

Intangible or Invisible?

The growing case for human capital disclosure by firms

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CalPERS

Board of Administration Offsite



Lancaster University
Management School

1. Valuing value
2. The materiality of people
3. Quantum clarity



1. Valuing Value



EPIC participants

Companies

Aetna
BASF
DowDuPont
Ecolab
Johnson & Johnson
Nestlé
Novartis
PepsiCo
Unilever

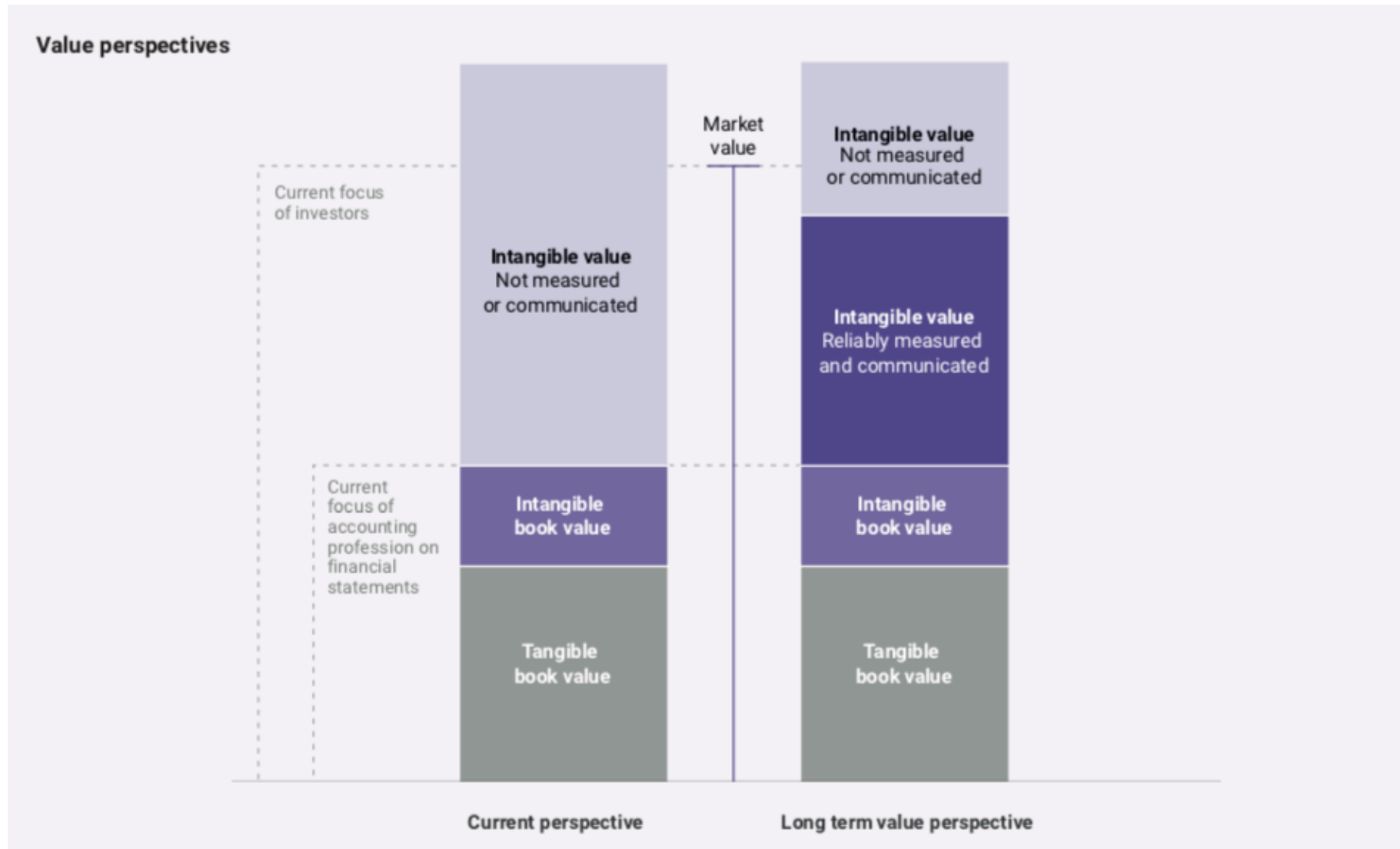
Asset managers

Amundi
Barings
BlackRock
Fidelity Investments
Investec Asset Management
J.P. Morgan Asset & Wealth Management
Neuberger Berman
Nuveen
Schroders
State Street Global Advisors
Vanguard

Asset owners

Allianz
Allstate
ATP
CalPERS
CalSTRS
Canada Pension Plan Investment Board
Government Pension Investment Fund
Guardian Life
MetLife
New Zealand Super Fund
Washington State Investment Board

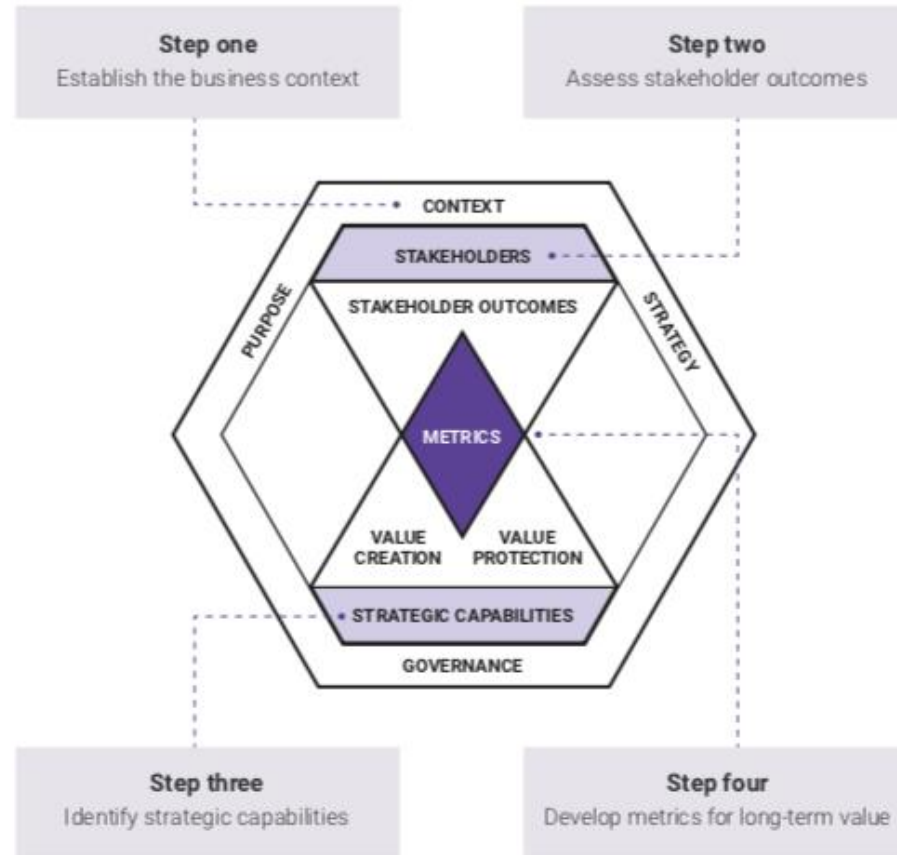
Invisible or intangible?



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

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

Companies can use this approach to better articulate to investors how they create and measure long-term value.



Feature: Five criteria for metrics



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 transferable 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).

2. The materiality of people

Human capital analysis

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

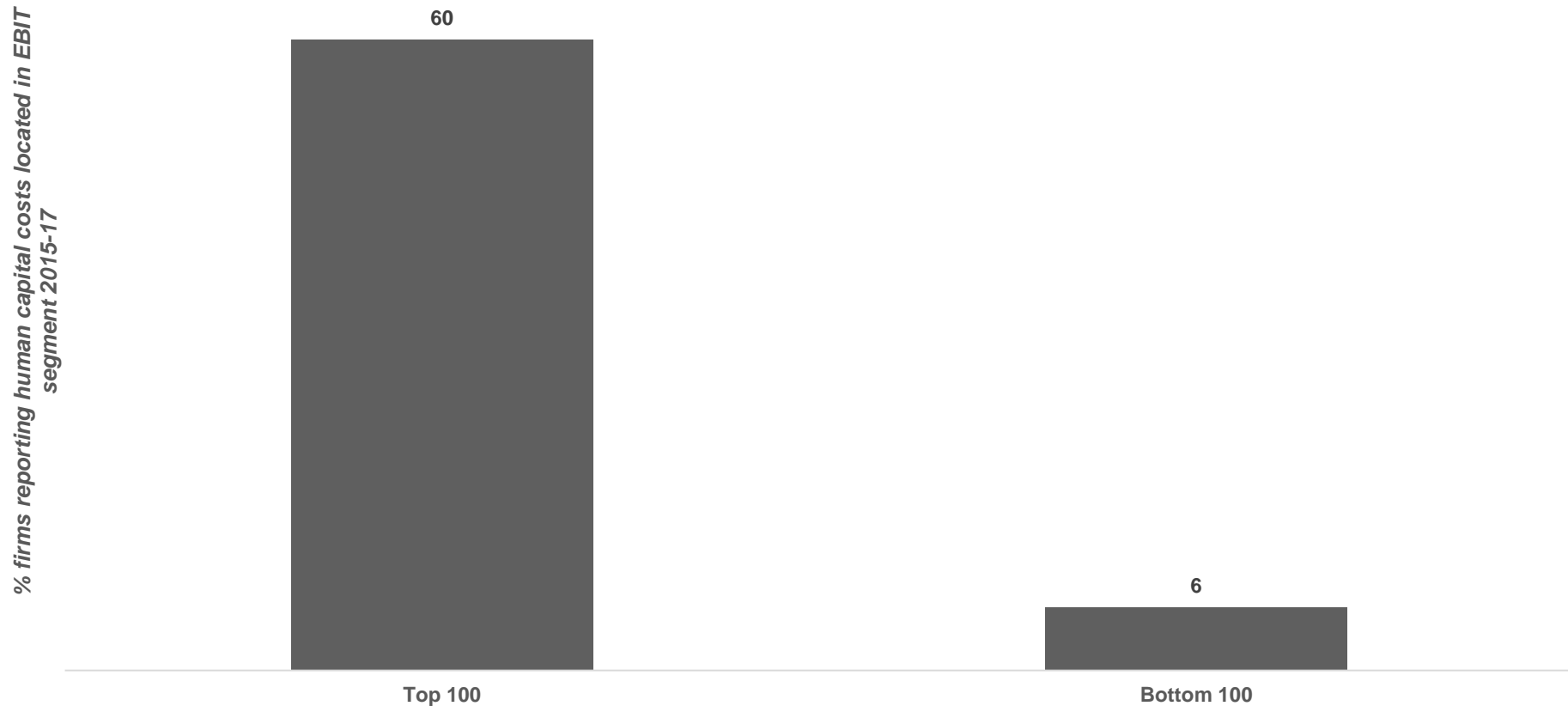
2. Narrative Analysis:

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

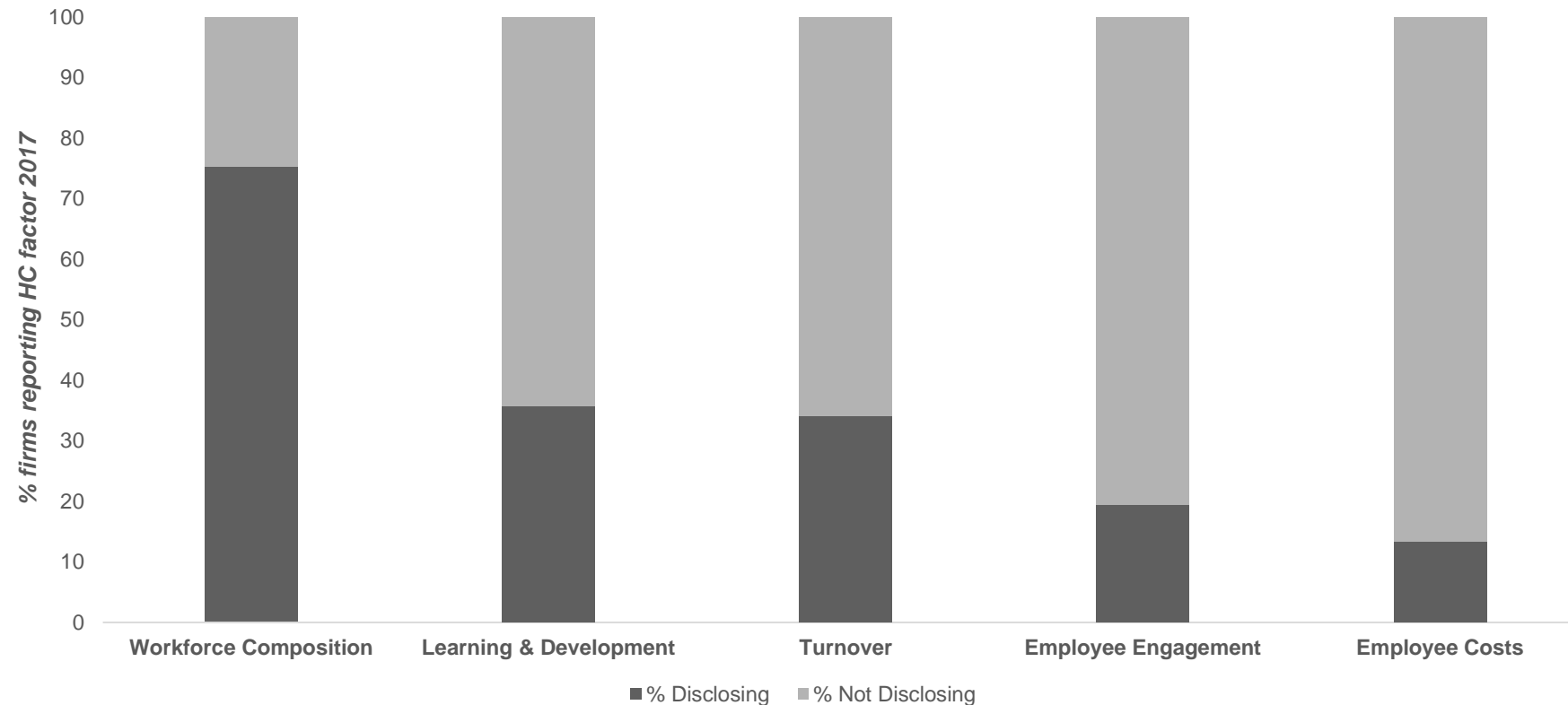
US: HC cost disclosers disproportionately higher performers



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.

US: HC factor reporting still in nascent form

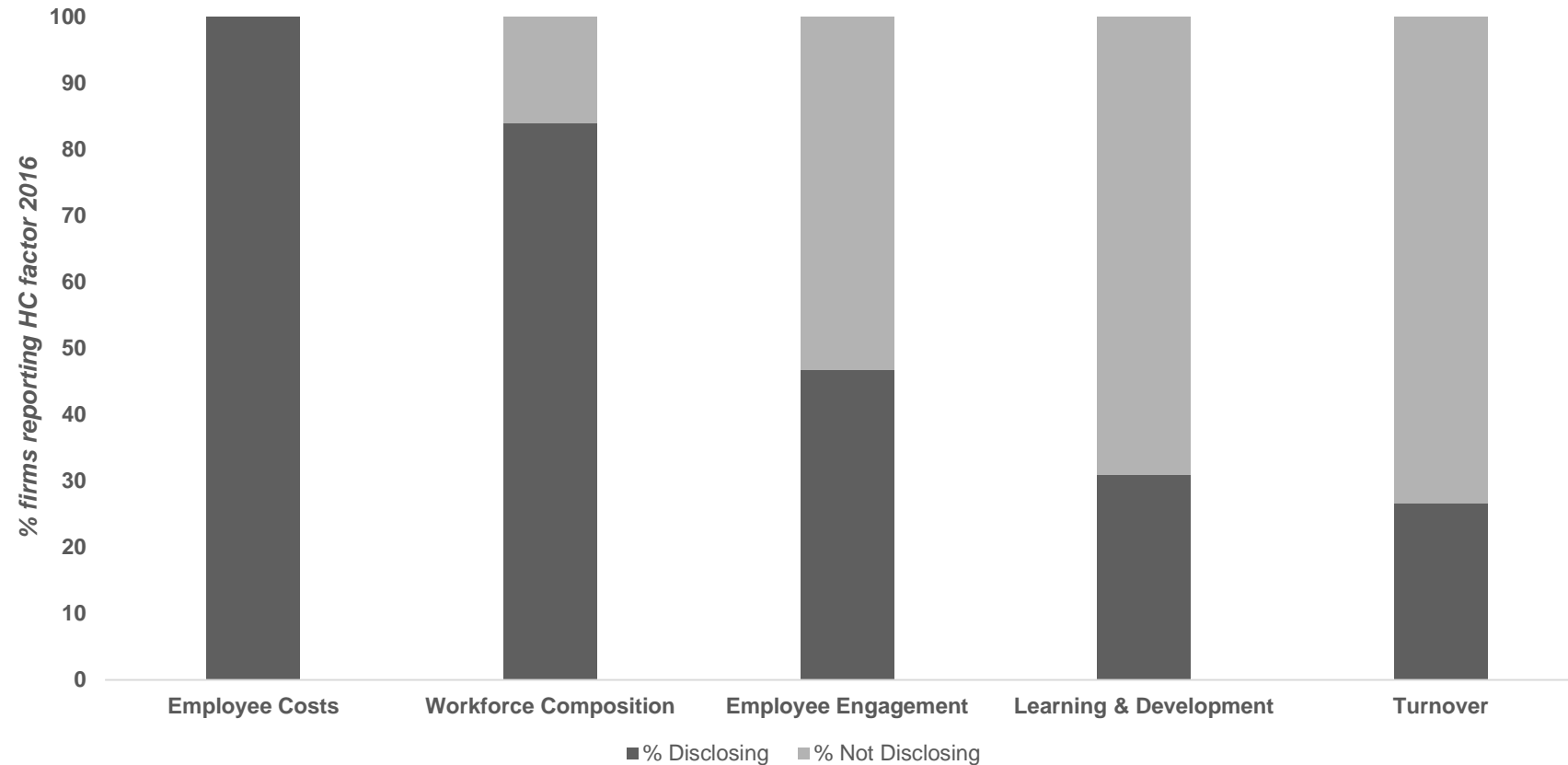
N= 100



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.

UK: HC factor reporting more mature

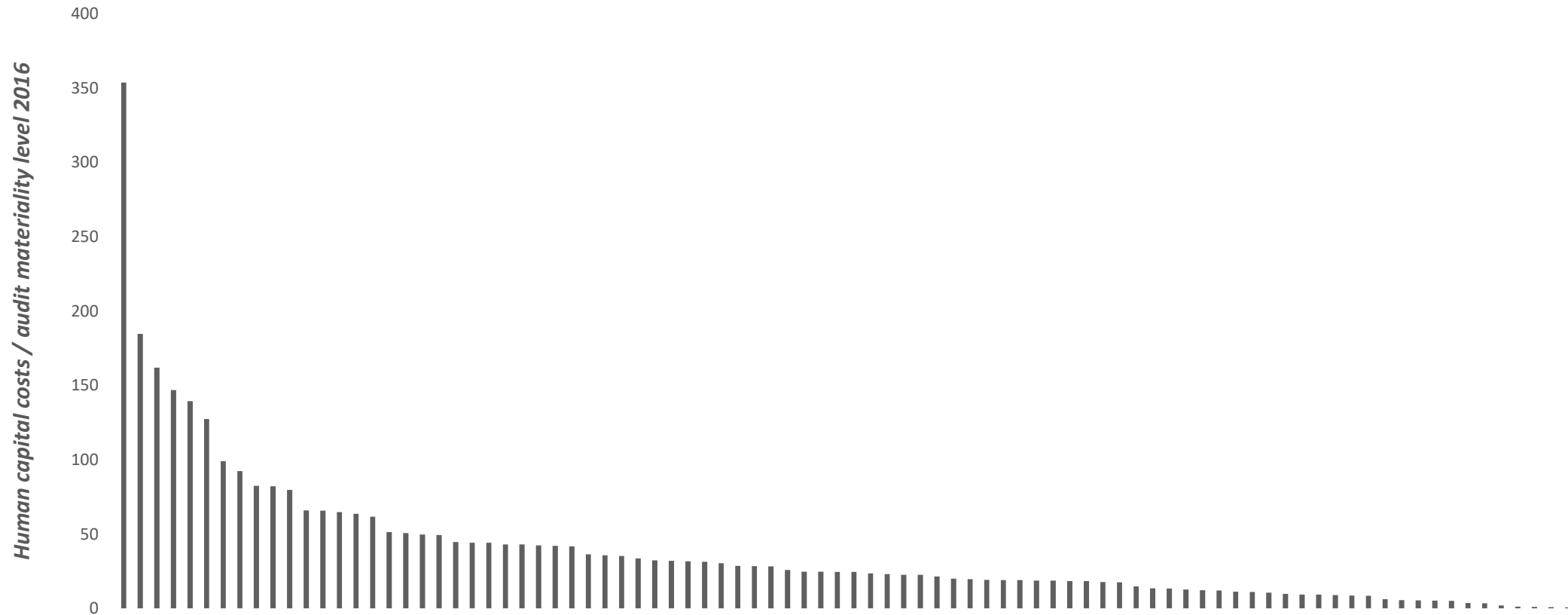
N= 100



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.

UK: The materiality of human capital

N=100



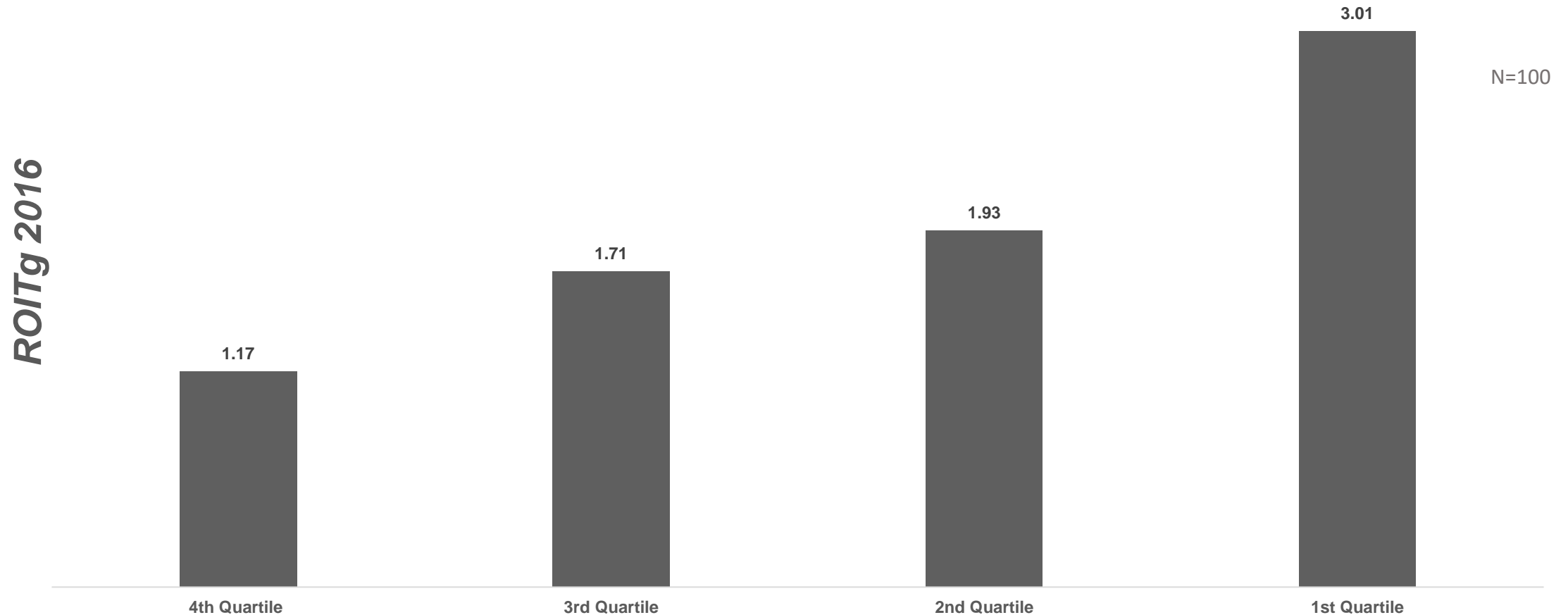
More than 4/5 firms in the FTSE 100 spend more on their human capital than their formally stated and audited level of materiality. Half FTSE 100 firms exceed this materiality level by greater than a factor of 20, underlying the fiduciary requirements of greater transparency relating to the reporting of human capital management.

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.

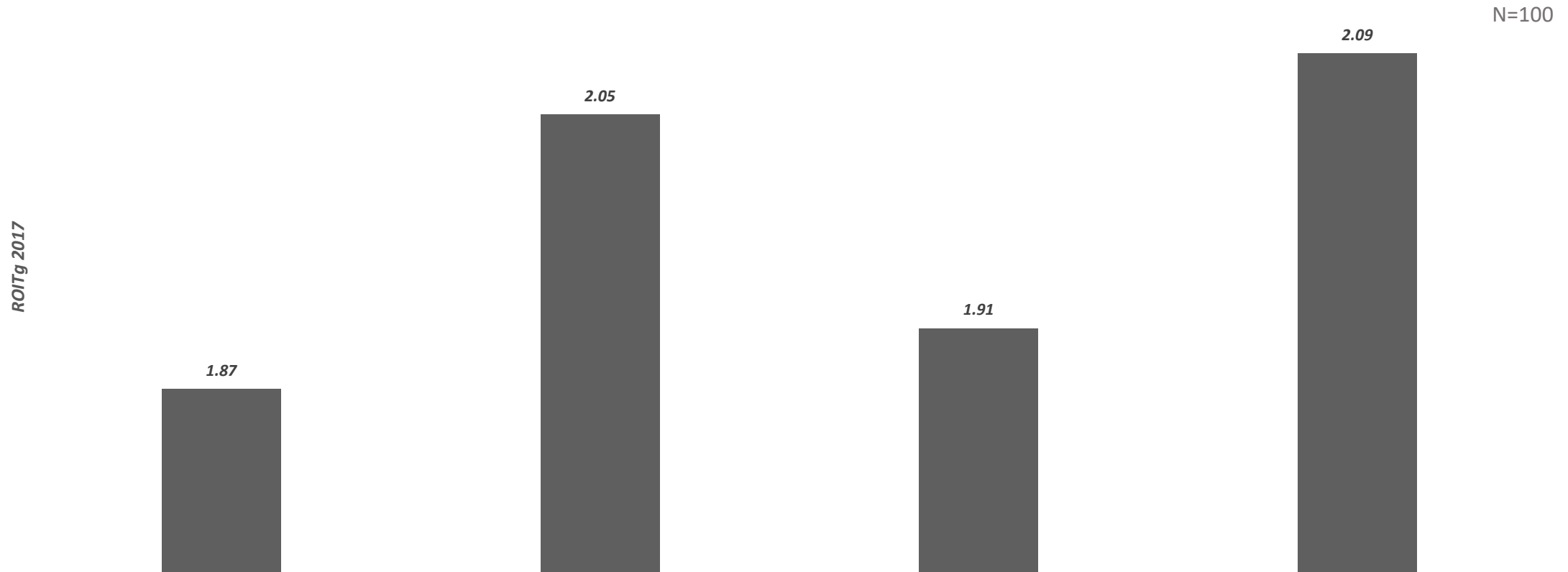
3. Quantum clarity

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.

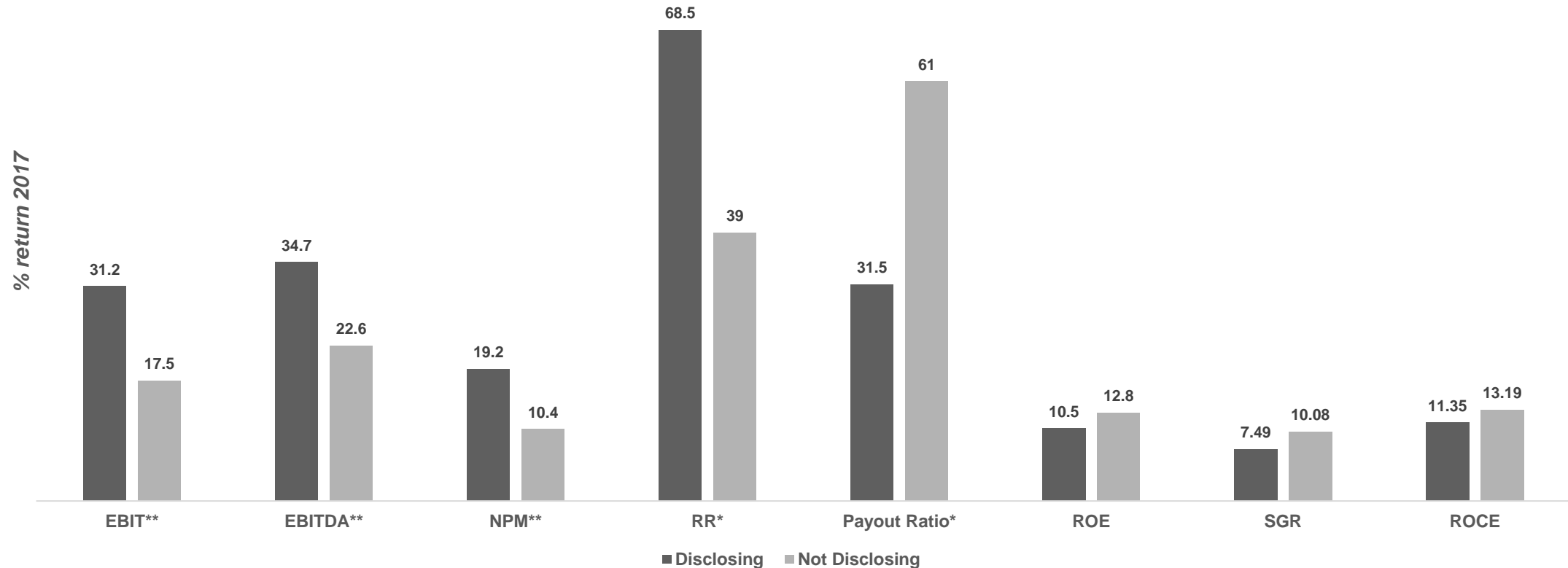
US: HCR Index less mature but material



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.

Value creation v value transfer

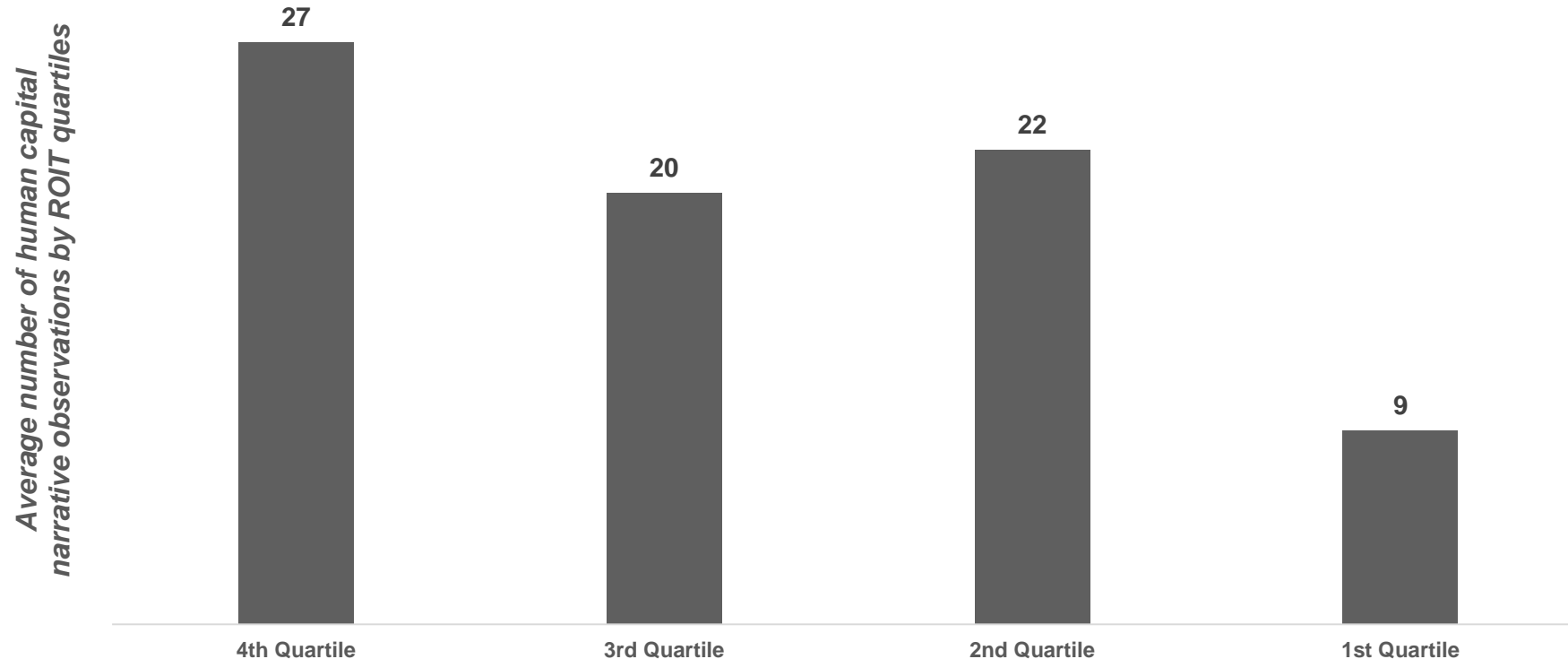
N=75/495



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.

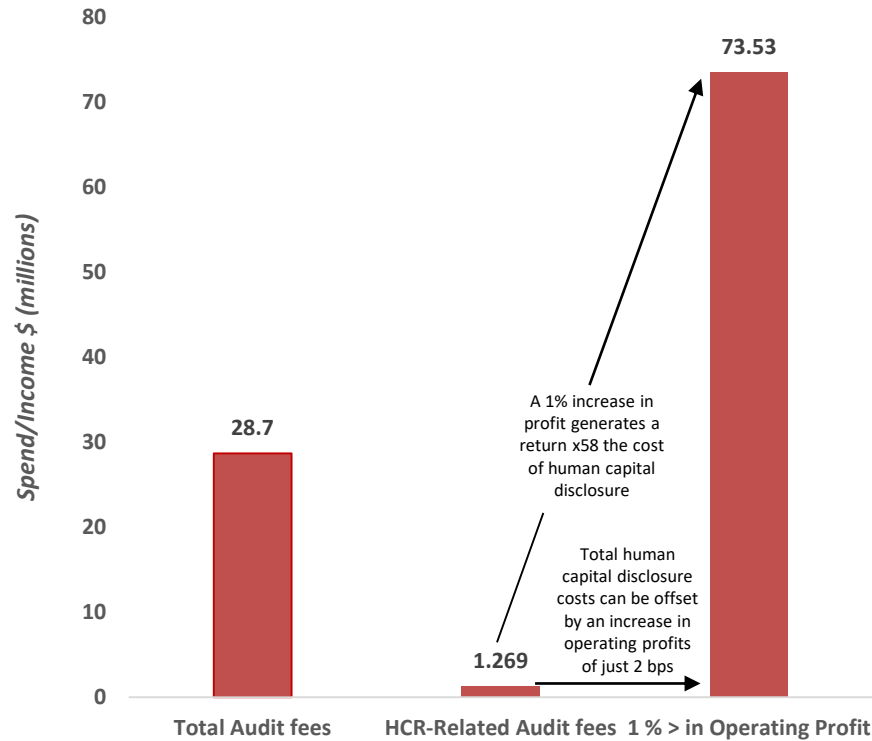
Quantum clarity: let the numbers do the talking

N=100

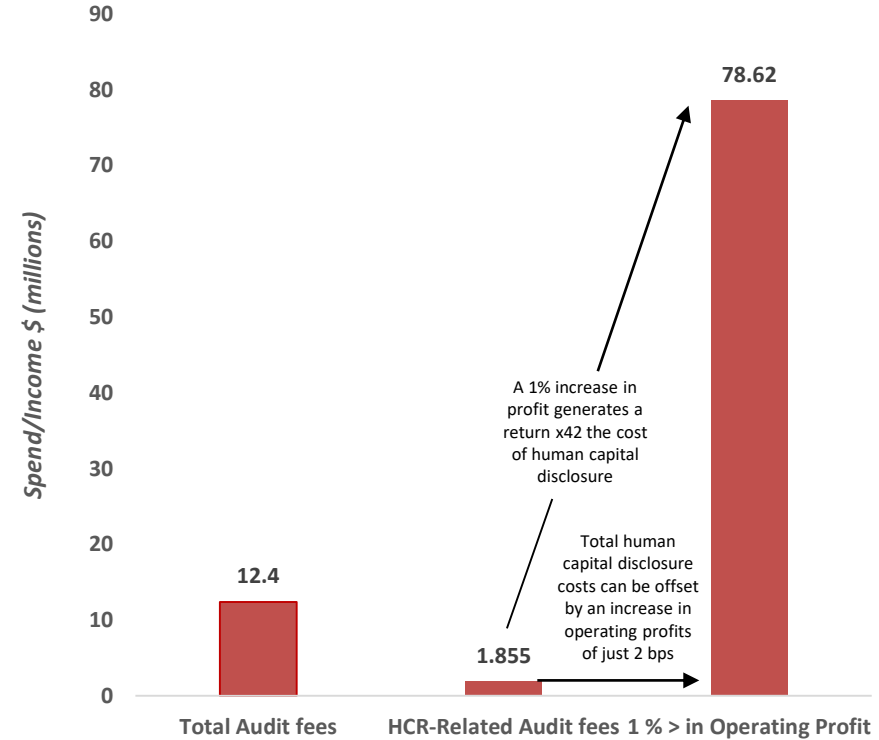


Examining the total number of narrative observations relating to their human capital deployment, we can clearly see how those firms in the upper quartile of human capital disclosure (right hand side), make fewer narrative observations. Clearly, these firms are letting their human capital deployment numbers 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..

Costs and Benefits of Human Capital Salaries and Benefits Audit (Oil)



Costs and Benefits of Human Capital Salaries and Benefits Audit (FMCG)



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.

TRIPLE-ACCREDITED, WORLD-RANKED



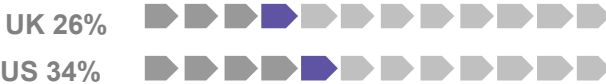
Source: FTSE100 & firm publications, Analysis by Lancaster University Management School

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**



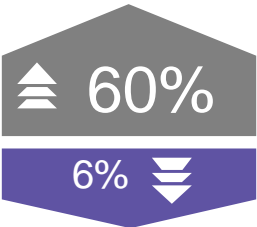
Frequency of human capital reporting – **Employee costs**



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

46% difference in ROIT between disclosures and non-disclosures

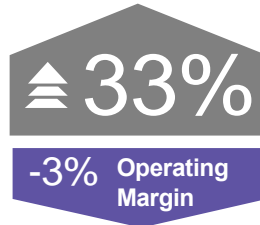
Of the S&P firms that disclose costs, 60% are in the top 100 S&P by EBIT for 2015-17



Firms with higher Human Capital Reporting scores show higher productivity



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



UK firms in top quartile secure **higher operating margins**

Firms who disclose the most human capital data say less in their narratives.

Low human capital disclosers use **3x** more narrative observations than top quartile firms

~60% of firms focus their narrative on operational description

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