ICGN
International Corporate Governance Network

ICGN Viewpoint

Human Capital Management: Why investors should care and what they should look for in corporate disclosure

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How companies manage their employees, often referred to as human capital management (HCM), increasingly is seen by investors as material to long-term performance and risk mitigation and a key aspect of integrated business reporting that unifies financial and non-financial risk disclosures. Companies and institutional investors have begun to embrace reporting guidelines such as the framework offered by the International Integrated Reporting Council, which describes human capital as one of the six kinds of capital companies use to create value, along with financial, manufactured, intellectual, social and relationship, and natural capital. This Viewpoint explains why investors are interested in HCM and the kinds of corporate reporting they expect companies to provide on the topic.

Why HCM is material

Corporate policies and practices relating to issues such as health and safety, training and employee compensation, incentives and well-being are key aspects of a company's competitive strategy. They play crucial roles in employee satisfaction and motivation, leading to a more engaged workforce that produces superior products and services for customers. Effective HCM is important to innovation and adaptation to new technologies and is needed to help companies remain competitive in a global economy. It is an important driver of long-term value creation and recognized as such by the attention given by management.

HCM can have an impact on a company's reputation and the way it is perceived by current and prospective employees, investors and other stakeholders such as regulators and governments, communities and NGOs. Poorly executed HCM can create legal liabilities and undermine a company's relationship with its stakeholders. A negative organizational culture with misaligned compensation incentives has featured prominently in numerous corporate failures in recent years, including those that precipitated the 2008 global financial crisis. Superior people management can give investors confidence in a company's long-term outlook and inform their long-term investment decisions.

As a result, HCM is a material factor in a company's long-term financial performance and can be instrumental to both value creation and risk mitigation. Companies have long recognized this relationship. Every large global corporation has a variety of policies relating to one or more HCM issues, with health and safety and employee training among the most common.[1] Decades of academic and practitioner research have confirmed the materiality of HCM policies. A 2015 review of this literature identified 92 empirical studies

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[1] An analysis of the prevalence of HCM policies among global corporations can be found in: Bernstein, Aaron and Larry Beeferman, Corporate Disclosure of Human Capital Metrics, Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School, 2017, available at https://lwp.law.harvard.edu/files/lwp/files/pension_paper_corporate_disclosure_of_human_capital_metrics_102317.pdf.

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published since 1990. The majority of these found positive correlations between a wide variety of HCM factors and standard financial performance metrics, including total shareholder return, return on assets, return on earnings, return on investment, return on capital employed, profitability and Tobin's Q.[2]

Need for disclosure

Investors currently lack the consistent and reliable data they need to assess corporate HCM policies and performance, either individually or across industries and markets. This information is required to make informed decisions about investments, efficient capital allocation, and proxy voting, and to inform discussions with boards and executives about corporate strategy and competitiveness. There are only limited regulatory requirements for such disclosures in most markets. Investors seeking to make HCM assessments instead must rely on voluntary reporting that often tends to be boilerplate, supplemented by external and surveys reports analyzed by environmental, social and governance (ESG) data research firms. These methods are inefficient for investors, which find it difficult to conduct in-depth analyses of specific companies or to compare differing approaches amongst competitors. They are inefficient for companies as well, causing a growing chorus of legitimate complaints about survey overload.

There is also a lack of consensus about how companies should measure HCM or what they should disclose. However, this is changing rapidly. Several investor efforts have been launched in recent years to request HCM disclosure, each of which outlines overlapping metrics they want companies to disclose. A group of U.S. funds called the Human Capital Management Coalition has been requesting more disclosure since 2014 and in 2017 submitted a petition to the U.S. Securities and Exchange Commission asking it to require such disclosures. Analogous efforts have been mounted in the UK by the Investment Association, the Pensions and Lifetime Savings Association and ShareAction through its Workforce Disclosure Initiative. An even more ambitious undertaking was begun recently by an international corporate group called the Social and Human Capital Coalition.

These efforts recognize that companies already generate internal HCM data of interest to investors, particularly on key issues such as training and employee health and safety. Publicly disclosing the data therefore would not require burdensome new investments in data collection systems and reporting frameworks. Instead, a common assumption among these groups is that most companies do not report much HCM data at least in part because the investment community has not requested it.

Investors can best appreciate a company's approach to HCM if it is explained in the context of the firm's business strategy. Superior HCM consists of mutually reinforcing policies that function as a cohesive system integrated into the broader strategy. This understanding should be elaborated with key performance indicators (KPIs) covering relevant policies and their outcomes. Among the relevant information investors want to see are lost-time injury rates, per employee training budgets, the skills, composition and engagement of the workforce, staff turnover and health and well-being standards. KPIs

[2] The review can be found in: Bernstein, Aaron and Larry Beeferman, The Materiality of Human Capital to Corporate Financial Performance, Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School, 2015, available at: https://lwp.law.harvard.edu/files/lwp/files/final_human_capital_materiality_april_23_2015.pdf

should cover both direct employees and indirect ones such as contract workers, part-timers and temporary staff. Investors would be best served by a narrative account of a company's HCM approach in relation to its business strategy, buttressed by specific metrics. Companies should frame this discussion in the context of how their treatment of employees and use of human capital is connected to the other forms of capital they employ.

Board oversight

Directors should explain how they oversee the firm's HCM as a part of the overall business strategy and how it fits in to the company's use of other capitals, as well as the impact on the firm's reputation. This should include topics such as the composition of the workforce and the sustainability of the employment model. As BlackRock said in a statement about its approach to human capital*:*

"HCM is both a board and a management issue. We would expect a company's board to be deeply engaged in the oversight of a company's strategy and the defining of a company's purpose – to help ensure the effective strategic implementation of HCM throughout their organization. Companies that can better articulate their purpose are more likely to build strong relationships with their employees (and customers), and have a clear sense of their strategic objectives. These are essential components of long-term growth."[3]

Investor Next Steps

Investors should make use of HCM disclosures by companies and be prepared to engage with portfolio companies on these topics when relevant risks or opportunities present themselves. To help investors better understand a company's individual performance in this area, companies should disclose material HCM information to guide investor analysis and decision making. Such efforts should be complemented by investor requests to legislative and regulatory bodies to include HCM in corporate disclosure guidelines and rules.

Investors should ask companies to report on their HCM strategy through a narrative discussion, complemented with relevant metrics, which can take place in the context of an integrated report. In turn, firms should outline how their HCM approach relates to the company's underlying purpose and business model and explain the workforce-related risks and opportunities they anticipate, along with the board's response to them. They should describe how the way they have employed, engaged and managed their employees has contributed to corporate performance, as well as the impact workforce-related factors have had on value in relation to costs, productivity, quality and revenue.

Key performance indicators should be tailored to the company's specific HCM strategy and often will include baseline metrics such as:

- Employee engagement, union representation, work-life initiatives
- Investment in training and development
- Lost-time injury and fatality rates
- Pay ratios (across highest, media and lowest quartiles)

[3] Available at: https://www.blackrock.com/corporate/literature/publication/blk-commentary-engagement-on-human-capital-march2018.pdf.

- Turnover (voluntary and involuntary, internal hire rate)
- Workforce compensation and incentive plans
- Workforce demographics (full time, part time, agency)
- Workforce diversity.

A consistent approach to definitions of these metrics will enable investors to compare companies with one another on HCM factors, as they do in more traditional financial metrics. This is a challenge both for corporations and other standard setters addressing HCM and other environmental and social risk factors. ICGN hopes to work with standard setters and investors to make progress on HCM and other forms of ESG reporting.

About ICGN Viewpoints

This ICGN Viewpoints was prepared by ICGN's Disclosure and Transparency Committee, with Aaron Bernstein as lead author. ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to generate debate. While not defining a formal ICGN position on the subject. ICGN Viewpoints are produced by our member-led Policy Committees and we encourage dialogue by contacting Committee chairs directly or the ICGN Secretariat as follows:

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