Research report
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HUMAN CAPITAL REPORTING
Investing for sustainable growth

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Author
This report was written by CIPD, in conjunction with Pensions & Investment Research Consultants Ltd (PIRC).
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Executive summary

‘The value of intangible assets within organisations, such as human and intellectual capital, has increased significantly in recent years as the global economy has become more knowledge intensive.’

The value of intangible assets within organisations, such as human and intellectual capital, has increased significantly in recent years as the global economy has become more knowledge intensive. At the same time, a growing body of evidence highlights the relationship between high-quality leadership and people management, more engaged and resilient staff, and improved business performance. The pace of this development, though, has not been matched by companies’ ability and willingness to report on their human capital management (HCM) strategies, nor on how HCM contributes to their sustainable performance. This is also evident in the mainstream investment community’s lack of interest in HCM metrics and narrative reporting as a means of deepening their understanding of the capacity of their business to deliver sustained value-creation through their people. Fundamentally, Hesketh (2014) finds that the data is there, but the understanding and meaning of it is not articulated. This makes it difficult for the various stakeholders to the organisation to evaluate how well companies are managed for the long term. These findings echo those of the Labour Government’s Kingsmill Review (Kingsmill 2001), which found that even though good HCM was clearly crucial to organisational performance, it was routinely under-reported.

A clear majority of respondents believe that company reporting on HCM should be promoted and improved, and that the materiality of HCM should be discussed in annual reports. The majority also believe that the quality of HCM reporting is not as good as it should be and that current standards of HCM reporting are generally not fit for purpose.

While some organisations do present people-related data in their annual reports and elsewhere (for example corporate social responsibility reports), recent research (Hesketh 2014) revealed that very few companies communicate an integrated understanding of the capacity of their business to deliver sustained value-creation through their people. Fundamentally, Hesketh (2014) finds that the data is there, but the understanding and meaning of it is not articulated. This makes it difficult for the various stakeholders to the organisation to evaluate how well companies are managed for the long term. These findings echo those of the Labour Government’s Kingsmill Review (Kingsmill 2001), which found that even though good HCM was clearly crucial to organisational performance, it was routinely under-reported.

A clear majority of respondents believe that company reporting on HCM should be promoted and improved, and that the materiality of HCM should be discussed in annual reports. The majority also believe that the quality of HCM reporting is not as good as it should be and that current standards of HCM reporting are generally not fit for purpose.
None of the investors interviewed in this project expressed a desire to put the value of a company’s stock of human capital on company balance sheets. Emphasis instead was placed on companies understanding and communicating the value of HCM to the operating performance of a business. It’s evident that investors want to use HCM data in combination with other perspectives on company performance to develop a more holistic view of their investments.

Most respondents echoed findings from Hesketh 2014: that is, that the value of HCM data is materially enhanced by an understanding of the wider contexts of the data. They also asserted that HCM data was more likely to enable them to better understand and put a value on company performance in regard to potential downside risk, as opposed to envisioning cases in which companies might deploy HCM strategies to improve performance; to create and exploit opportunities; and to build competitive advantage.

Language remains a barrier to better use of HCM data. Confusion over HCM terminology and measures, continues to prevent better uptake of HCM reporting by organisations and investors alike. It is crucial to consider whether this is because stakeholders are unsure about where and how human capital management relates to human capital leadership and what role HCM reporting has in that regard. Even if this is the case, respondents expressed a strong demand for companies to provide better insights into how HCM relates to corporate culture, and how organisations should focus on reporting narrative accounts in a more consistent manner.

Other familiar barriers highlighted by this research include companies’ reluctance to report on areas in which their performance is poor. Yet, while many investors canvassed for this research implied that the poor state of HCM reporting might be attributable to corporate attitudes and behaviours, they were also universally confident of one other countervailing perspective: demand from investors for better HCM data is inadequate (some would say completely absent). That is, investors fail to encourage companies to provide better HCM reporting.

One key reason for this failure is that many investors are effectively ‘blind’ to such data. Even when companies do provide credible, clear and unambiguous HCM data that has the capacity to enable investors to better understand strategy, performance and valuation, such data is frequently ignored because many investors don’t recognise this information as powerful and pertinent.

Recommendations

This report suggests a series of recommendations for both increasing demand among investors for this type of information, and for improving practice among employers. This in turn will ensure that more
organisations generate, analyse and report on key HCM information to improve decision-making, justify investments in people, and demonstrate to external stakeholders they are led and managed for the long term.

What interested investors can do
- It is critical that investors interested in HCM ensure that such interest extends all the way down to the investment processes that determine how company performance is appraised and valued, and that fund managers are held to account in respect of providing evidence that HCM analysis factors in their processes.

What asset owners can do
- Asset owners who also believe in the value of HCM to company performance can ensure that the mandates they provide to investment managers require evidence that HCM performance is taken into consideration and evidenced within investment processes.

What gatekeepers can do
- Investment consultants that match asset owner demand to investment manager capabilities can also do a better job on behalf of their clients by requiring investment managers to evidence that non-financial factors of performance (such as HCM) are integrated into investment processes.

What professional education bodies can do
- Review curriculum to place more emphasis on the subject of business model configuration and strategy.

What reporting companies can do
- Companies need to ensure they present better information on HCM to external stakeholders such as investors by providing a clear narrative underpinned by key metrics.

The VyT partnership is committed to improving organisational practice in the area of HCM metrics and reporting both internally and externally by building on the findings of the VyT research and framework. This will involve further research to test and refine the framework, and further exploration of existing best practice and case studies, as well as of training and professional education among the HR, finance and general management communities.

What policy-makers and government can do
- There is a strong case for the creation of voluntary public reporting targets among FTSE 350 companies on agreed fundamental human capital metrics, as these would provide useful reference points for more insightful narrative reporting on human capital management and its links to business performance.
- In addition, government can lead by example by ensuring that consistent HCM reporting is embedded in the annual reporting of all public sector organisations as a means of providing more insight into how the public sector invests in, manages and develops its people to improve resilience and drive value for service users.

The availability of human capital data to businesses is increasing. It’s therefore somewhat surprising to see such a lag in the willingness of organisations to actively communicate it externally. There is also a gap in the capabilities of investors to appreciate human capital data and derive real value from it. While both organisations and investors note its potential, there is still some way to go before both groups benefit fully from human capital information.
Human and intellectual capital form a significant part of the competitive advantage of twenty-first-century organisations, and yet remain out of view for most firms’ critical stakeholders. Given the nature of the intangible assets involved, it is difficult for businesses and their stakeholders to properly assess an organisation’s effectiveness in terms of creating, transferring and deploying knowledge. This lack of visibility, coupled with an unstable and uncertain economic environment, can make it nearly impossible for organisations to articulate their true potential for creating long-term value.

Although the assets in question are difficult to manage and measure, their value is clear. Research by NESTA (Goodridge et al 2014) estimates that between 1990 and 2011, the value of intangible assets in the UK grew from £50.2 billion to £137.5 billion, while at the same time the value of tangible, physical assets has increased much more slowly from £72.1 billion to £89.8 billion (Figure 1). In 2015, intangible investment will be 50% higher than investment in tangibles (Hutton 2014).

Investment in intangible assets has, unsurprisingly, followed suit. Research by the OECD (2013) points to growing investment in knowledge-based capital over the long term when compared with other traditional forms of capital. In the UK, investment in knowledge-based capital grew throughout the 1990s, before dipping in the 2000s, while investment in tangible assets fell sharply over the period. By 2009, investment in knowledge-based capital was 34% higher than tangible investments.

The way in which businesses communicate the value of their assets through standardised annual reporting remained relatively static until 2007’s financial crisis sparked greater public interest in the way in which businesses are governed and operated. Various business failures – from mis-selling in the financial services sector to serious board failures resulting in the publication of incorrect results – mean that public and media interest is now directed firmly towards organisations and their leaders. There is growing public recognition that business disasters are not just the result of

![Figure 1: Tangible and intangible assets (£ billion)](source: Nesta Innovation Index 2014)
Integrated reporting

The recognition of the increased importance of human capital within organisations and its links to the other capitals that drive business value is reflected in the increasingly influential and global Integrated Reporting Initiative (IR). IR provides a format for organisations to report on how their strategy, governance, performance and prospects lead to the creation of value in the short, medium and long term. IR promotes a more cohesive and efficient approach to corporate reporting and aims to improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital. It highlights the complex inter-relationship between human capital and other capitals such as financial, manufactured and intellectual in creating value within organisations (IIRC 2013).

inadequate regulation, but also stem from scant understanding of very human business issues. The public is increasingly aware of and alert to the role of toxic organisational culture, poor people management and inadequate training in corporate failures over the last ten years.

In 2013 the Government published new regulations for narrative reporting, which amended existing company law (the Companies Act 2006 (Strategic Report and Directors’ Report) Regulations 2013). At the request of the BIS, the Financial Reporting Council published guidance (FRC 2014) for UK-based organisations supporting the new legal requirements to further promote better transparency on these high-risk, business-critical issues. Under the Regulations, medium to large publicly quoted organisations must produce a strategic report based around human capital issues, such as gender diversity and human rights, while small organisations must continue to report through the Directors’ Report (FRC 2014). The changes originated from two consultations on narrative reporting which proposed reinstating the operating and financial review process to ensure that social and environmental duties are sufficiently covered in organisation reporting (BIS 2010, 2011). The new guidelines indicate a socio-political shift towards more sustainable and transparent reporting, and have the potential to provide a standardised platform from which organisations can demonstrate the value of their human capital. However, business leaders are still free to decide that reporting on human capital management (with the exception of gender diversity) is not material to the development or performance of their business, so may choose to largely ignore this aspect of narrative reporting.

It is not only external stakeholders such as investors and regulators who benefit from more robust reporting of human capital.

‘It is not only external stakeholders such as investors and regulators who benefit from more robust reporting of human capital.’
Valuing Your Talent www.valuingyourtalent.co.uk

This emphasises how important it is for organisations to use a range of quantitative and qualitative measures – such as labour turnover or employee engagement levels – in order to offer a rounded perspective on business issues, and to help identify which sorts of HR or management practices will best drive sustainable business performance.

To enable human capital to be fully and effectively valued in business decision-making, there must be a change in mindset, competency, and culture within business at all levels. Recognition of how data on people, performance and behaviours links to financial performance and business success is key. It follows that there must be adequate competence within the finance and HR professions to recognise, develop and act on this insight.

CIMA’s Global Management Accounting Principles provide a framework to do this and build culture, leveraging financial and non-financial data to drive integrated thinking and behaviours within the organisation. These principles include effective communication which creates insight drawing on relevant information; enabling organisations and leaders to see the big picture by joining the dots; and practising stewardship to build trust – all of which must be tested against and also enable value-creation over the short, medium and long term (CIMA 2014).

For all these reasons, the professional body for HR and people development (CIPD), the UK Commission for Employment and Skills (UKCES), the Chartered Institute of Management Accountants (CIMA), the Chartered Management Institute (CMI), and Investors in People (IIP) have joined forces to improve the quality of HCM information and reporting. This includes a focus on both internal HR analytics to drive better business performance and external HCM reporting to improve transparency and deepen stakeholders’ understanding of what drives sustainable value in organisations, (see box on page 8).

For the partners, the purpose of such reporting is to improve companies’ ability and willingness to make strategic investments in people, and to improve how skills are deployed and how people are managed and developed – all with a view to helping to create more productive, sustainable and successful businesses for the future.

Initial research has been conducted by the partners as part of the joint human capital research programme, Valuing your Talent (VyT). Initial findings are that although some organisations do publish people-related data in their annual reports and corporate social responsibility reports, very few communicate an integrated understanding of the capacity of their business to deliver sustained value-creation through their people. Current reporting is also largely inconsistent in terms of regularity and constitution: with some data reported one year but not the next, for example, and with definitions differing across time periods (Hesketh 2014).

‘To enable human capital to be fully and effectively valued in business decision-making, there must be a change in mindset, competency, and culture within business at all levels.’
Valuing your Talent (VyT)

In July 2014, the VyT partners published significant new research which explored how organisations were using human capital management data and analysis to provide insights to inform executive decision-making, justify investment in people and drive sustainable business performance. Managing the Value of Your Talent: A new framework for human capital measurement (Hesketh 2014) helped create a new human capital management framework to enable organisations to improve how they generate, report and analyse HR data to support strategic investment in people.

Sponsored by the UKCES, VyT is a collaboration between the Chartered Institute of Management Accountants, the Chartered Management Institute, and the CIPD – three professional bodies representing the accounting, management and HR professions – together with the Royal Society for the Encouragement of Arts, Manufacturers and Commerce (RSA) and Investors in People (IIP).

The research drew on more than 60 interviews across the HR and finance functions of over 40 organisations in the UK. It concluded that, although business leaders have long stated that people are their greatest asset, wider stakeholders have become increasingly concerned with establishing the extent to which executives enable their people to succeed. In turn, leaders are increasingly required to offer much greater insight into the strategic imperatives of their organisations and the value drivers underpinning their business models.

HR leaders, CFOs and other members of the finance community interviewed for this research placed human capital at the heart of such an understanding, and expressed the need for companies to deliver a much clearer line of sight through to an organisation’s relationship with its people. This included gaining understanding of cultures and behaviours critical to both sustainable performance and to risk, as well as how organisations are building resilient and diverse workforces for the future.

VyT also highlighted the challenges inherent in capturing and understanding human capital data. Beyond core quantitative metrics, which themselves are not consistently defined, much human capital data is qualitative and subjective. It is the combination of hard data (such as employee turnover) and soft data (for example, from employee engagement surveys) that can provide useful insights into what drives value, organisational culture and people risk. It is the art of the executive to consider and use that data to improve how investments in people are made to support sustainable performance. The value of a consistent and clear narrative is also illustrated in the report’s case studies, and highlighted by Peter Cheese, CEO of the CIPD:

Organisations should report a narrative with some common underlying metrics that gives insight on the makeup of the current organisation and workforce (headcount and demographic type data, labour costs), how it is changing (for example, recruitment, retention rates), how it is developing (for example, investments in training, progression rates), and some insight on the cultural and organisational dynamic which engagement can be an indicator of (Hesketh 2014).

To understand the perspectives of the investment community, the research also drew on information from a roundtable discussion with members of the investment community conducted in partnership with the National Association of Pension Funds (NAPF). This found that one of the principal barriers to better HCM reporting exists in the form of a ‘chicken and egg’ problem. Companies are not providing better data because investors, who are the principal audience for such information, are not asking for it, while investors are not valuing or scrutinising HCM data because the amount, quality and type of information reported externally is poor.

The VyT partners are using the research and framework as a basis to improve human capital reporting among organisations. Further research is planned to test and refine the framework with organisations of different sectors and sizes.
About the research

This report is designed to explore in more detail the views and perspectives of members of the investment community and those who work with it on the issue of human capital management reporting. The VyT partnership commissioned governance and responsible investments consultancy Pensions and Investment Research Consultants (PIRC) to conduct a series of interviews, then collate and analyse the resulting insights.

Sixteen interviews were conducted, which included seven participants from the socially responsible investment (SRI) or environmental, social and governance (ESG) sphere and three from more mainstream investment backgrounds. The sample was largely self-selected as it proved difficult to recruit a good balance of interviewees from the wider investment community. It also drew on interviews with academic experts on this subject, and from a representative of the Financial Reporting Council. They were asked their views on the potential value of HCM information in terms of providing insights into business value or risk, the state of existing practice, and on barriers to improving reporting. Interviewees were also asked their views on the utility of four key measures recommended for external reporting by the VyT research (see Table 1).

Definitions

While there are various academic understandings of the definition of human capital, the following broadly established definitions were used during the interviews:

- **Human capital** describes the value of people at work and their collective knowledge, skills, abilities and capacity to develop and innovate.

- **Human capital management** enables organisations to make more productive use of people through measurements, analysis and evaluation rather than guesswork. It provides guidance on the development of HR and business strategies that enable improvements in levels of employee engagement and business performance by such means as better selection, training and leadership.

- **Human capital management reporting** aims to provide quantitative as well as qualitative data on a range of measures (for example labour turnover or employee engagement levels) to help identify which HR or management practices drive sustainable business performance.

Table 1: Four key HCM measures

<table>
<thead>
<tr>
<th>HCM metric</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total cost of workforce employed (including contingent labour)</td>
<td>Discussions over the capacity of some firms to obtain greater return than others on their investment in people cannot take place when we do not have the denominator with which to work out the ‘people equations’ (that is, common definitions of headcount measures).</td>
</tr>
<tr>
<td>Recruitment costs</td>
<td>The extent to which employees remain in or leave the organisation (their staff ‘churn’) provides an important lens on the ‘operational momentum’ of a business.</td>
</tr>
<tr>
<td>Total investment in training and development</td>
<td>Winning the war for retaining talent requires greater line of sight for stakeholders into the scale of investment made in the development of talent.</td>
</tr>
<tr>
<td>Employee engagement survey scores</td>
<td>Given the evidence that the financial performance of organisations is positively related to the extent to which they engage their employees, we need a clearer line of sight to the ongoing nature of the relationship between organisations and their people.</td>
</tr>
</tbody>
</table>
Analysis of results

The respondents canvassed in this study were mostly predisposed to favour more frequent and better-quality HCM reporting because of their backgrounds in socially responsible investing or environmental, social and governance investment. They considered the suggested standardised metrics on which companies might report more consistently as representing a step forward in HCM reporting.

Nonetheless, our research suggests that better HCM reporting alone is unlikely to create a virtuous circle in which a critical mass of investors sees the value in such metrics and communicates additional demand for better HCM reporting. This is because a significant proportion of investors are blind to the importance and value of such data even when they are clearly presented to them.

How to address this? The report’s conclusions propose some possible ways forward. For example, the problem of the lack of investor demand for HCM data might be addressed by providing more examples of its value, by enhanced investor education, and by greater pressure from asset owners and employee benefits consultants to actively use HCM data. The VyT programme can, over time, help improve the quality of HCM reporting and analysis within organisations, and the adoption of voluntary reporting standards could encourage more organisations to report externally on these matters.

Investor perspectives on HCM and HCM reporting

A clear majority of those interviewed for this research believed that company reporting on HCM should be promoted and improved, and that material HCM matters should be discussed within annual reports. The majority also believed that current HCM reporting is of substandard quality and that standards of HCM reporting with which they’re familiar are generally inadequate when it comes to effectively demonstrating the value of human capital.

Most respondents were careful to point out the supremacy of the annual report versus the corporate social responsibility (CSR) report in regard to reporting HCM data:

- Disclosure in the annual report would affirm a board’s view of the material nature of any HCM data that gets reported.
- HCM data in the annual report would (‘hopefully’) be audited.
- It would more likely be considered by those that buy and sell shares if presented in an annual report.

The reality is that most mainstream financial analysts and fund managers do not read separate CSR reports for companies.

David Russell, Co-Head of Responsible Investment, USS Investment Management

Not one of the investors interviewed in this project expressed a desire to put the value of a company’s stock of human capital on company balance sheets. Indeed, most respondents aired views that aligned with those articulated by their fellow respondent, Chris Higson (a professor in accounting practice at London Business School), who argued for greater use of human capital data as a method of reporting and strategic management: ‘Let’s not argue about putting the value of human capital on the balance sheet. That’s too difficult. But let’s work up a scorecard that allows you to understand its contribution and performance.’

Emphasis instead was placed on companies linking the value of HCM to the operating performance of a business. Even if most did not frame their interest in respect of developing an HCM scorecard, they did express a desire to use HCM data in combination with other perspectives on company performance to develop a more holistic view of their investments.

Interestingly, fund managers and analysts who were interviewed for this project, but would not align themselves with members of the responsible investment (RI) community, recognised that elements of their appraisals of corporate performance and valuation incorporated analysis of HCM factors and metrics.
Most respondents echoed findings from previous research which illustrated that the value of HCM data is materially enhanced by an understanding of the broader narrative of the business. For instance:

In this area there is always going to be a role for more narrative reporting. It is useful to know the staff turnover figure, but you want to know why it is at that level, what the baseline for that industry is. If there has been a move up or down, why that has occurred, has there been a business restructuring or has it been that the staff have become more dissatisfied over the past year?

Kate Elliot, Ethical Researcher, Rathbone Greenbank Investments

Some called on companies to go further than is currently the case in this regard: to provide investors with supporting context that would enable them to make better sense of HCM data. Others believed that HCM disclosure was simply the starting point in a process in which the onus was on them to conduct the research and have the conversations that might expand on its materiality to business performance.

Investor focus on HCM as risk management versus value-creation

A lot of investor focus is on what might go wrong to reduce the value of my investment and what a company is doing about that risk. I suppose the downside is more immediately obvious than the upside.

Chris Hodge, Executive Director of Strategy, Financial Reporting Council

Many respondents invited to discuss whether HCM data and HCM reporting enabled them to better understand company performance and evaluate a company’s worth offered the opinion that it is easier to equate HCM with financial performance on the downside rather than the upside, and that poor HCM performance would likely be a reliable indicator of poor financial performance in the future.

Indeed, there was an overwhelming tendency amongst respondents to discuss HCM in respect of corporate risk management – as opposed to envisioning cases in which companies might deploy HCM strategies to improve performance, to create and exploit opportunities, and to build competitive advantage (see Appendix 1).

It’s hard to say that one HCM factor will inevitably lead to outperformance, and harder still to say that it will lead to outperformance over a timeframe that most fund managers are interested in.

Dr Raj Thamotheram, CEO, Preventable Surprises

The tendency to look to HCM measures when all others fail was concisely highlighted by one global head of RI:

It’s just one piece of the jigsaw and it tends to only come into focus when things appear to be going or have gone wrong.

Will Oulton, Global Head of Responsible Investment at First State Investments

Many respondents predictably cited health and safety data as important to building an understanding of corporate risk management. Indeed, a majority of those interviewed appeared both content with corporate health and safety data disclosure and willing and able to use such data in their analysis of companies that operate in sectors where health and safety has a high profile – in the mining industry, for example.

There’s a lot more data on health and safety than most other aspects of HCM and fund managers are more likely to take notice of this, particularly if fatalities have occurred.

David Russell, Co-Head of Responsible Investment, USS Investment Management

Investor views on key metrics

The Managing the Value of Your Talent (Hesketh 2014) report recommended that all organisations should report on four core HCM measures. These are:

1 total cost of workforce employed (including contingent labour)
2 staff recruitment and turnover costs
3 total investment in training and development
4 employee engagement survey scores.

The research explored interviewees’ views on these suggested key metrics.
Total cost of workforce employed (including contingent labour) data

A lot of our members in the last six months have expressed a desire to know more – even basic information such as how many people a company employs, which can often be hard to find.

Will Pomroy, Policy Lead: Corporate Governance, NAPF

While Managing the Value of Your Talent (Hesketh 2014) anticipated that the investment community would be interested in data that can communicate the total cost of workforce employed, respondents did not state in interviews that they would use the data to calculate the organisation’s return on investment in its people. A majority, however, did express interest in the metric.

Some companies’ disclosure is very poor. Even as far as failing to report on the number employees they have. While I think that’s rare now, we do have cases where transparency of human capital management is very basic or non-existent.

Amanda Young, Head of Responsible Investment, Standard Life Investments

One additional respondent believed the metric to be of great value in respect of enabling an accurate assessment to be made of the cost of workforce versus the pay-out paid to shareholders in dividends. The same respondent believed that this calculation would be even more accurate if any total cost of workforce employed metric data were supported by disclosure of any employee restructuring costs in the period.

Views on recruitment cost data

We pick up the industry standard churn over time. In the recruitment industry if you get above a churn of 30%, it’s either telling you something about culture or it’s telling you something about training and re-training [costs].

Adam McConkey, Director, Henderson Volantis Capital

The majority of respondents expressed specific interest in greater company disclosure of staff turnover data, although none made explicit the link between this data and the information that might be provided by employee engagement survey data. The individuals who were accustomed to analysing and valuing people-intensive businesses (as above) also considered staff turnover data to be potentially valuable to their understanding, even though the data was not always easy to obtain.
In one case, the individual’s interest in these metrics arose from a desire to understand the culture of the organisations in which he might invest – where, for him, staff turnover measured against an internally calculated industry standard could be a useful indicator of a healthy or poor company culture.

We are trying to build a picture of the current perception of the company’s sustainability, which is reflected in its value. What we’re trying to test is whether the culture, or the business reality, is aligned with that perception and if there’s a disconnect: which either becomes an alarm bell or a green flag.

Adam McConkey, Director, Henderson Volantis Capital

Views on total investment in training and development data

Most companies give some narrative around training and development, but drawing anything useful out of what is reported is quite often very difficult.

Will Pomroy, Policy Lead: Corporate Governance, NAPF

One fund manager volunteered that he might look at the level of a company’s investment in training and development in combination with other metrics such as R&D spend in order to ascertain which companies have continued to invest in sustaining their performance during the downturn (and therefore which would grow more quickly during a recovery).

Another respondent reported having embedded training and development data into a quantitative fund that seeks to outperform the stock market using HCM data, and a third (asset owner) sought granular data on the degree to which companies invest in employee training and development with a view to ensuring that staff have the opportunity to secure sequentially higher levels of responsibility within the organisation, or to pursue skill acquisition that is important to them, which fits with their aptitudes.

Companies should be thinking about how they train people to do jobs that are more skilled. Not just looking short term and trying to have the right people in the right jobs for current performance – but how they develop their staff to deliver future performance. ... It’s very difficult to get a picture of that. You can look at internal mobility – some companies provide information on that but it’s not easy to interpret.

Jean-Philippe Rouchon, SRI Analyst, ERAFP

Outside of these, respondents generally expressed difficulty in knowing what they might do with training and development data. Some considered such information as input data only, which tells people very little about business outcomes. Others reflected on comparability issues between companies and questioned the value of the data on this basis. Most also expressed a desire for additional, related data such as demographic data relating to existing and required skillsets within an organisation – the number of engineering staff aged over 55 in an oil and gas company, for example – as this might help inform them of the sustainability of key human capital resources.

Views on employee engagement survey score data

Interviewees were split on the question of employee engagement data, with some regarding it as a useful proxy for employee motivation and others seeing it as too subjective and easily gamed.

It wouldn’t get a second look ... there’s no way the narrative in a report and accounts is ever going to be anything other than positive. You can largely discount it as a sales blurb.

Sell-side analyst

Employee engagement is not a magic bullet indicator of future share price performance but it is very relevant. Discontented employees do not make for good customer care, and poor morale also impacts innovation – so it’s important at both ends of the performance spectrum.

Dr Raj Thamotheram, CEO, Preventable Surprises

In Managing the Value of Your Talent, Hesketh (2014) accepts that employee engagement survey data might be the most contentious of the metrics on which it was encouraging more external reporting. It noted research that explores the relationship between employee engagement and organisational performance, but it also observed that many in the financial community feel uneasy about a potentially subjective data point.

This proved to be the case from feedback from interviewees in this research. The idea of encouraging greater external reporting of employee engagement survey scores encouraged far greater discussion amongst respondents than any of the other three metrics being investigated.

Frequently informed by experience of participating in employee engagement surveys in their own places of work, and seeing how (in their opinion) management may sometimes publish survey scores...
in ways that show a company in its best light, many respondents had reservations about the robustness and objectivity of such data.

I won’t participate in it [the employee engagement survey] anymore. When I’m presented with those questions rarely have I seen one that is well configured and if it’s not well configured, it’s asking the wrong questions.  

Anonymous contributor

That said, informed by a perspective that the context in which an individual performs frequently has an overwhelming influence on that person’s behaviour, a minority of respondents offered the countervailing opinion that employee engagement survey data had the potential to offer valuable insights into this aspect of company performance.

The engagement data gets to motivation and the context in which people work. You’d have to delve into it a bit, but it should do.  

Dr Zella King, Executive Fellow, Henley Business School

The fundamental issue with the data appears to be with doubts over the consistency of approach across companies. Relatedly, several respondents suggested that if a standard approach to capturing and reporting employee engagement scores could be developed, the data could be useful to investors. That said, there was no push from investors to clarify which of the engagement measurement systems in the market is most appropriate, nor how to build the standard measure of engagement.

I think a measure of both employee engagement and employee satisfaction would be very important – with the qualification that you want to know the question that has been asked, so it is not one of those leading questions where a company almost gets the answer it wants.  

Kate Elliot, Ethical Researcher, Rathbone Greenbank Investments
Exploring barriers to better human capital reporting

Most investors are interested in the number and the hard facts and rightly so. The numbers are important. And that can sometimes be frustrating from cultural aspects that drive so much of that success and are critical to the sustainability of it. Cultural aspects and ROI can be long term and sometimes difficult to report and that’s why you have to have the belief that you are doing the right things culturally even if they are unseen through reporting.

Kathy Sharkey, Chief People Officer, DX (Group) plc

Some respondents felt that confusion over terms could provide an obstacle to improved human capital reporting. All respondents felt that the definition of human capital set out for the purposes of this research approximates their own (or makes sense, if they had not previously conceived a definition of the term).

For example, citing prior experience that sought to encourage companies to better external reporting on brand value, Professor Chris Higson at London Business School expressed the opinion that, unless an agreed taxonomy on HCM exists, the absence of commonly understood terms would always hold back better reporting.

Kate Elliot, Ethical Researcher, Rathbone Greenbank Investments

There’s a lot of attention being paid to culture at the moment for obvious reasons. That and risk may be the best way into this discussion – but it’s one of the most difficult things for board members to get a handle on. They might have an excellent statement of values coming out of the board but they struggle with knowing to what extent it’s actually being embedded in the company, and finding a way of reporting that which gives them and shareholders comfort on these issues is a real challenge.

Chris Hodge, Executive Director of Strategy, Financial Reporting Council

If you don’t set the culture and the tone from the top, at board level, then it won’t feed through to your HCM strategy. The culture of a company is essential. A certain culture requires a certain type of individual to be recruited. I just think that culture is not something that can be easily measured by a company’s accounting firms, for instance.

Amanda Young, Head of Responsible Investment, Standard Life Investments

Several respondents believed that one of the principal barriers to better HCM reporting exists in the fact that ‘companies are reluctant to provide more information on something they do not manage very well today’ (to use the words of Jean-Philippe Rouchon, SRI Analyst at ERAFP). While this theme occurred throughout a number of interviews, no respondent was able to expand on the reasons why such reluctance exists in the business community.

Others echoed prior opinion, which has been expressed on this subject to the effect that the HR function is not well placed within companies in respect of raising the profile of HCM issues.

I think that there is a disconnect about what boards think about their employees and what’s actually happening on the ground. … While the HR function is probably one of the key parts of a business, it’s often treated as a support function as opposed to a strategic function.

Amanda Young, Head of Responsible Investment, Standard Life Investments

And, as is frequently the case when corporate reporting is discussed, the issue of sensitivity around disclosure was raised as a potential reason for companies being unwilling to share certain data. For example:
You can certainly see the value of employee engagement survey data for the management and the board, but I’m not sure how comfortable they would be sharing that.

Chris Hodge, Executive Director of Strategy, Financial Reporting Council

Yet, while many were inclined to suggest that the poor state of HCM reporting could be attributed to corporate attitudes and behaviours, respondents were also universally confident of one other countervailing perspective: demand from investors for better HCM data is wholly insufficient (some would say completely absent) in respect of encouraging companies to provide better HCM reporting.

Why investors are blind to the value of HCM data

One reason this research identifies for the lack of interest in HCM data amongst the mainstream investor community is that many investors are both so focused on other types of data and, simultaneously, so unaware of the potential value of HCM information that they simply don’t consider it, even when it is presented to them.

There’s an apocryphal story about how, when the native Aborigines first met the settlers, they could see the [white] people but not their ships. They had never seen ships and weren’t “looking” to see them. I fear it’s similar for financial analysts and HCM. Given how most analysts are selected, trained and remunerated they are at a big disadvantage in seeing anything that is “non-financial”, even if it’s very business relevant.

Dr Raj Thamotheram, CEO, Preventable Surprises

The decision-making environment in which fund managers and investment analysts operate is one of the most complex of any profession. As such, it contains far too much information for practitioners to depict clearly and succinctly, even if they’re able to draw on their specialist knowledge.

To achieve some measure of clarity, their attention systems therefore select a subset of the available data on which to focus. By helping them focus on some things and filter out others, the subject of their attention distils the possible universe of data they might look at into their universe of relevant data (Gallagher 2009). This means they can become blind to the data they choose not to pay attention to, even when it is in their presence (see Appendix 1).

So, how does an investor determine what information to pay attention to (and, in effect, what to ignore)? The answer to that question depends on the investor’s experience – for it is the patterns that we have learned to store in our long-term memories that overwhelmingly determine how we perceive the world and make decisions (Klein 1999).

The example of Halfords (see Appendix 1) demonstrates that it was the arrival of a new CEO (Matt Davies), in 2013, with experience of running an organisation which placed a premium on customer experience that meant he recognised a strategic problem that demanded an HCM solution when he arrived at Halfords.

He already perceived the world through a customer experience lens, and cemented the value of investing in staff recruitment, training and development and employee engagement in this respect through his previous experience as CEO of Pets at Home (where he faced another Halfords-like challenge).

Without such patterns there is no recognition – only blindness. In the same way, many investors are unable to see value in HCM data because they have no stories in their memory banks of HCM explaining company and/or share price performance: hence they are not expressing any demand for such data.

If the Accounting for People report (Kingsmill 2003) was able to declare ‘This is the moment when HCM takes its place in the Boardroom,’ it does not appear to be the case that HCM has yet taken its place in the investment processes of those that place a value on company performance.

It may be in the consciousness of some practitioners. But it is not yet in pattern recognition systems. As another respondent observed of the larger spectrum of professionals in the investment management industry: ‘They’ve never worked in anything other than the financial industry … so when the right carrot is dangled in front of them they don’t recognise it as a carrot.’
The role of regulation

In light of the current poor state of HCM reporting that respondents agreed is not as good as it could be, some supported a regulatory approach as a prospective solution, which would require companies to report certain mandatory HCM data.

*Given that we’ve had the Kingsmill Review [Kingsmill 2001] 14 years ago and 12 years of voluntary effort since the Accounting for People report [Kingsmill 2003] and achieved very little, regulation has to be part of the solution to better reporting, as it is in some European countries like France and Denmark.*

**Dr Raj Thamotheram, CEO, Preventable Surprises**

*It is almost the last stage in the process. We’ve seen it with greenhouse gas emissions disclosure, where a few leading companies will move first and disclose voluntarily and then you have initiatives like the CDP that create pressure and encourage the bulk of companies to report. But you are always going to have a few that don’t respond to these voluntary measures and that is when regulation can play a role – in closing that final gap.*

**Kate Elliot, Ethical Researcher, Rathbone Greenbank Investments**

*Benchmarking companies is a good way to wake them up. No company wants to be seen to be worse than its competitors. This makes benchmarking a very useful tool.*

**Amanda Young, Head of Responsible Investment, Standard Life Investments**

*A number of supporting views also favoured mandatory HCM reporting because of company reluctance to be seen to be managing badly.*

Nonetheless, this subject also divided opinion: a number of respondents suggested that companies should be left free to report on the HCM factors they believe to be most relevant to their businesses – which may, or may not, include metrics that others believe should be standardised across industries.

We are interested in companies reporting on material risks and opportunities to their business and the decision about that materiality should be left with the board … that would mean for varying companies there would be a varying need for reporting on human capital issues, depending on the sector, the size of the employee base and the skills and attributes.

**Andrew Ninian, Director of Corporate Governance and Engagement, The Investment Association**

Benchmarking of HCM reporting was also considered by others as a useful way of encouraging higher standards, not least because companies are reluctant to appear near the bottom of any related ranking.
Recommendations – where to next?

It is apparent that companies cannot rely solely on the provision of better data through using the four metrics considered in this study to improve the quality and frequency of HCM reporting. The solution needs to address the demand side of the problem as well as the supply side: investors must be equipped to both query using HCM-focused questions and analyse using HCM data.

Indeed, investors were generally unable to articulate any value-creation stories of HCM in action and/or to provide compelling evidence of cases in which HCM insights have enabled them to better understand company performance and valuation. It appears that, for now, many investors remain unaware of the potential value of human capital data. Even for those investment professionals who have a keen interest in the subject, HCM is still so abstract that it’s difficult for them to extract specific value from HCM metrics – including those that were the subject of this exercise.

What interested investors can do

Aside from demonstrating downside health and safety risks and obvious instances in which high staff turnover can draw attention to poor performance, it seems clear that even those investors most interested in HCM have not seen examples of HCM creating value in action.

One reason for this may be that the responsible investment professionals charged with promoting the HCM agenda are not the same staff that manage investment portfolios, making it possible that the HCM stories might exist within one community but not the other.

Although this is doubtful, there is still an onus on investors who believe HCM can make a difference to company performance (and who also want to encourage better HCM practice) to build a bank of case studies so that patterns of HCM in action are easier to recognise.

The fact that stories of health and safety risk management exist today, where (arguably) none existed ten years ago, and that both investors and companies can now have extended dialogues on this subject, shows this can be done. But it is critical that investors interested in HCM ensure that such interest extends all the way down to the investment processes that determine how company performance is appraised and valued, and that fund managers are held to account in respect of providing evidence that HCM analysis factors in their processes.

What asset owners can do

Asset owners who also believe in the value of HCM to company performance can ensure that the mandates they provide to investment managers require evidence that HCM performance is taken into consideration and evidenced within investment processes.

On the basis of the interviews we conducted – and the absence of stories of HCM in action – it appears that some asset owners (at least) are not doing this to the extent that is required to encourage HCM patterns to emerge within the investment management industry.

What gatekeepers can do

The investment consultants that match asset owner demand to investment manager capabilities can also do a better job on behalf of their clients. On the basis of the evidence available here, the bar is currently being set low in respect of requiring an investment manager to evidence that non-financial factors of performance (such as HCM) are integrated into investment processes.

What professional education bodies can do

The subject matter covered in the qualifications that many investors must acquire in their formative years can shape their beliefs about how companies create value and how they are valued by investors.

Current investor education appears light on the subject of business model configuration and strategy (other than how an industry context can shape performance from the outside in, vis-à-vis Michael Porter’s five forces (Porter 1979)); this may well be an important omission.

If investors do not form early beliefs about how different business models work, and view strategy as an inside-out means of overcoming barriers to success, investors are
naturally biased towards overlooking the value of HCM data which may illuminate critical aspects of company performance and essential elements of strategic success.

**What reporting companies can do**

Clearly, if corporate reporting is about helping investors make sense of business performance, companies’ best interests are served by providing the relevant data to do this – including HCM data.

Mainstream investors are not interested in making sense of business performance, however. They are interested in forecasting performance – and this makes a material difference to what investors want companies to report.

That is, for such investors:

- Any data that does not help them make a forecast of future business performance (for some) and share price performance (for all) are classified as noise (and ignored).
- Data that they perceive helps them make these forecasts are classified as information (and frequently devoured on that basis).

It seems clear that a large part of the investment management industry is failing to see the value in HCM data, and is therefore treating it as noise that can be ignored rather than information that should be attended to. In those circumstances, companies may be advised to present HCM data in a way that more clearly supports investors in making forecasts of business performance.

The VyT partnership is committed to improving organisational practice in the area of HCM metrics and reporting both internally and externally by building on the findings of the VyT research and framework. This will involve further research to test and refine the framework, and further exploration of existing best practice and case studies, as well as of training and professional education among the HR, finance and general management communities.

**What policy-makers and government can do**

Given the poor standard of current HCM reporting, the VyT partners believe there is a strong case for policy-makers to intervene and encourage more regular public reporting of an agreed core of human capital data. There is enough interest from the interviewees who participated in the research for this report to suggest that the four key metrics investigated in this research are well worth further consideration for this purpose.

In addition, government can lead by example by ensuring that consistent HCM reporting is embedded in the annual reporting of all public sector organisations as a means of providing more insight into how the public sector invests in, manages and develops its people to improve resilience and drive value for service users.

Looking ahead, the VyT partnership believes there is a strong case for the creation of voluntary public reporting targets on agreed fundamental human capital metrics, as these will provide useful reference points for more insightful narrative reporting on human capital management and its links to business performance.

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1 Michael Porter is the Bishop William Lawrence University Professor at The Institute for Strategy and Competitiveness at Harvard Business School and is a leading authority on competitive strategy. His five forces analysis is a framework to analyse level of competition within an industry, with a view to informing business strategy development. It describes five forces that determine the competitive intensity and therefore attractiveness of an industry in terms of: the threat of substitute products or services, the threat of established rivals, and the threat of new entrants, and the bargaining power of suppliers and that of customers.
Appendix 1: Case study
Valuing your Talent at Halfords

‘We’re not doing this out of the goodness of our hearts. We’re not training people for the sake of it. We are training people so that we can leverage that experience to drive sales. That’s the strategy.’ Matt Davies, CEO, Halfords

Halfords, a specialist retailer of leisure and car products, provides a useful current case study of effective human capital management reporting in action and demonstrates the importance between the successful alignment of business and HR strategy underpinned by clear HCM measures.

In May 2013, the new CEO of Halfords, Matt Davies, took the opportunity, during a discussion of the company’s preliminary results to investors, to reveal the board’s strategy to restore performance in the company to what he believed would be a permanently higher level (Halfords 2013).

Addressing an audience of investment analysts, and combining narrative and data in a way that would later be supported in the company’s 2014 annual report, Davies took considerable care to describe the strategic challenges that explained Halfords’ poor performance to date, and the human capital-centric means by which he intended to transform the company’s performance.

With around 70% of its customers requiring some form of advice in order to make a purchase, Davies confirmed that Halfords was a speciality retailer. ‘Specialism is something we should celebrate,’ he said. ‘That’s our business. We’re experts.’

Yet Halfords’ customer satisfaction rating measured using a Net Promoter Score (NPS) ranked alongside that of low-cost organisations competing on price and generalist retailers that compete on assortment and range: not on expert service (see opposite).

And because previous management teams had failed to recruit the right staff and to equip employees with the product knowledge required in their role – and because they had failed to embed a service culture into the company – Halfords had left itself vulnerable to competition from business models that were not encumbered by high staff and product choice costs.

Pointing to data that showed that more than 20% of Halfords’ staff left the company in the first three months of their employment, Davies explained that measures such as employee turnover have historically illustrated a significant challenge for the business:

‘Recruitment, training and retention of great people has not been part of Halfords’ core focus in recent years. We consequently have a large churn of people. All the time people are leaving and joining, leaving and joining; it’s like a merry-go-round.’

That explained why Halfords had experienced declining like-for-like sales in 10 of the 13 quarters prior to Davies joining the company – and why his diagnosis of the strategic challenge that confronted Halfords focused on recruitment, on training and development, and on employee engagement.

Although prior management could not see the solution, the treatment Davies arrived at was simple. He had ‘never seen a specialist retailer where expertise is more important than Halfords’ and the new level of service to which he was aspiring would be something that Halfords’
main competitor – supermarkets
– would never be able to deliver,
and something which would give
Halfords a clear advantage over
online-only competitors that have
no stores or colleagues on the
ground. His message to investment
analysts was clear:

‘So what we need to do is we
need to engage our colleagues,
as we know that highly engaged
colleagues result in satisfied
customers. So our programme
makes recruitment development,
and retention of people, a core KPI.
This particular investment will be the
most important investment we make
in the next three years.’

In all, Halfords would invest around
£50 million over the period to
improve staff recruitment, training
and retention processes.

Davies funded Halfords’ investment
in HCM and additional investment
in store refurbishment and digital
strategy by cutting the company’s
dividend by 35%. That got the
attention of investors, who marked
the company’s share price down
by up to 19% on the day of the
announcement.

However, based on the questions
Davies received from the sell-side
analysts to whom he unveiled his
strategy, very few appeared to see
the value in the HCM narrative that
Davies related to them. In the hour
or so that followed his address,
Davies fielded around 22 questions
from the audience – only three of
which could be said to be related
to the training, development and
retention issues that he said were
absolutely central to Halfords’
strategic differentiation and
performance.

Analyst questions were more
concerned with:

• How much space would
Davies be dedicating to parts,
accessories and clothing?
• What would be the cost saving to
Halfords from its business process
technology investment?
• How do the company’s price
points compare with the
competition?
• What will happen to square foot
expansion?
• What is the revenue split
between high-end and low-end
bicycles?
• What would the company’s level
of capital expenditure be going
forward?
• What would the depreciation
charge be over the course of the
company’s capital expenditure
programme?
• What would the change in rental
on new store leases be?

Echoes of those questions have
accompanied every discussion of
Halfords’ results ever since, and
even Davies himself stopped talking
at length about his company’s
HCM strategy when he addressed
analysts.

Afterword
A great deal has happened to
influence the business and share
price performance of Halfords since
Matt Davies gave his initial address
to analysts in May 2013 – including
Davies being recruited as CEO of
UK and Republic of Ireland Retail at
Tesco.

Commenting on results at Halfords
in May 2014, Davies accepted there
were many contributory factors
to like-for-like sales growing at a
rate of 6.8% when the company
reported its interim results for fiscal
year 2015 (Halfords 2014a) (and in
the appreciation of Halfords’ share
price from a closing low of 339.3p
on the day Davies announced
the dividend cut to over 460.0p
the day before he announced his
departure to Tesco). Yet he was
also convinced that the investment
he made in recruitment, in training
and development and in employee
engagement was a major factor
in the company’s improved
performance (Halfords 2014b).

For example, Davies was also able
to report that staff turnover at
Halfords had fallen from around 21%
to just over 10% in the first year of
his HCM strategy; that colleague
engagement had risen from 64% to
80% over the same timeframe, and
that the company’s NPS score had
increased from around 55% in the
previous year and was on its way
to a score of above 75% (Halfords
2014b).
Appendix 2: Contributors

We are grateful for contributions from the following (although ultimate responsibility for the text lies with the VyT team):

DX (Group) plc
Kathy Sharkey, Chief People Officer

ERAFP
Jean-Philippe Rouchon, SRI Analyst

Financial Reporting Council
Chris Hodge, Executive Director of Strategy

First State Investments
Will Oulton, Global Head of Responsible Investment

Henderson Volantis Capital
Adam McConkey, Director

Henley Business School
Dr Zella King, Executive Fellow

The Investment Association
Andrew Ninian, Director of Corporate Governance and Engagement

London Business School
Professor Chris Higson, Associate Professor of Accounting Practice

National Association of Pension Funds
Will Pomroy, Policy Lead: Corporate Governance

Merseyside Pension Fund
Linda DesForges, Investment Manager

Preventable Surprises
Dr Raj Thamotheram, CEO

Rathbone Greenbank Investments
Kate Elliot, Ethical Researcher

RPMI Railpen Investments
Deborah Gilshan, Senior Investment Manager

Standard Life Investments
Amanda Young, Head of Responsible Investment

USS Investment Management
David Russell, Co-Head of Responsible Investment

Anonymous sell-side research analyst
References


