduly shaped existing efforts at producing meaningful metrics by focusing on easily measurable but unhelpful items (e.g. recruitment or training costs).

To break out of this impasse requires a significant shift in thinking among all stakeholders. Firstly, human capital must not be seen as an intangible. HCM reporting must not be about making false distinctions between the 'tangible' and the 'intangible' but showing where, how, and by how much human capital impacts on company performance and market value. Once this principle is accepted we will be able to start a more informed discussion "on how companies can better articulate how their human assets drive their strategy, contribute to growth and are aligned with the creation of long-term shareholder value."

The Maturity Institute goes further in having an over-arching goal (and principle) that shareholder value cannot be maximised until the value of human capital is being maximised: in doing so societal value has the best possible chance of also being maximised. In essence, the MI view is that the purpose of HCM reporting is to indicate whether this virtuous cycle of *inclusive* capitalism is working. In our experience, when this solution is presented to investment analysts and investor bodies its inherent sense becomes very obvious and is welcomed as a mutually inclusive 'win' rather than a zero sum game.

A sample HCM report



Our first sample human capital report was published in 2004, after being commissioned by Personnel Today in response to the UK Government's Accounting for People Taskforce Report (2003). Since then this has been significantly developed with further additions and refinements (see Appendix A). This experience has taught observers important lessons in the mechanics and possible depth of company reporting. In particular, the well-accepted accounting conventions of variances in profit & loss statements do not translate well or easily into HCM reports. For example, what is an analyst to make of the staff figures shown in the Barclays Africa Group table in the NAPF report (Figure 3)? Is the downward trend in the "Permanent employee turnover rate" a plus or a minus in value terms? Does the "Women in senior leadership roles (%)" truly signify recognition of the value that a diverse board and executive can bring? HCM metrics and indicators, by their very nature, are notoriously problematic; which is why HCM reporting is still both in its infancy and has made little progress to date.

A way forward

We must recognise that HCM reporting presents a totally new paradigm for company reporting. It places a much higher value on people than ever before and demands a reporting framework and method that can stand up to rigorous scrutiny. However, it is still early days and so experimentation is a necessary part of the learning process. The principle of voluntarism should also take precedence over any attempt at regulation and the market should be presented with at least one sample, working document as a guide for producing a meaningful HCM report. If, as a result, we can witness very clear indicators of demonstrable connections between enlightened human capital management and company value this will be welcomed by executives who fear red-tape and bureaucracy; the investment community who need a more accurate picture of intrinsic value; employees who will be assessed on their value contribution and society at large.

Through MI, OMS LLP is preparing a new, generic, corporate reporting template as a guide that can be used and adapted for the specific context of different industry sectors and organisation. This incorporates our historical work but also integrates the new thinking and methodology we have developed through our recent human capital ratings work.

We would be delighted to work in partnership with companies who are willing to experiment with our HCM reporting template.

Paul Kearns & Stuart Woollard
16th June 2015

Appendix A.

Extracts from 'HR Strategy. Creating business strategy with human capital' (Routledge 2010)

Due Diligence and Reporting on Human Capital

NO SIMPLE ALGORITHM BUT A COMPREHENSIVE REPORT

There is no single algorithm, no step 1–2–3 that can produce your HR-business strategy even though Google obviously think otherwise, according to the Wall Street Journal -.

> *Concerned a brain drain could hurt its long-term ability to compete, Google Inc. is tackling the problem with its typical tool: an algorithm. The Internet search giant recently began crunching data from employee reviews and promotion and pay histories in a mathematical formula Google says can identify which of its 20,000 employees are most likely to quit.*
>
> http://online.wsj.com/article/SB124269038041932531.html.

Instead you need to create a complete picture, a human capital 'report', both for internal and external consumption, that will contain most of the necessary elements that keep you on the right track. This report is designed to be the antidote to that clichéd, 'motherhood and apple pie', sentimental gush – 'our people are our greatest asset'. That hackneyed phrase is not even factually correct; people are never an asset because you do not own them. They could leave you tomorrow at no cost to themselves but at a potentially great loss to you. They should not even be considered as a resource. No, the only accurate way to regard your people is to see them as highly valuable, yet temporary, capital that they rent out to you in return for a salary. When viewed in this way you have to accept full responsibility for maximizing the return on this capital while you have it at your disposal. Wasting human capital is as serious a crime as burning cash. So this human capital report is your opportunity to convince your toughest judges and critics that you manage your human capital better than any other CEO.

In Chapter 2 we saw that this was the thinking behind the short-lived Accounting for People Taskforce. The original ideas and intentions were right but the timing was probably wrong. In 2003 the global economy was booming and returns were already high, so there was less of an appetite for considering how to get more value out of the most difficult capital of all to manage, human capital. In the light of more recent events the time has come again to revisit HCM reporting. So this time around let us be absolutely clear what the purpose of this HCM report is and consider what different stakeholders might want from it. There are quite a few different and possibly conflicting agendas out there.

A WORKING EXAMPLE OF AN HCM REPORT

Deciding what to report internally will be a matter for your own judgement, but any reluctance to provide detailed indicators of HCM would reveal a lack of confidence. An unwillingness to share information with employees would also suggest that you have not really embraced the sort of open and honest communication philosophy that one would associate with an HCM strategy. How much you might want to report externally is a different proposition.

Any board director might be understandably reluctant to display any information that was of a highly sensitive, commercial or competitive nature. It would be naïve to suggest you reveal any more information than you have to, unless you think it would enhance your reputation and share price. Leaving those provisos to one side, Table 9.1 shows a summary HCM report containing some of the indicators that should convince any interested party whether you really have a strategic handle on your human capital. This should form part of the complete, annual company report.

NOTES, NARRATIVE AND INTERPRETATIONS OF THE HCM REPORT

The first general note is that this is not meant to be a report that adheres to any existing accounting and auditing conventions but rather enhances them by offering a totally different perspective. We could go much further and declare that HCM reporting abhors the traditional type of auditing practice that takes static snapshots of organizations and breeds fear every time it arrives for its next inspection. This report is not part of an inspection regime, more an opportunity for people in the organization to monitor their own progress. There is nothing here for any individual to fear if they are working in a highly mature organization.

It is explicitly designed to challenge those conventions with a view to shaking up complacent management thinking. An HCM analyst will already be capable of seeing through the obfuscation, smoke and mirrors of normal company reports and will want to pose many serious questions that need to be asked that check out the very heart of the enterprise.

No single piece of data should be given too much weight in isolation. This is why our recommendation is that additional notes on the more qualitative indicators need to be written (e.g. line 35: organization structure – type) and the report presented as part of a complete narrative of how the organization is developing, year on year. It is the overall picture, determined by an in-depth analysis of a range of variables and factors that will provide an accurate impression and a level of confidence as to whether the organization is managing its human capital well.

It is also worth reminding ourselves that all rating scales, whether they are credit rating agencies such as Moody's or an accredited scheme, like Investors

TABLE 9.1 XYZ plc – Human Capital Report

	Indicator	2009–2010	2010–2011	Variance +/–
1	Turnover – sales (£000's)	£100,000	£105,000	**£5,000**
2	Operating costs (£000's)	£ 90,000	£96,000	(£6,000) 6.6%
3	Operating profit (£000's)	£ 10,000	£9,000	(£1,000) – 10%
4	Share price high/low (£)	5.50/4.50	5.60/5.00	**+0.10/+0.50**
5	Market value/capitalization (£000's) – share price × total shares	£1,000,000	£1,060,000	**£60,000**
6	Book value (£000's)	£300,000	£270,000	(£30,000)
7	'Intangible' value = market value – book value (£000's)	£700,000	£790,000	**£90,000**
8	Nominal number of named 'employees' registered on 'payroll' including contractors	10,000	9800	–2%
9	Total number of hours paid (= FTEs)	18,400,000	18,032,000	–2%
10	Total number of hours actually worked	26,000,000	27,300,000	+5%
11	Employee years (46 weeks @ 35 hours)	16,149	16,956	+5%
12	Turnover per employee year (1 ÷ 11)	£6192	£6192	=
13	Operating cost per employee (2 ÷ 11)	£5573	£5661	+£88
14	Profit per employee year (3 ÷ 11)	£619	£530	(£89)
15	Intangible value per employee year (7 ÷ 11)	£43,346	£46,591	**£3245**
16	Number of key employees	300	295	–5
17	Raw staff turnover (last 12 months)/target	12% / 8%	10% / 8%	**–16.6%**
18	Staff turnover – unplanned/unwanted	4%	8%	+100%
19	Average length of service (LOS – in years)	4.00	3.75	–0.25
20	Stability 3/12/36 months (%)	95/88/60	90/85/55	–5/-3/-5

Continued

TABLE 9.1 XYZ plc – Human Capital Report—cont'd

	Indicator	2009–2010	2010–2011	Variance +/–
21	Inexperienced workers (<6 months)	1080	950	–130
22	Key employees who left this year	12	15	+3
23	New key employees added	6	8	**+2**
24	Key employee staff turnover	4%	5%	+1%
25	Key employee average LOS (years)	6.0	5.5	–0.5
26	Job offers turned down – actual / %	120/10%	150/15%	+30/+5%
27	Key employee job offers turned down – actual/%	12/60%	5/4%	**–7/–56%**
28	Average time taken to fill a vacancy (months)/target – all employees	3.0/2.5	4.0/2.5	+1.0/=
29	Average time taken to fill vacancy (months)/target – key employee	9.0/6.0	8.0/6.0	**–1.0/=**
30	HR function activity/spending – Box 1/2/3	75/5/20	70/15/15	**–5/+10/–5**
31	Training and development activity/spending – Box 1/2/3	55/5/40	70/20/10	**+15/+15/–30**
32	Performance management system – in place (years)/% jobs covered	1.0/10%	2.0/50%	**+1.0/+40%**
33	Learning system – in place (years)	1.0	2.0	**+1.0**
34	Innovation – ideas implemented per annum as % of total employees/value (£000's p.a.)	300%/£2,000	275%/£2,500	–25%/+£500
35	Organization structure – type	Classic silo	Silo to Matrix	+
36	Process changes – number/time taken	5/3 months	25/2.5 months	**×5/–0.5**
37	Employee engagement index (survey)	75%	80%	**+5%**
38	Quality assurance system	PDCA	PDCA	+
39	Unionization	80%	80%	–
40	Maturity stage – HR/Learning	2/2	3/2	**+1/=**