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REPRINTED FROM:

RISK & COMPLIANCE MAGAZINE

OCT-DEC 2016 ISSUE

www.riskandcompliancemagazine.com

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MERCER

Published by Financier Worldwide Ltd
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risk & compliance

www.riskandcompliancemagazine.com

PERSPECTIVES

WHEN IT COMES TO HUMAN CAPITAL REPORTING, MUM'S STILL THE WORD

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The idea that an organisation's workforce is an 'asset' rather than simply a business cost is now broadly embraced by corporate leaders everywhere. Quite a few of them even declare, in their annual reports, that it is their organisation's 'greatest asset'. How remarkable then, that in those very same annual reports a proper accounting of the size, composition and management of the greatest asset is nowhere to be found.

This omission should be of concern to the investment community and those charged with regulating capital markets, because the evidence is mounting that substantial value is at stake in getting human capital management right. For example, a study of the US manufacturing sector found strong, positive relationships between sustained advantages in workforce productivity and the market value of companies, as measured by Tobin's Q, the ratio of the firm's market value to the replacement value of its capital assets. In effect, a consistent advantage in workforce productivity was found to function as an intangible asset for companies. But what explains differences in workforce productivity?

In our experience, human capital management is a significant, measureable driver of variations in workforce productivity in organisations, and often the most important avenue to sustained productivity advantages.

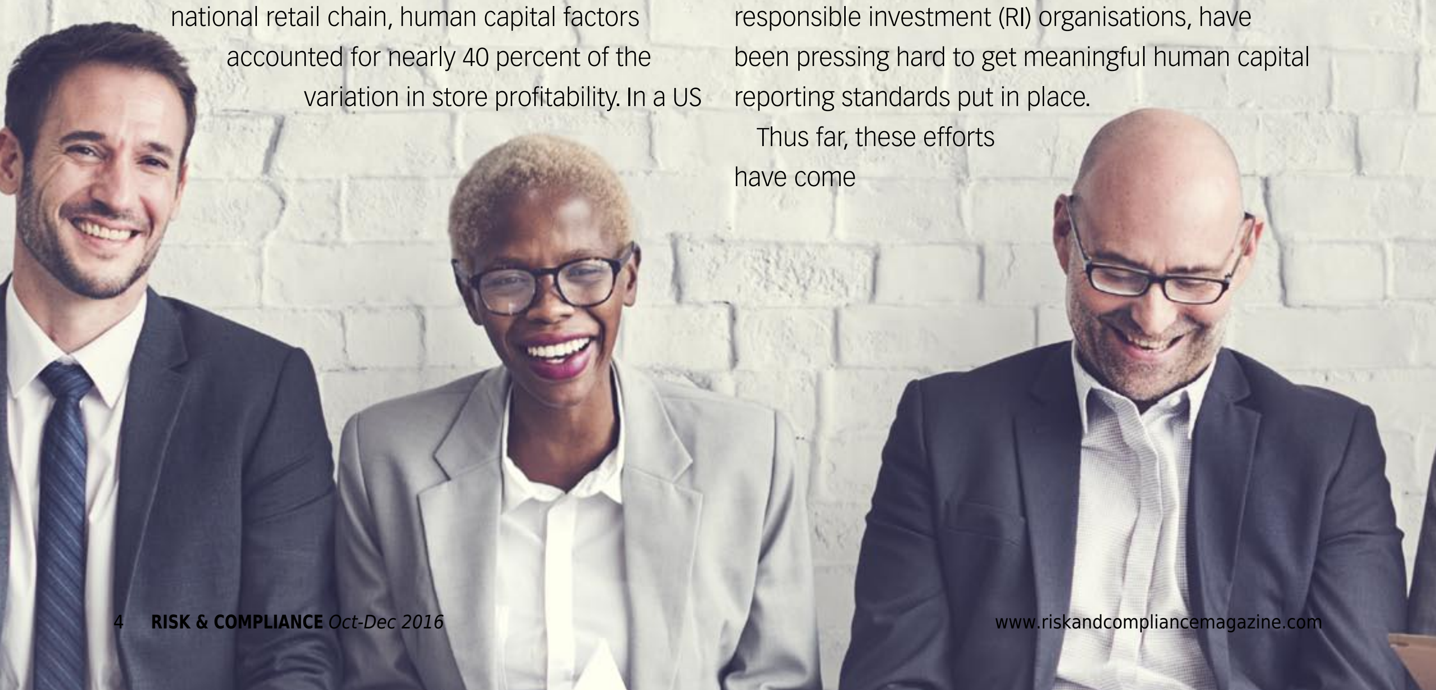
For example, in a large hospital system, statistical analysis showed that about 63 percent of the variation in relative workforce productivity across hospitals within the system and over time was attributable to human capital management, and not to differences in financial capital, technology or the vintage of equipment.

What really mattered were factors relating to the composition and management of the workforces in these facilities – factors such as the quality of staff, part-time/full time ratios, management ratios, supervisory spans of control, overtime utilisation and turnover. Simply optimising part-time utilisation across the system was estimated to be worth 3 percent of revenues annually, a large amount for a healthcare organisation straining under reduced reimbursements. Optimising across all key management levers would net much more.

Other examples tell a similar story. In a large national retail chain, human capital factors accounted for nearly 40 percent of the variation in store profitability. In a US regional bank, the impact of human capital varied from a low of 10 percent to a high of over 40 percent depending on the performance measure analysed. The message is clear: while its relative contribution varies across industries and even across companies within industries, human capital management matters – often a great deal.

The absence of meaningful reporting on human capital management has not gone unnoticed. Over the past two decades there have been serious efforts in various jurisdictions to get human capital out of the shadows. Some have emanated from the financial accounting world, some from the 'sustainability' or the Environmental, Social, and Corporate Governance (ESG) world. And various investor groups, whether they be government or private pension funds, shareholder activists or responsible investment (RI) organisations, have been pressing hard to get meaningful human capital reporting standards put in place.

Thus far, these efforts have come



up short. All too often, the annual reports of publicly traded corporations still resort to boilerplate commentary about their organisation's human capital. Almost nowhere does the information provided about the company's workforce and the way it is managed bear any resemblance to what is reported on physical, financial and 'relational' assets (e.g., 'goodwill'). To date, there is still no commonly accepted standard on what organisations should report about their workforces.

Achieving consensus on a set of standardised measures of human capital management to be publicly reported has proven elusive, for good reason: determining the right measures to report to shareholders is a challenging task. The problem lies in the highly contextual nature of human capital management. Indeed, effective human capital management is far less about 'best practice' or adherence to some external benchmarks than it is about 'best fit'.

Practices that work well in one environment may fail miserably in another. For instance, 'pay for performance' or variable pay is commonly regarded as an important instrument for enhancing employee motivation. Countless executives proudly proclaim that their organisation's reward systems are 'results oriented', yet there is substantial evidence that the impact of variable pay schemes is highly dependent on a variety of contextual factors, such as the volatility of the performance measures to which payoffs are tied, the way work is organised and the structure and intensity of supervision, among other things.

This helps explain why variable pay programmes have very high variance in their effectiveness. Sometimes they contribute enormously to higher performance. Sometimes they actually diminish performance. This variance is due fundamentally to problems of systems 'fit', not plan design. All too often, variable pay plans are put in place in an environment

where they cannot possibly succeed because other management practices or contextual factors are arrayed against them. Simply knowing the incidence and extent of pay for performance in a firm says little about the efficacy of rewards, let alone human capital management, in organisations.

Even the most basic measures of human capital management can be highly misleading if not assessed in context. For example, employee turnover is often looked at as an important measure of how well an organisation is managing its workforce. If employees are leaving at relatively high rates, something in the employment proposition must not be working. Moreover, turnover imposes costs on organisations.

Common bottoms-up approaches to estimating the cost of turnover, taking into account the resources expended on recruitment, selection, hiring, on-boarding, training, as well as the ramp-up time for employees to reach reasonable levels of productivity and the resulting disruptions to work and teams, suggest turnover is very costly – with estimates varying from 50 percent of pay for non-exempt hourly employees to 150 percent or more for salaried staff. By these calculations, how could one not conclude that lower turnover is 'better' than higher turnover and that management teams that maintain low turnover are holding labour costs down and securing gains for shareholders?

But conclusions based on such bottom-up calculations may be misleading. Employee turnover can have important positive effects as well: it can help weed out poor performers and open up positions for up-and-coming talent. Most importantly, turnover may be a vital instrument to speed adaptation of organisations to changing business needs. In today's economy, business strategies and conditions are constantly changing, due to competitive forces, advances and shifts in technologies, customer needs and values. Inevitably, these require changes in an organisation's workforce as well.

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In periods of transition, higher turnover may be necessary to enable the kind of workforce transformation required to drive business success. Those organisations that make the required shifts more fully and quickly will outperform those that lag. As such, higher turnover may be a better predictor of business success than lower turnover. It is surprising how often the problem in organisations is too little turnover, not too much. Simply reporting out turnover rates without providing information on the contextual factors that permit intelligent interpretation of this measure can be seriously misleading.

As these examples demonstrate, when it comes to human capital management, what matters most is how well-aligned workforce practices are with each other and with the strategic goals of the organisation. Unfortunately, measuring 'best fit' is a far more complex endeavour than measuring alignment with so-called 'best practice'. Given the challenges of creating 'best fit' measures, is the effort to create universal standards for human capital reporting a lost cause? We think not.

The goal of human capital reporting should be to provide information by which investors can gauge whether the organisation is securing the right workforce – the right mix of skills, capabilities, and experience – and whether it is managing that workforce in a way that drives productivity. To make this determination, investors need to have some knowledge about the methods and processes used by company management to ensure human capital is, in fact, being managed as an asset and managed effectively.

Key questions include: (i) does the organisation have in place an explicit workforce strategy that defines the set of workforce 'assets' required to achieve business goals, and a set of consistent, mutually-reinforcing management practices designed to ensure these assets are secured and productively managed?; (ii) what are the core elements of this workforce strategy?; (iii) on what is this workforce strategy based? Specifically, what kind of quantitative and qualitative information is management relying on to inform its workforce decisions?; (iv) what measures are in place to track whether the strategy is being executed effectively?; (v) are these measures being used to hold executives and line leaders accountable for results?; and (vi) what processes and measures are in place to identify potential or looming risks to the organisation's human capital and what institutional structures or practices can be called on to mitigate any risks identified?

Rather than mandate a specific set of metrics to be reported by all, it may be preferable to oblige management to provide responses to process questions such as these, backed by hard data to substantiate their answers. This would represent a huge improvement over the status quo. It would enable investors to distinguish companies that pursue a disciplined asset management approach to human capital from those who do not.

Competitive pressures to convince investors of the efficacy of their human capital management would spur management teams to make their reporting on human capital meaningful and compelling. And yes, the delineation of process envisioned here could be complemented by reporting on some basic measures of human capital management that have universal value and social significance – for example, measures relating to workforce demographics, pay equity, employee engagement, workforce productivity and innovation.

But these metrics would not be rendered in a vacuum. They would be but a part of a larger narrative designed to help investors understand the logic of the company's approach to human capital and, in the process, to make management teams themselves focus on the right questions and pursue their answers in the right way.

For many organisations, human capital is the largest single investment they make and the one they know least about. Fortunately, pressures are mounting for this to change. Advances in workforce sciences, the proliferation of workforce data easily accessed from Human Resources Information Systems (HRIS), and the rapid strengthening of workforce analytics capabilities make it possible, finally, for organisations to apply an asset management discipline to their human capital. Many companies have started to pursue this journey. In fact, many larger organisations are now creating in-house analytics functions to help guide management decisions about their human capital.

We are living in the age of human capital, where an organisation's workforce – both who it is and how effectively it performs — is often the principal and only enduring source of competitive advantage. In the face of this reality, it is imperative that organisations provide capital markets meaningful information about their human capital. Investors cannot possibly make informed decisions if they are in the dark about companies' management of their human capital assets. Greater transparency about human capital management is in the interest of workers too. Formally elevating labour to an 'investment' category recognises its importance to creating value and helps overcome the outmoded positioning of labour as the 'variable' cost of production.

Developing effective standards for human capital reporting is both the next frontier in the management of human capital as a discipline and the logical consequence of the changing nature of labour's contribution to the creation of economic value. Investors should be encouraging this development and leading the charge to have publicly-traded companies provide the information they need to make wise investment decisions. R&C

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