Intangible or Invisible?
The growing case for human capital disclosure by firms

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Invisible or intangible?

1. Valuing value
2. The materiality of people
3. Quantum clarity
1. Valuing Value
Invisible or intangible?

EPIC participants

31
Participant companies along the investment chain

9
Companies

USD 1.5 Trillion
Market cap

11
Asset owners

USD 30 Trillion
Assets under management

11
Asset managers
Invisible or intangible?

**EPIC participants**

<table>
<thead>
<tr>
<th>Companies</th>
<th>Asset managers</th>
<th>Asset owners</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aetna</td>
<td>Amundi</td>
<td>Allianz</td>
</tr>
<tr>
<td>BASF</td>
<td>Barings</td>
<td>Allstate</td>
</tr>
<tr>
<td>DowDuPont</td>
<td>BlackRock</td>
<td>ATP</td>
</tr>
<tr>
<td>Ecolab</td>
<td>Fidelity Investments</td>
<td>CalPERS</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>Investec Asset Management</td>
<td>CalISTRS</td>
</tr>
<tr>
<td>Nestlé</td>
<td>J.P. Morgan Asset &amp; Wealth Management</td>
<td>Canada Pension Plan Investment Board</td>
</tr>
<tr>
<td>Novartis</td>
<td>Neuberger Berman</td>
<td>Government Pension Investment Fund</td>
</tr>
<tr>
<td>PepsiCo</td>
<td>Nuveen</td>
<td>Guardian Life</td>
</tr>
<tr>
<td>Unilever</td>
<td>Schroders</td>
<td>MetLife</td>
</tr>
<tr>
<td></td>
<td>State Street Global Advisors</td>
<td>New Zealand Super Fund</td>
</tr>
<tr>
<td></td>
<td>Vanguard</td>
<td>Washington State Investment Board</td>
</tr>
</tbody>
</table>
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Value perspectives

Current focus of investors

Intangible value
Not measured or communicated

Market value

Intangible value
Reliably measured and communicated

Intangible book value

Tangible book value

Current perspective

Long term value perspective
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A four step process to develop metrics for long-term value

1. Lead indicators
   - The metric represents a backward or forward looking indicator that serves as a proxy for future value creation (>5 years). It relates to the company’s ability to create value in the short, medium and long term.

2. Measuring outcomes and impacts
   - The metric measures performance at least beyond output. Outcome and impact metrics convey results of business activities for the intended scope over the long term.

3. Materiality
   - The metric reflects a company’s significant economic, environmental, and social impacts and substantively influences the assessments and decisions of stakeholders. It conveys information that substantively affects the company’s ability to create value.

4. Comparability
   - The metric can be applied consistently over time; the definition and calculation methodology remains the same to aid comparability. It is transferrable to most companies within or across industries to enable meaningful (peer-to-peer) comparisons.

5. Investor verified
   - The metric is relevant to investors. It has been validated by investors (or is at least considered to be potentially relevant for investors’ decision-making).

Download the full report: https://www.epic-value.com
2. The materiality of people
1. **Quantitative Analysis:**
   1. Income statement analysis of 700 firms to establish reporting of human capital items (HCR)
   2. In US, analysis of AGM Proxy Statements to secure employee-related data
   3. Other documents investigated have included CSR reports and other IR-related media
   4. Over 2,000 documents have been consulted and codified by the project team

2. **Narrative Analysis:**
   1. ARs, Form 10-ks, Proxy Statements, CSR reports and other IR related materials
   2. Discourse analysis codifying (unstructured) data relating to:
      1. Human Capital Indicators identified by *Valuing your Talent* (Hesketh, 2014)
         1. Human capital costs (salaries, bonuses and pension benefits of all employees)
         2. Turnover and recruitment data (regrets/non regrets and incoming data points)
         3. Training and development (total training days, type and costs)
         4. Workforce composition (D&I, skills and other related data points)
         5. Engagement (surveys exploring employees' attitudes to work and their firms, e.g., purpose, wellbeing)
   2. The distribution and content of human capital-related narratives relating to:
      1. Balance between number and narrative data points
      2. Balance between strategic and operational justifications
      3. Balance between material and discursive causal argumentation
      4. Balance between individual, organisational and extra-organisational factors

3. **Combined Quantum and Narrative Analysis**
   1. Using a new methodology (*urtext* and HCDI) developed by Hesketh at Lancaster University:
      1. Parametric and Non-Parametric techniques
      2. Exploring linear and non-linear relationships between human capital factors and performance
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US: HC cost disclosers disproportionately higher performers

Those firms disclosing their HC costs in the S&P 500 firms are disproportionately and consistently found in the top 100 firms 2015-17 measured by EBIT margin, and under-represented in the bottom 100 EBIT-performing firms.
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US: HC factor reporting still in nascent form

Only 75 firms in the S&P 500 formally report their human capital related costs (salaries, bonuses and benefits). Although most firms in the S&P Top 100 by Revenue disclose data relating to workforce composition (e.g., D&I data), the overwhelming majority fail to report other key human capital factors. Compared to the UK and EU, the most striking of these is total workforce cost with less than 1:8 in the US, compared to 100% in the EU and UK. There are regulatory reasons for this.
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UK: HC factor reporting more mature

Due to regulation in the UK and EU, all firms report total costs relating to employee salaries and benefits, and, from April 2017, data relating to gender pay and workforce composition are compulsory. Significantly more firms report employee sentiment data (e.g. engagement), although the UK lags behind the US on employee turnover.

Source: FTSE100 & Firm publications. Analysis by Lancaster University Management School for EPIC
More than 4/5 firms in the FTSE 100 spend more on their human capital than their formally stated and audited level of materiality. Half FTSE 100 firms exceed this materiality level by greater than a factor of 20, underlying the fiduciary requirements of greater transparency relating to the reporting of human capital management.

Source: FTSE100 & firm publications, Analysis by Lancaster University Management School
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Lancaster research findings for EPIC

• Consensus on what comprises human capital disclosure (HCD)
  • Endorsement by CEO’s of 5 talent-related KPIs:
    • 1) Composition; 2) costs; 3) turnover; 4) training; 5) engagement

• Systematic analysis and unique dataset of *Lancaster HCD Index*

• Case for HCD moved beyond aspirational to *financially material*
  • HCD disclosers disproportionately high performers
  • Linear relationship between *HCDI-ROIT*
    • The more discursive the HCD, the poorer the performance

• Work continues on establishing *human capital asset* calculation
  • Now, we can add *mean excess returns* and *risk-adjusted returns*

• Research adopted by WEF and SASB and (soon we hope) SEC.
3. Quantum clarity
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UK: HCRI signals relative employee out-performance

These data are compiled from HCR scores of equal weighting across all five variables and splitting firms into overall score quartiles. HCR appears to signal firms securing higher productivity from their employee base disclose more human capital related data. This suggests we cannot rule out human capital factors as a leading indicator of out-performance.

Source: FTSE100 & firm publications, Analysis by Lancaster University Management School
The linear relationship between employee productivity and human capital reporting is less pronounced in the US, perhaps reflecting the relative under-performance of information on human capital-related factors. Nevertheless, those firms in the Top S&P 100 by revenues with the highest scores secure higher levels of productivity from their employees than those in other quartiles.

Source: S&P, Compustat & firm publications, Analysis by Lancaster University Management School for EPIC
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Value creation v value transfer

N=75/495

Reading from left to right, this chart illustrates how value creation and value transfer differ between those firms who disclose their human capital costs (n=75) and those who do not. Firms disclosing their HC costs perform strongly in value creation, whereas those firms not disclosing their costs offer their shareholders higher rates of returns, but not significantly so. These findings are broadly repeated across the last three years (2015-17) with the pattern then breaking down pre-2015, suggesting modification in the underlying decisions made by disclosers versus non-disclosers in the last several years.

Source: S&P, Compustat & firm publications, Analysis by Lancaster University Management School for EPIC
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Quantum clarity: let the numbers do the talking

Examining the total number of narrative observations relating to their human capital deployment, we can clearly see how those firms in the upper quartile of human capital disclosure (right hand side), make fewer narrative observations. Clearly, these firms are letting their human capital deployment numbers do the talking for them. Clearly, there is scope for greater efficiency in human capital disclosures via tighter prescription of the required human capital disclosure data points.

Source: FTSE100 & firm publications, Analysis by Lancaster University Management School for EPIC
We have calculated the human capital-related costs to the different elements of the audit process. We have then used this figure to compute the total cost of human capital audit, relating it to the spend on total employee remuneration by firms. In the example we model the firm’s human capital audit costs at $1.27m. A 1% increase in operating profit we have conservatively estimated to be brought about by greater understanding of the business through human capital audit, represents a financial benefit 58x that of the estimated audit costs. We estimate an increase in operating performance of just 2 bps will cover human capital cost-related audit.

Source: FTSE100 & firm publications, Analysis by Lancaster University Management School
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EPIC: Our research findings in a nutshell

Positive correlation between performance and disclosure of HCD data

Regulations drive HCD disclosures

Frequency of human capital reporting - Turnover

- UK 26%
- US 34%

Frequency of human capital reporting - Employee costs

- UK 100%
- US 13%

In the US, firms that disclose their Human Capital ‘costs’ secure higher levels of productivity than non-disclosers.

1.17 ROI

3.01

46% difference in ROI between disclosures and non-disclosures

UK firms in top quartile for reporting get greater return on investment in talent

Firms with higher Human Capital Reporting scores show higher productivity

33% Operating Margin

-3%

UK firms in top quartile secure higher operating margins

60% of firms focus their narrative on operational description

Low human capital disclosers use more narrative observations than top quartile firms

~60%

Of the S&P firms that disclose costs, 60% are in the top 100 S&P by EBIT for 2015-17

60%

6%
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