Dr Anthony Hesketh
Department of Organization, Work & Technology
Lancaster University Management School
Lancaster
United Kingdom
LA1 4YX

Tel: [redacted]
Cell: [redacted]
Email: [redacted]
www.lancaster.ac.uk/lums

21 March 2019

Anne Sheehan
Chairman
Investor Advisory Committee
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Ms. Sheehan

Ref. Investor Advisory Committee Meeting, 28 March 2019

I write to the SEC Investor Advisor Committee (IAC or Committee) to highlight the relevance of my work to your ongoing discussion regarding disclosures on human capital. I am excited by the work of the IAC on disclosure of human capital data and offer myself and my work as a resource to the Committee in its ongoing work and future discussions.

By way of background, I am a UK-based tenured academic at Lancaster University Management School with a deep and long-standing interest in the relationship between human capital management and organizational performance. My thesis is a straightforward one. The way we value our relationships with organizations and the products they create is changing, with concomitant and material changes for the underlying financial value of organizations. Human capital and its management are becoming increasingly material to these changes.

Below, I outline how material this contribution appears to be, highlighting a new and robust evidence base underpinning the veracity of the recent call made by the *Embankment Project for Inclusive Capitalism* (EPIC) for deeper and wider forms of disclosure pertaining to human capital management.[1] After a short introduction to my work, I present the key findings from my research for EPIC and then discuss the implications of these results in the context of Chairman Jay Clayton's recent remarks on a telephone call with SEC Investor Advisory Committee Members.[2]

1. The reason for my contacting you

The financial materiality of human capital to firm valuation has evaded the accounting industry's grasp for half a millennium. Stretching back over the last decade, the aim of my research has been to enable global corporations and their wider stakeholders (e.g. investors, employees, suppliers and wider society) to better understand how they manage, measure and report on the value creation of their people.[3]

To date, I have worked directly with senior executives on human capital-related projects in over 100 major corporates (e.g., Aetna, Accenture, IBM, Microsoft, Johnson & Johnson, Unilever, Xerox); major financial regulators (e.g. the Financial Reporting Council and IASB in the UK); "Big Four" audit firms (Deloitte and EY), and, more recently, executives of leading asset owners and managers (e.g., Barings, Blackrock, Fidelity, Investec, Schroders, Vanguard). My recent research has explored the financial materiality of human capital disclosure practices which is of growing importance to the investment community and other stakeholders.

2. Introducing my research for EPIC

Following the positive reception to my work on human capital for the UK government, accounting, management and human resources bodies in 2014,[4] I was approached by the Big Four accounting firm, EY, with a view to collaboratively developing a new evaluation and auditing instrument based on my *Valuing your Talent* Framework (VyT) and my work developing an equation for *the return on invested talent* (ROIT).[5] During this initial work, discussion turned to unpacking the transformation of value more widely with my participation in the *Embankment Project for Inclusive Capitalism* (EPIC).[6]

EPIC was a joint initiative between corporates, asset managers, investors and citizens, EY and over 30 global business leaders to establish metrics that measure long-term value creation for all stakeholders. With the collective power and diversity of the entire investment chain, representing over $30 trillion of assets under management and almost 2 million employees around the world, the original and continuing research has played a central role in contributing to the creation of a unique initiative to measure the multi-dimensions of long-term value that businesses create. I led the empirical research on human capital disclosure for EPIC, culminating in the endorsement of the VyT indicators and Return on Invested Talent (ROIT) equation by participating firms.[7]

3. The EPIC research approach

The research sought to establish the human capital disclosure (HCD) practices of firms in the U.S. S&P 500, UK FTSE 100 and Fortune 100. Specifically, we sought to capture data pertaining to three challenges relating to HCD:

1. *How wide?* The *number* of firms engaging in HCD.
2. *How deep?* Different *types* of human capital-related factors disclosed by firms.
3. *How material?* The *relationship* between HCD and firm performance.

The evidence-base for our analysis comprised two parts:

***3.1 Quantitative data capture and analysis*:**

a. Deep dive analysis of the financial statements of 700 firms to extract financial fundamentals and to establish reporting of human capital items for the period 2012-17.
b. In the U.S., analysis of the (then) 350 published S&P 500 2018 AGM Proxy Statements to extract employee-related data.
c. Annual reports, CSR reports and other investor relations-related media were also consulted across 300 firms (the top 100 firms in the S&P 500, entire FTSE 100 and the top 100 firms in the Fortune 1000) for quantitative and narrative data.
d. In total, over 2,000 investor relations-related documents released by firms were consulted and codified by the project team.

3.2 Narrative data capture and analysis to establish:

a. The balance between number and narrative data points in HCD.
b. The balance between strategic and operational narrative descriptions for human capital-

related interventions.

c. The balance between material (quantum) and discursive (articulated) causal argumentation of the relevance of human capital disclosures.

Using a *human capital disclosure index* (HCDI) that I developed, EPIC was able to explore and model the relationship between human capital disclosures and firm performance. With the HCDI on one side of the equation, and the ROIT metric on the other, our analysis enabled us to explore with *robust quantum data points* the association between the financial returns obtained by firms and their human capital disclosure practices.

The HCDI was calculated by focusing on data relating to five indicators originally established and defined by the *Valuing your Talent* project and endorsed by EPIC participants (Table 1):

Table 1: The Valuing your Talent Core Human Capital Indicators

Disclosed Item	*Data examples*
Human capital costs	Salaries, wages, bonuses and pension benefits of *all* employees
Turnover	Voluntary/involuntary leavers and incoming employee data points
Training and development	Total training days, type and costs
Workforce composition	Diversity &inclusivity (D&I), skills and other related data points
Engagement and culture	Surveys exploring employees' attitudes to work and their firms, e.g., purpose, wellbeing and empowerment

I have discussed the rationale for the choice of these variables at length elsewhere.[8] All of the data points outlined above meet the criteria of comparability, verifiability, timeliness and understandability advocated by international accounting standards.[9] They also now benefit from clear definitions offered by the recent publication by *Guidelines for Human Capital Reporting for Internal and External Stakeholders* (ISO 30414:2018).[10] Moreover, each of the variables has the advantage of representing internal data points already disclosed by a substantial number of firms.

In line with *International Accounting Standard IAS 19*, it has been compulsory for firms in the European Union (EU) since 1998 to report their *total* human capital costs in relation to salaries, bonuses and pension benefits. Firms in the U.S. are not currently legally mandated to report this data, resulting in just 15 per cent of S&P 500 firms electing to do so (see Slides 8 & 9 in the attached deck). Discussion with experienced auditors in leading accounting firms reveals any incremental costs incurred by firms in meeting these new reporting variables to be minimal.[11] Our modelling reveals the potential future financial benefits released as a consequence of firms' enhanced transparency and subsequently more effective management of the human capital processes will exceed the cost by many times (see 4.7 below).

Largely because of this and other recent legislation and developments (e.g., the recent obligation for UK firms to report gender pay gap data, and now the recent ISO standard on Human Capital Reporting), human capital disclosure practices are more mature in the UK and EU in comparison to the U.S. For example, a report published this month by Deutsche Bank research analysts observed, 'given many companies are thinking about implementing [human capital variables] as soon as possible, it will soon be possible to incorporate human capital issues into fair value analysis.'[12] This brings us nicely to the data obtained by the EPIC *Human Capital Working Group*.

4. EPIC research results

At the very least, EPIC's findings suggest a rejection of the null hypothesis that human capital disclosure has no effect on firm performance. In fact, our data suggest the depth of human capital disclosure is highly associated with high performance.

More specifically, our analysis established:

4.1 **Human capital cost disclosers perform better**. Those S&P 500 firms disclosing their total human capital costs are disproportionately represented in the highest performing firms (see Slide 11), whether measured in terms of *risk-adjusted returns* or *means excess returns*, both asset management industry standards (Slide 12).

4.2 **The deeper the disclosure, the greater the economic returns secured from talent**. Using the HCDI developed by myself and endorsed by EPIC participants, analysis has established how firm financial performance increases in step with human capital reporting intensity (see Slides 13-15).

4.3 **Disclosers obtain a higher return on investment from talent (ROIT).** Similar to the concept of return on invested capital (ROIC), the ROIT calculation enables firms to establish the returns generated from their investment in human capital. The ROIT for those firms in the upper quartile of human capital reporting (£3.01 for every £1 invested) were nearly three times those with those with the lowest quartile of human capital disclosure (£1.17). Even in the U.S., where human capital disclosure is less extensive, top-quartile reporting firms ($2.09 for every $1 invested in their talent) on average outperform the returns secured from talent by those in the bottom quartile of human capital reporting ($1.87).

4.4 **Human capital cost disclosers focus on value creation over the long term**. Firms who disclose in full their human capital costs on average secure higher levels of operating margin and retain higher levels of earnings to reinvest in the future returns of their businesses (Slide 16). Non-human capital cost disclosers secure greater returns on equity but leverage significantly higher levels of debt.

4.5 **More developed human capital reporters let their numbers do the talking.** Evaluating recent developments in corporate narrative reporting, analysis also revealed how those firms with greater levels of human capital disclosure in *quantum* form use three times *less* words in their supporting narratives than other firms (Slides 18 and 19).

4.6 **More than 4/5 firms in the UK's FTSE 100 spend more on their human capital salaries and benefits than their formally stated audit 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 disclosure of human capital practices (Slide 20). Our research established nearly one in three firms (30%) in the S&P 500 exercised their right not to include all of their global workforce, omitting 5 per cent or more from 2018 proxy statement payment ratio relating to the median employee's salary. This raises potentially serious as well as financially material issues over the integrity of firms' income statements.

4.7 **The possible future benefits from greater human capital disclosure far outweigh the costs.** Our modelling reveals firms' *total* human capital disclosure-related costs are at levels significantly below the anticipated economic returns we have conservatively estimated to be brought about by greater understanding of the business through more effective human capital management as a result of disclosure (see 4.3 above). Only a very small increase in operating performance (several basis points) is required to cover any additional costs incurred though human capital disclosure. Significantly, the vast majority of firms already undertake significant audits of their payroll systems thereby reducing the need to attract any additional costs for reporting purposes.

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We pause here to insert a caveat. We are not implying the disclosure of data pertaining to human capital management is a conventional causal or 'leading indicator' of out-performance. However, our findings are interesting. Of the 75 firms in the S&P 500 consistently disclosing their human capital costs, nearly two-thirds (60%) can be found in the top-performing 20% of firms. This trend has been consistent over the duration of the timescale under analysis (2012-17). Conversely, those disclosing their human capital costs are disproportionately under-represented in the bottom-performing 20% of firms in the S&P 500. Something appears to be going on, which underlines the need for further and more uniform compulsory disclosure. The executives involved in the human capital working group favoured the interpretation that well-run businesses who were confident enough to articulate their metrics around human capital in quantum form might be better placed to make financially accretive material interventions. At national level, even the slightest performance-gain from a more transparent approach to disclosing and managing human capital resources might be substantial for the U.S. economy.

5. Possible implications of EPIC for the IAC to consider

In this section we address Chairman Clayton's remarks during the telephone call with SEC Investor Advisory Committee Members on February 6, 2019.[13] We have grouped Chairman Clayton's remarks into two overarching sections. We deal with each in turn.

5.1. Framework for analysing disclosure rules

Chairman Clayton raises five specific issues in relation to the framework for analysing disclosures. Our research for EPIC has ramifications for each of these topics. We unpack these below.

1. Materiality: Chairman Clayton evokes Justice Marshall's observation and how, 'disclosure rules and guidance, and our issuers, should focus on the material information that a reasonable investor needs to make informed investment and voting decisions.'[14] Our findings are of interest here on four counts:

a) Our research has revealed how more than 4/5 firms in the UK's FTSE 100 spend more on their human capital than their formally stated and audited level of materiality (slide 20). Half FTSE 100 firms exceed this level of materiality by more than a factor of 20, underlining the significance of human capital in meeting directors' fiduciary requirements of disclosure (see Section 4(6) above).

b) In the U.S. reporting context, human capital is a currently neglected factor of economic production requires a higher level of granularity afforded to it than currently offered by the cost of goods sold (COGS) or the general sales and administration (GS&A) on current income statements.

c) We believe the five core human capital indicators presented above and the ROIT metric offer the investment and wider stakeholder communities the opportunity to calculate from robust financial fundamentals the "metabolic rate" at which people perform in different firms. This enables information pertaining to material questions to be answered including: what is the role of our human capital in delivering our strategy? How are we performing? How do we know? Is the performance of our human capital improving or declining? Where is most value located or at most risk in our human capital base? Where might we invest for greatest economic returns?

d) Finally, EPIC represented a direct response to the evolution in wider society's changing conception(s) of value.[15] The investment community is demanding more information in relation to employees' experience of working for an organization. New comparative market places are evolving raising new challenges in shaping the new modalities through which the different elements of value flow.[16] These new modalities are bringing with them different ways of understanding, articulating and measuring sustainable value, be they *economies of experience* (employee value propositions), *reciprocity* (who you do business with and how) or *materiality* (the evidence base for claimed performance provided).[17] Such new economies materially shape wider aspects of human capital value ranging from potential employee and wider consumer decision making with clear ramifications for the brand value of organizations.

2. *Comparability*: EPIC participants debated at length the disclosure requirements relating to human capital. The five core indicators outlined above (see Table 1) represent the agreed indicative human capital disclosures required from firms and endorsed by EPIC chief executives.[18] Whilst a number of firms are already reporting these indicators in the UK and EU, the U.S. trails behind, especially in the disclosure of human capital costs (slides 8-9). Each of the five core indicators highlighted above represent, 'metrics that provide for reasonable market-wide comparability.'[19] There may be a requirement here for GAAP to clarify the role of human capital costs and benefits in contributing to, or even representing the resource or *architectures of firm value* under construction.[20]

3. *Flexibility*: EPIC participants were keen to accommodate variations between firms and sectors in relation to human capital disclosures but recognised the need for a central core of metrics to ensure comparability. A flexible approach could also accommodate over time the development of second and third waves of voluntary disclosures as firms respond to changes in markets and industry for the underlying drivers beneath core human capital disclosure requirements. Firms also have the flexibility to provide supporting narratives to elucidate on the stories behind the core quantum disclosures in their human capital management strategies. This would enable investors to, 'be better served by understanding the lens through which each company looks at their human capital.'[21]

4. *Efficiency*: Our analysis established how those firms providing the deepest level of core quantum human capital disclosures required less volume in their narrative reporting to articulate progress: a classic case of saying materially more with less (Slide 9). A possible corollary of adopting the five core human capital disclosure items might be to reduce costs via savings in time and reduced reporting space currently plaguing firms' annual reporting. Significantly, there is growing evidence that those firms who provide deeper levels of human capital disclosure also enjoy material benefits in securing lower costs of equity capital.[22] Additional research by financial analysts has established how, 'improving disclosures makes the capital allocation process more efficient and reduces the average cost of capital.'[23] By introducing a few core metrics, significant value may be released in line with Chairman Clayton's request for the, 'most effective [rule] with the least cost.'[24]

5. *Responsibility (or liability):* Chairman Clayton highlights how, 'rules have little long-term value if they cannot be effectively monitored and enforced.'[25] By focusing on the EPIC core set of human capital disclosures which represent robust and quantum data points, the SEC can steer a clear path forward for uniform disclosure in this materially important space, thereby further enabling the protection of investors through maintaining fair, orderly, and efficient markets and facilitating capital formation.

5.2 Moving human capital from a cost to value driver

Chairman Clayton observes how, 'today, human capital and intellectual property often represent an essential resource and driver of performance for many companies,' and how this represents, 'a shift from human capital being viewed, at least from an income statement perspective, as a cost.'[26] This observation brings into sharp focus how in a knowledge-based and service-oriented economy human capital does not represent the *costs* of the gasoline running through the engine, which is to be sourced as efficiently as possible. Rather, human capital represents the value-driving engine - or human *resource*

- of the firm.[27]

Significantly, recent changes to the IFRS's *Conceptual Framework for Financial Reporting* have brought to a conclusion the revised definition of an asset, 'as a present economic resource controlled by the entity as a result of past events.'[28] For example, the newly separate definition of an economic resource as, 'a right that has the *potential* to produce economic benefits,' may not only enable developments in GAAP to, 'clarify that an asset is the economic resource, not the ultimate inflow of economic benefits,'[29] but, building on a previous IFRS discussion document[30],may even allow us to explicitly highlight how the workforce itself can constitute an economic resource, opening up the very real possibility of future developments in GAAP relating to the associated costs and benefits of *human capital resources*.

With the latest definition of an asset now deleting the need for the *expected* flow of economic resources, 'to be certain, or even likely, that economic benefits will arise,' the requirement for further transparency and granularity in human capital resource-related costs and benefits is now material to our understanding of how a, 'low probability of economic benefits,' arising from a firm's human capital management, 'might affect recognition decisions and the measurement of the asset.'[31]

In conclusion, the recent paper from Deutsche Bank research analysts referred to above, together with the findings from EPIC's human capital working group, clearly indicates portfolio managers are waking up to the materiality of human capital in their fair value calculations and are consequently factoring in data points to their analysis. The CEOs of firms across the entire value chain have endorsed the core human capital disclosure items as a way forward to deepen our understanding of how firms are recognising and leading on the importance of the contribution made by their people. In short, the time for human capital accounting has come.

I wish you and the Committee a productive discussion.

Yours sincerely

Dr Anthony Hesketh

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[1] Coalition for Inclusive Capitalism & EY (2018) *Embankment Project for Inclusive Capitalism (EPIC)* (New York: CIC/EY).

[2] Clayton, J. (2019) Remarks for Telephone Call with SEC Investor Advisory Committee Members, February 6th, 2019, https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-call-020619#_ftn2., accessed 15/2/19

[3] See Hesketh, A. & Fleetwood, S. (2006) Beyond Measuring the HRM-Organizational Performance Link: Applying Critical Realist Meta-theory, *Organization*, Vol. 13 No. 5, pp. 677-699; Hesketh, A. & Fleetwood, S. (2006) 'HRM-Performance Research: Under-theorised and Lacking Explanatory Power*,' International Journal of Human Resources Management*, 17(12), pp.1979-1995; Fleetwood, S. & Hesketh, A.J. (2006), 'Prediction in Social Science: the case of research on the Human Resource Management-Organisational Performance Link,' *Journal of Critical Realism* Vol. 5, No. 2., pp. 228-250.; Fleetwood, S. & Hesketh, A. (2007) 'Theorising Under-theorisation in Research on the HRM – Performance Link', *Personnel Review* ; Fleetwood, S. & Hesketh, A. (2010) *Explaining the Performance of Human Resources Management* (Cambridge, Cambridge University Press); Hesketh, A. & Hird, M. (2010) The Golden Triangle: How Relationships Between Leaders Can Leverage More Value From People, in P. Sparrow, A. Hesketh, M. Hird, C. Cooper (eds) *Leading HR* (Oxford: Palgrave), pp. 103-135; Hesketh, A. (2014) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES); Hesketh, A. McMinn, H. and Lewis, H. (2014) *What Price Talent? Introducing a new metric to understand the return on investment*

from talent (London: Deloitte); Hesketh, A. (2017) Architectures of value: moving leaders beyond big data and analytics. In P. Sparrow & C. Cooper (eds.) *A research agenda for Human Resource Management*. Cheltenham: Edward Elgar; Hesketh, A. (2019) 'The leadership of value. Leading the Leading Indicators of good dividends,' in S. Kempster and T. Maak (eds), *Good Dividends: Responsible Leadership of Business Purpose*: Routledge: New York.

[4] Hesketh, A. (2014) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES)

[5] Hesketh, McMinn and Lewis (2014) *What Price Talent? Introducing a new metric to understand the return on investment from talent* (London: Deloitte)

[6] EPIC/EY (2018) *Embankment Project for Inclusive Capitalism (EPIC)* (New York: CIC/EY, Inside Back Cover

[7] See EPIC (2018), pp. 42-44; EPIC/EY/CEO Statement of Support (2018) *Business leaders unite to advance long term value measures* (New York: CIC EY). The original research citing these metrics was published in Hesketh, A. (2014)) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES)and Hesketh, McMinn and Lewis (2014) *What Price Talent? Introducing a new metric to understand the return on investment from talent* (London: Deloitte)

[8] Hesketh (2014) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES)

[9] For example, see International Accounting Standards Board (IASB) (2018) *The conceptual framework for financial reporting* (London: IASB/IFRS Foundation), Chapter 3.

[10] The International Organization for Standardization (ISO) *Human resource management — Guidelines for human capital reporting for internal and external stakeholders*, Lignes directrices — Bilan du capital humain à l'attention des parties prenantes internes et externs, ICS: 03.100.30. See International Organization for Standardization. (2018, December). "Human resource management – Guidelines for internal and external human capital reporting." Retrieved from: https://www.iso.org/standard/69338.html.

[11] This is based on confidential personal correspondence with major accounting firms. There is considerable variation and complexity between firms in relation to size and industrial sector. The additional metrics we are suggesting are already collected by a number of firms and any incremental cost would be minimal as a percentage of the total audit costs. Indeed, many of the Fortune 1000 firms outside the US are already undertaking this disclosure.

[12] Templeton, L & Allen H. (2019) *Valuing human capital*. Deutsche Bank Research 13 February, 2019, p. 2.

[13] Clayton (2019) *ibid*.

[14] Clayton (2019) *ibid*

[15] Hesketh, A. (2019)) 'The leadership of value. Leading the Leading Indicators of good dividends,' in S. Kempster and T. Maak (eds), *Good Dividends: Responsible Leadership of Business Purpose*: Routledge: New York.

[16] Almquist, E., Senior, J and Bloch, N. (2016) 'The Elements of Value: Measuring and delivering what consumers really want,' *Harvard Business Review*, September, pp. 47-53

[17] Hesketh (2019)) 'The leadership of value. Leading the Leading Indicators of good dividends,' in S. Kempster and T. Maak (eds), *Good Dividends: Responsible Leadership of Business Purpose*: Routledge: New York

[18] EPIC/EY/CEO Statement of Support (2018) *Business leaders unite to advance long term value measures* (New York: CIC EY).

[19] Clayton (2019) *ibid.*

[20] For example, see Barney, J. (1991) 'Firm Resources and Sustained Competitive Advantage,' *Journal of Management*, Vol 17., No. 1: 99-120; Hesketh (2014) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES); Hesketh, A. (2017) Architectures of value: moving leaders beyond big data and analytics. In P. Sparrow & C. Cooper (eds.) A research agenda for Human Resource Management. Cheltenham: Edward Elgar

[21] Clayton (2019) *ibid.*

[22] For example, see Boujelbene, M.A. & Affes, H. (2013) ‘The impact of intellectual disclosure on cost of equity capital: A case of French firms,’ *Journal of Economics, Finance and Administrative Science*, p. 18(34), pp. 45–53.

[23] Source: CFA (2013*) Financial Reporting Disclosures: Investor perspectives on transparency, trust and volume*, Appendix C,, pp.105-107; FASB (2001) *Business Reporting Research Project* (FASB); Sengupta, P (1998) “Corporate Disclosure Quality and the Cost of Debt,” *Accounting Review*, vol. 73, no. 4 (October 1998):459; Francis, J.R., Khurana, I.K. and Pereira, R. (2005) “Disclosure Incentives and Effects on Cost of Capital around the World.” *Accounting Review*, vol. 80, no. 4 (October 2005):1125; Agnes Cheng, C.S., Collins, D. and He Huang, H. (2006) “Shareholder Rights, Financial Disclosure and the Cost of Equity Capital,” *Review of Quantitative Finance and Accounting*, vol. 27, no. 2 (September 2006):175.

[24] Clayton (2019) *ibid.*

[25] Clayton (2019) *ibid.*

[26] Clayton (2019) *ibid.*

[27] See Hesketh (2014) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES) for a discussion.

[28] IFRS (2018) *Conceptual Framework for Financial Reporting: Summary of changes*, March 2018 (London: IASB/IFRS) p.8

[29] IFRS (2018), *op cit.*, emphasis added.

[30] IFRS (2013) *A Review of the Conceptual Framework for Financial Reporting*, Discussion Paper DP/2013/1, para. 3.5, (c), (iv), p. 38.

[31] IFRS (2018), *op cit.*

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Lancaster University
Management School

A Capital Idea?
The financial case for human capital disclosure by firms

Presentation to accompany slides sent to the the chair of the ISC, SEC 21 March 2019

Anthony Hesketh BSc Econ, PhD

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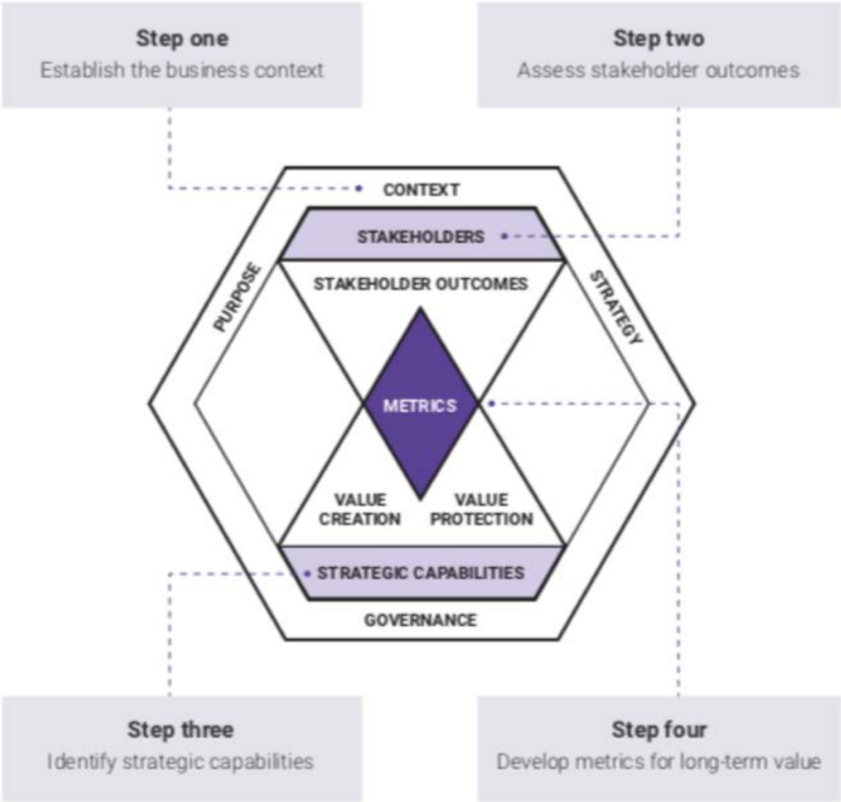
Introducing Embankment Project for Inclusive Capitalism (EPIC)

EPIC's global significance

Wider stakeholder/Investment community led …

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).

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 *HC Disclosure Index-ROIT* (FTSE 100)
  - The more discursive the HCD, the poorer the performance
- Work continues on establishing *human capital asset* calculation
  - Now, we can add *means excess returns* and *risk-adjusted returns*

Our research findings in a nutshell

Positive correlation between financial performance and disclosure of HCD data

Regulations drive HCD disclosures

Frequency of human capital reporting - **Turnover**

UK 26%

US 34%

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

UK 100%

US 13%

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

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

60%

6% S&P 100

Firms with higher Human Capital Reporting scores show higher productivity

3.01

1.17 ROIT

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

33%

-3% Operating Margin

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

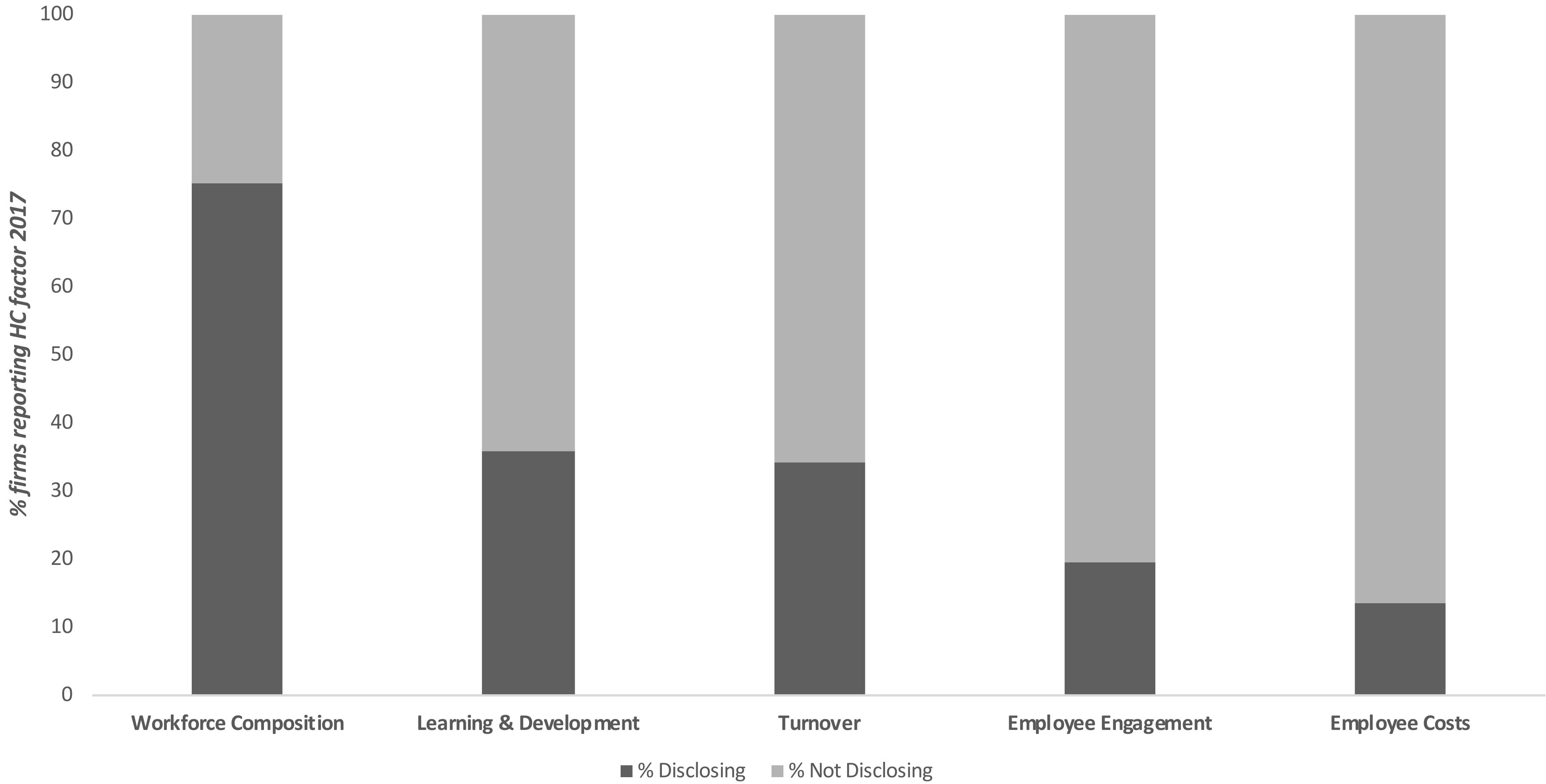
~60% of firms focus their narrative on operational description

Human Capital Disclosure - How deep and wide?

US: HC factor reporting still in nascent form

N= 100

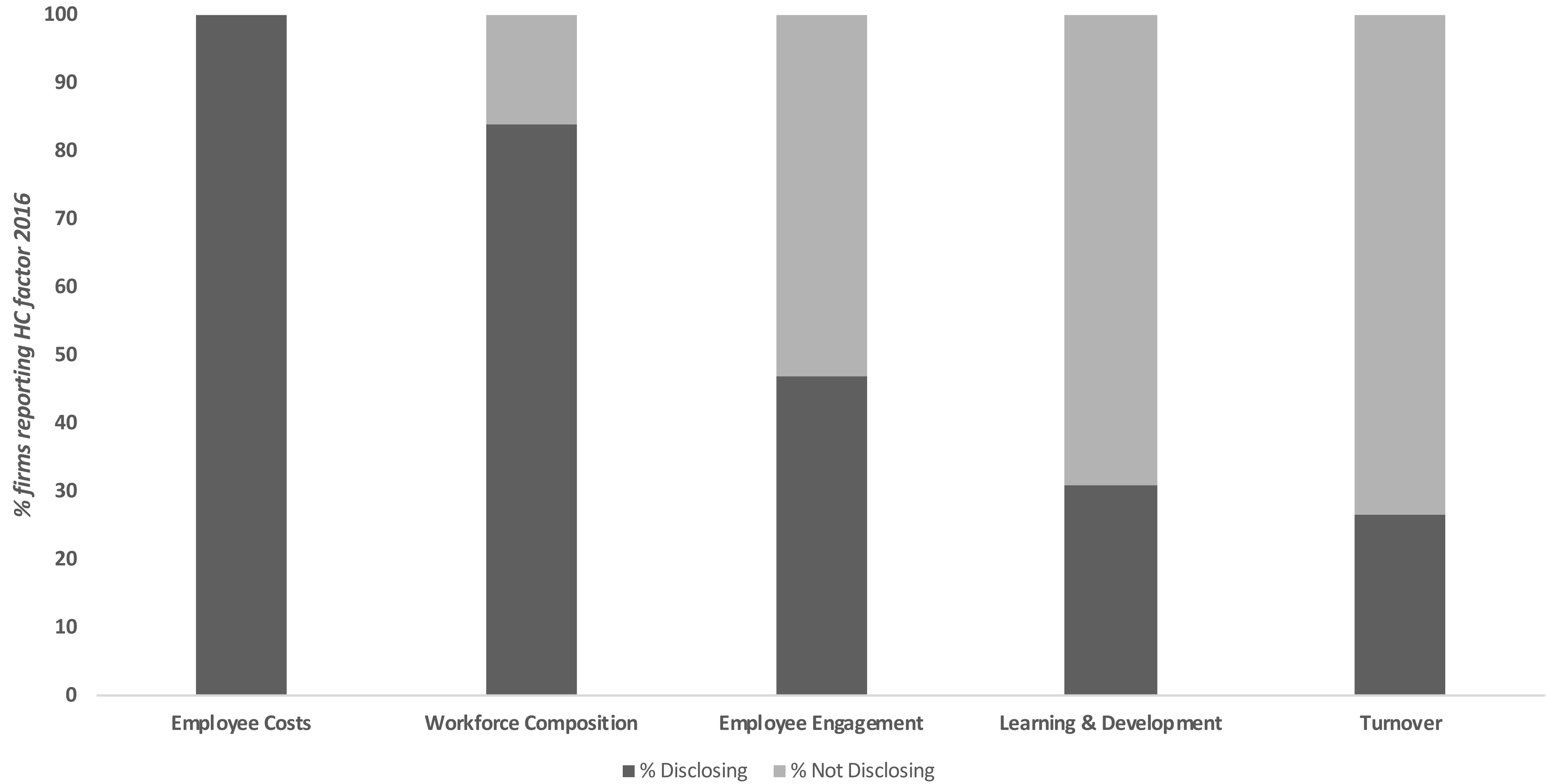
Source: S&P 500, Analysis by Lancaster University Management School for EPIC



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 will also be compulsory. Significantly more firms report employee sentiment data (e.g. engagement), although the UK lags behind the US on employee turnover.

Source: FTSE100 & Firm publications. Analysis by Lancaster University Management School for EPIC

Human Capital Deployment

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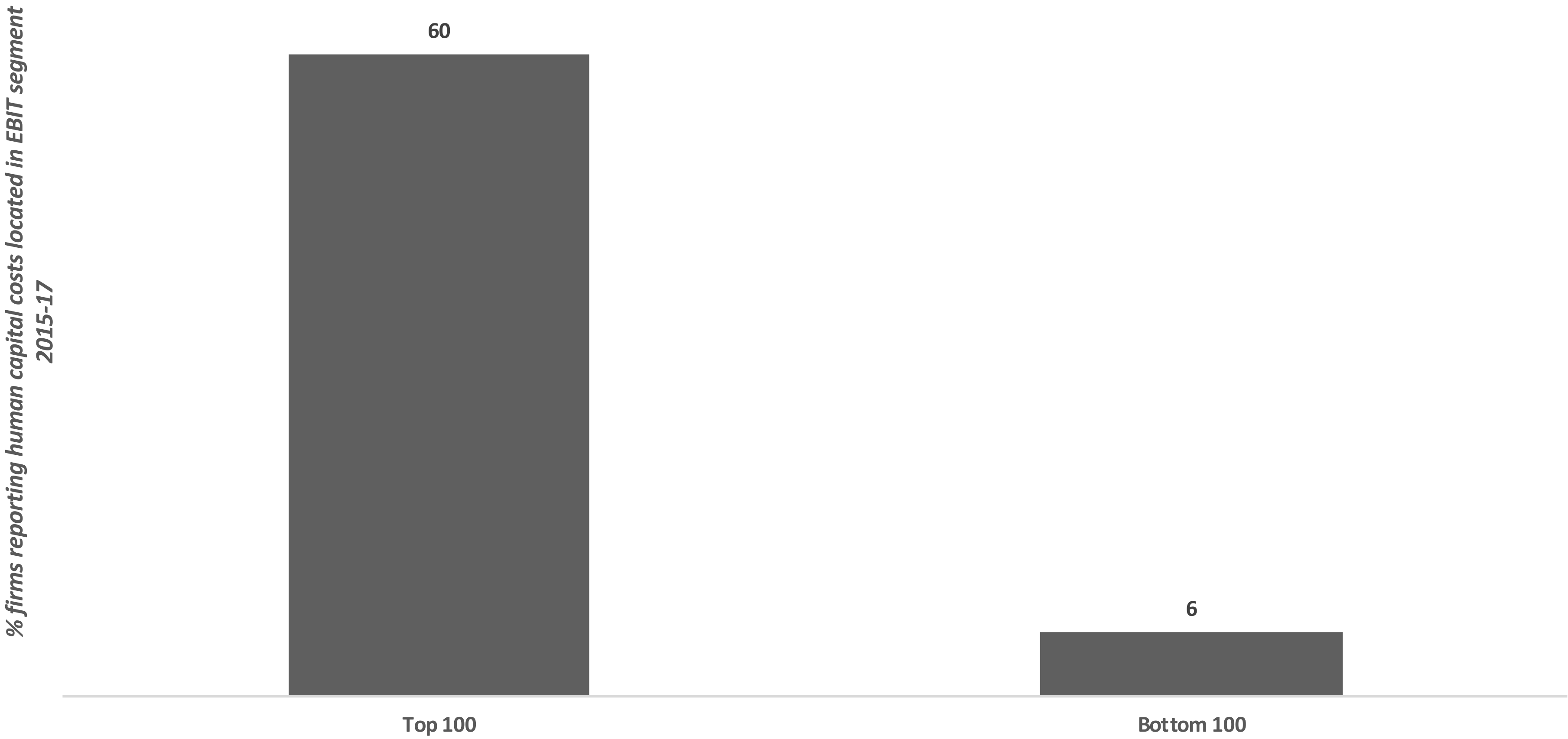
The Performance Case

US: HC cost disclosers disproportionately higher performers N=495

Source: S&P 500, Analysis by Lancaster University Management School for EPIC



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.

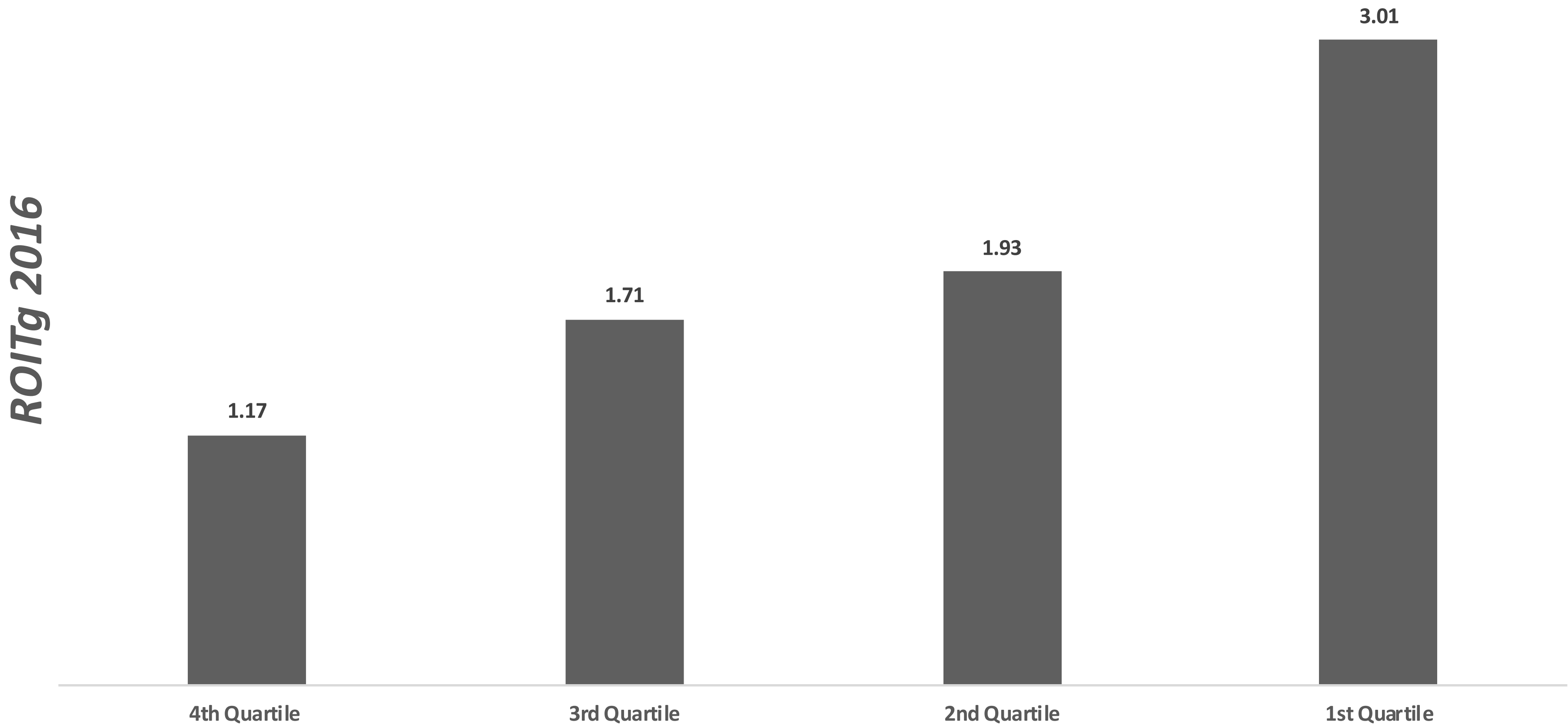
Disclosers outperform non-disclosers

Yearly Average Data			
2017	Mean Excess Returns (%)	Sharpe Ratio	Volatility (Std. Dev.)
Disclosure Group	0.79	0.21	5.42
Non-Disclosure Group	0.73	0.17	0.73
2016			
Disclosure Group	1.25	0.64	7.77
Non-Disclosure Group	1.11	0.16	7.19
2015			
Disclosure Group	-0.028	0.005	6.27
Non-Disclosure Group	0.175	0.052	6.79
2014			
Disclosure Group	1.54	0.31	5.17
Non-Disclosure Group	1.41	0.28	5.74
2013			
Disclosure Group	3.85	0.64	6.17
Non-Disclosure Group	2.67	0.49	5.83
2012			
Disclosure Group	1.88	0.26	7.00
Non-Disclosure Group	1.72	0.29	6.45

This slide provides analysis of the performance of disclosing versus non-disclosing firms in relation to two important benchmarks with which asset managers have challenged us. First, *mean excess returns* captures the performance of firms relative to the risk free rate. The second, the *Sharpe Ratio*, helps us to understand the return of an investment compared to its risk and is the most widely used method for calculating the risk-free return. On both measures, the human capital disclosing firms outperform non-disclosing firms in five and four of the six years (2012-17), respectively. Human capital disclosure is, then, financially material in the terms of the asset management's own industry standard.

UK: HCRI signals relative employee out-performance

N=100

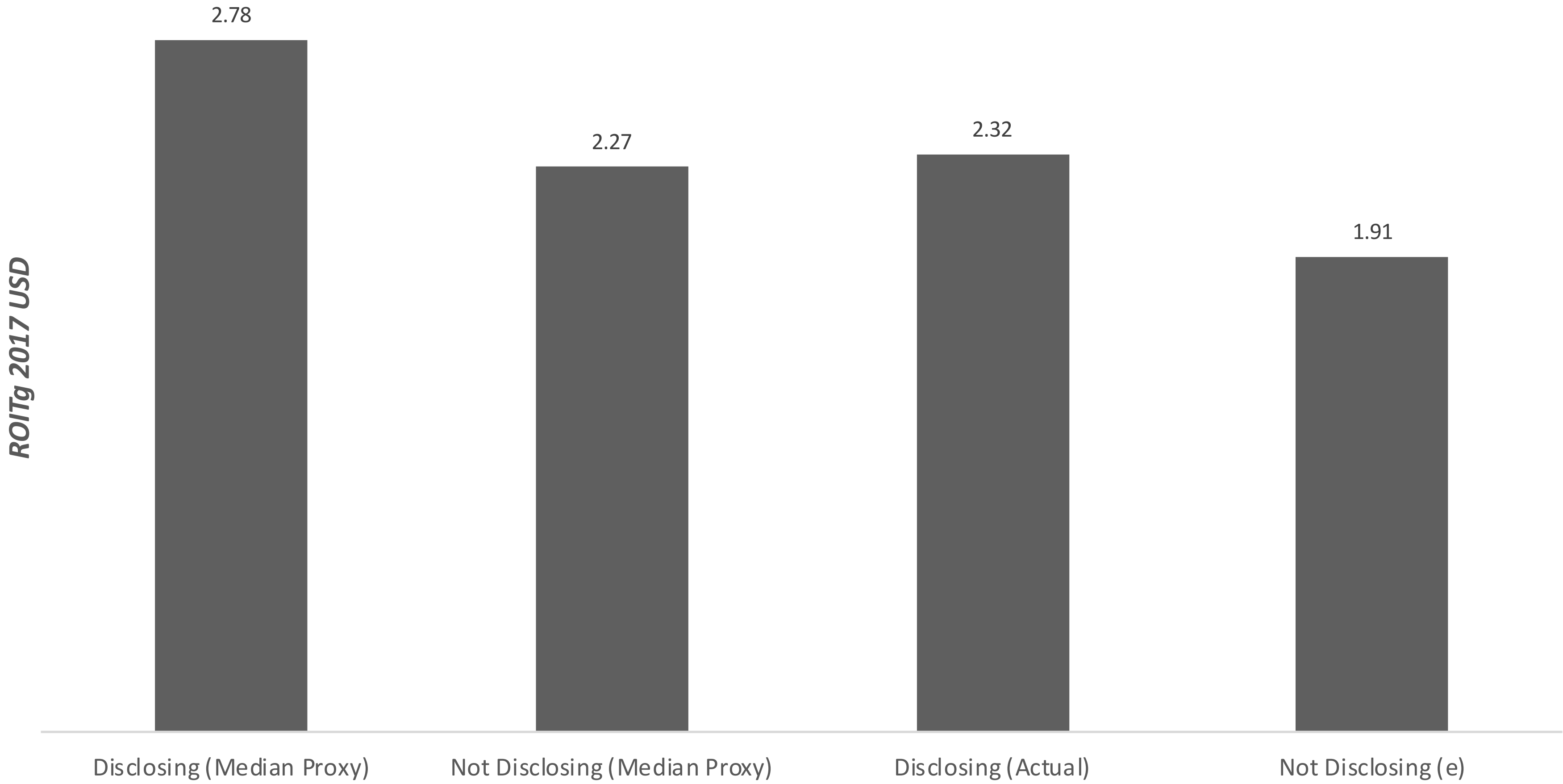


These data are compiled from HCR scores of equal weighting across all five variables and splitting firms into overall score quartiles. HCR appears to signal firms securing higher productivity from their employee base disclose more human capital related data. This suggests we cannot rule out human capital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

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

US: HC cost disclosers more productive than non-disclosers

N=350

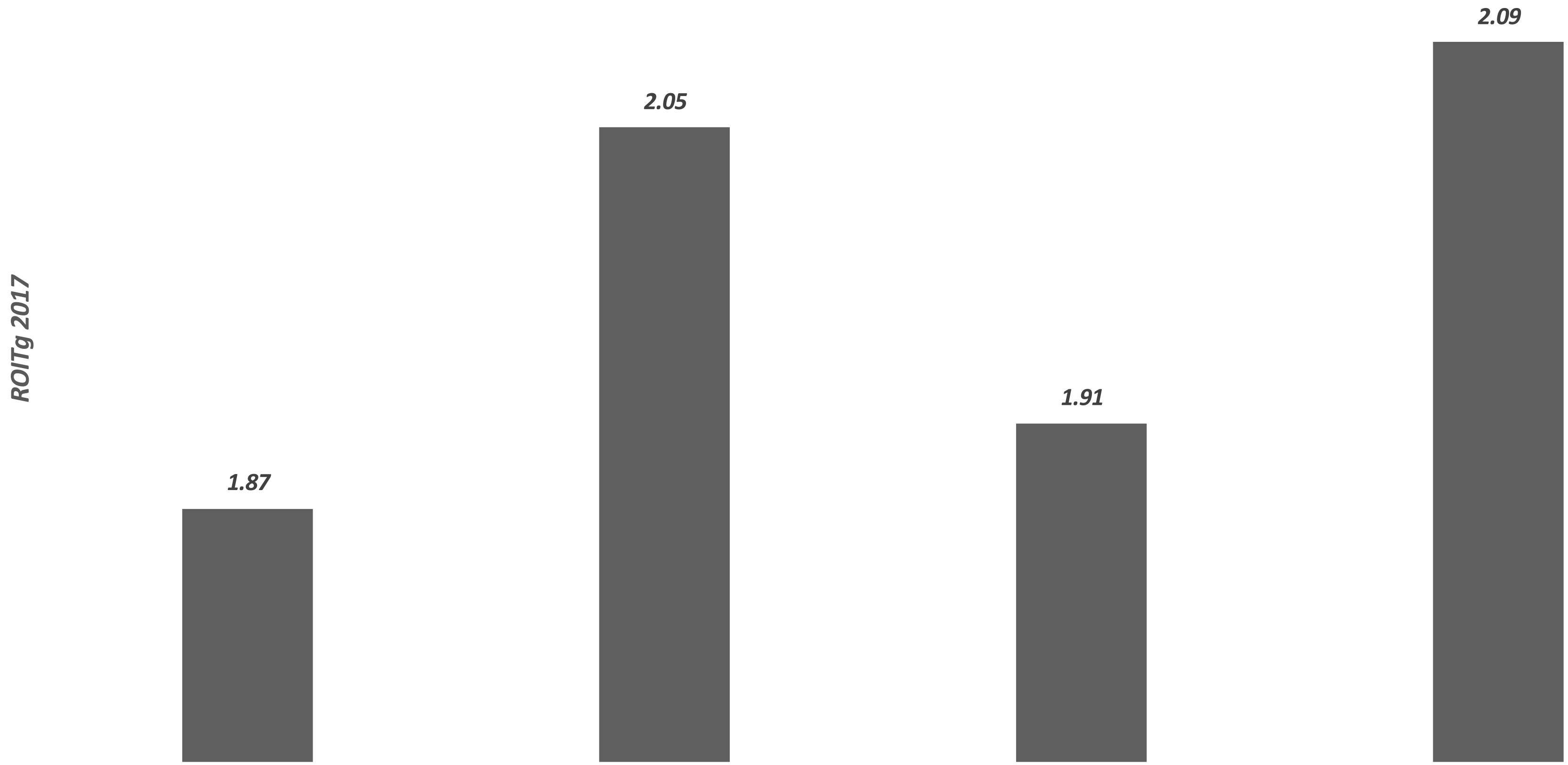


Using a comparative measure developed by Lancaster University called *Return On Invested Talent (ROIT*), which measures the $ return per $1 invested in talent and associated charges, reveals those who disclose their HC costs secure higher levels of productivity than those who do not disclose details. This was established in two ways. First, the returns of disclosers and non-disclosers were compared using the median employee's pay now required in 2018 Annual Proxy Statement forms. This revealed a 23% difference in ROIT between disclosers and non-disclosers. This was augmented by a second approach developed by the SRG team at Lancaster University to model the costs of non-disclosers, revealing a 22% in ROIT between disclosers and non-disclosers.

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

US: HCR Index less mature but impactful

N=100

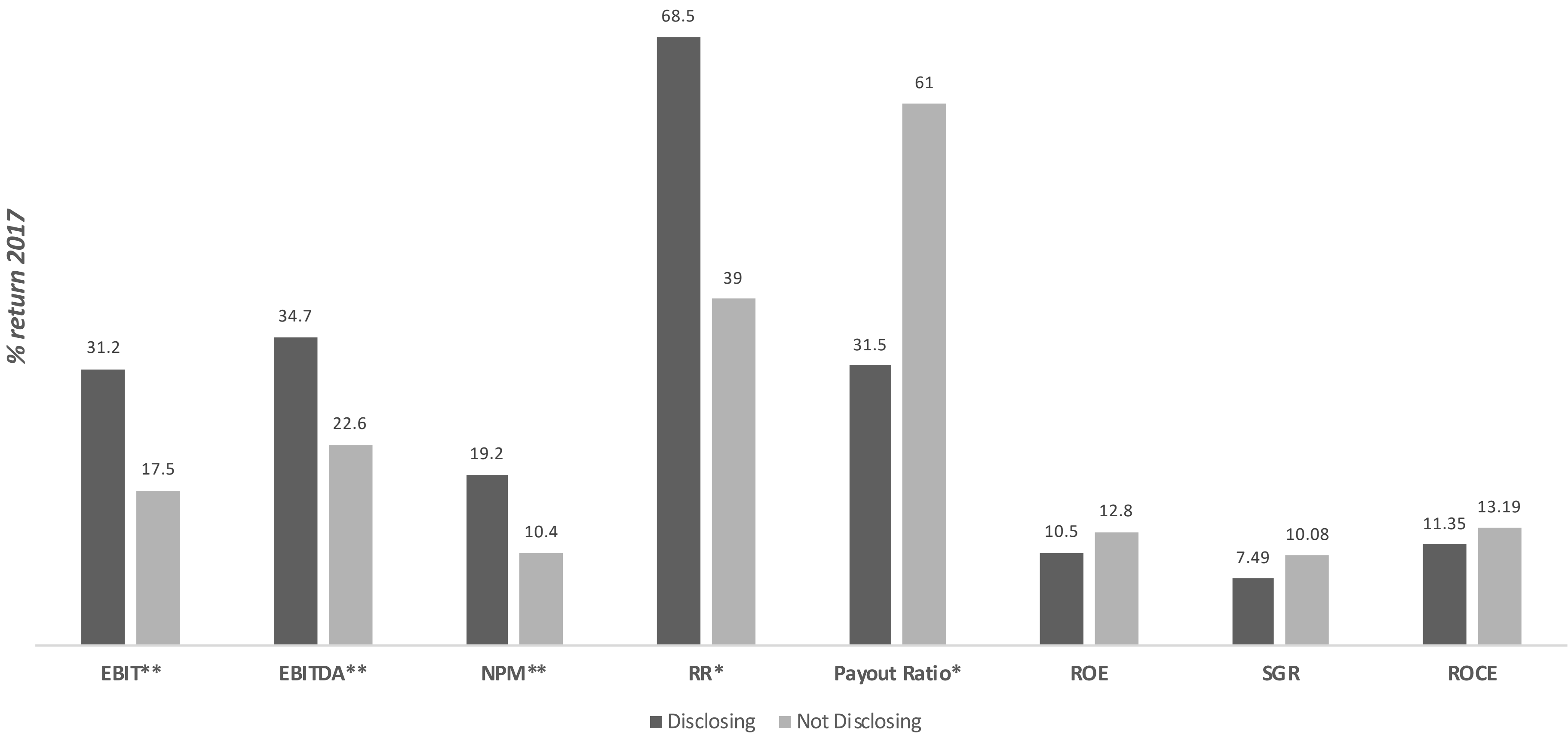


The linear relationship between employee productivity and human capital reporting is less pronounced in the US, perhaps reflecting the relative under-performance of information on human capital-related factors. Nevertheless, those firms in the Top S&P 100 by revenues with the highest scores secure higher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

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

Value creation v value transfer

N=75/495



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

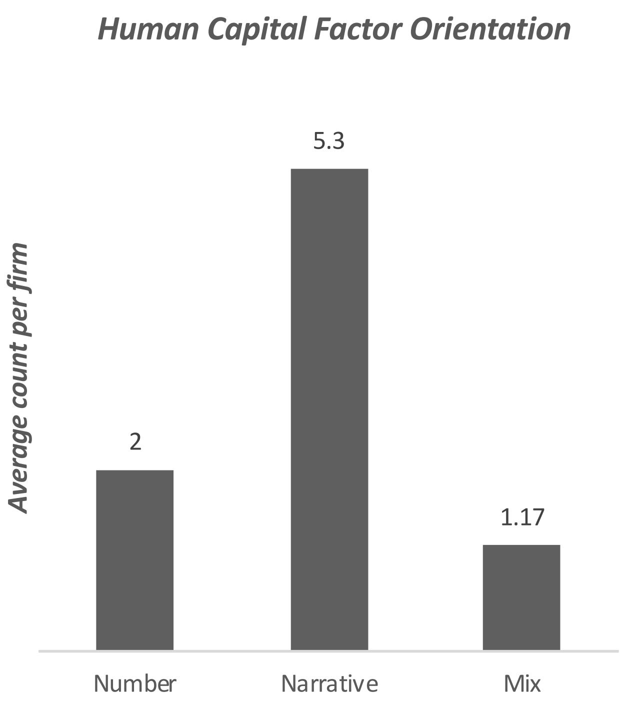
Source: S&P, Compustat & firm publications, Analysis by Lancaster University Management School for EPIC

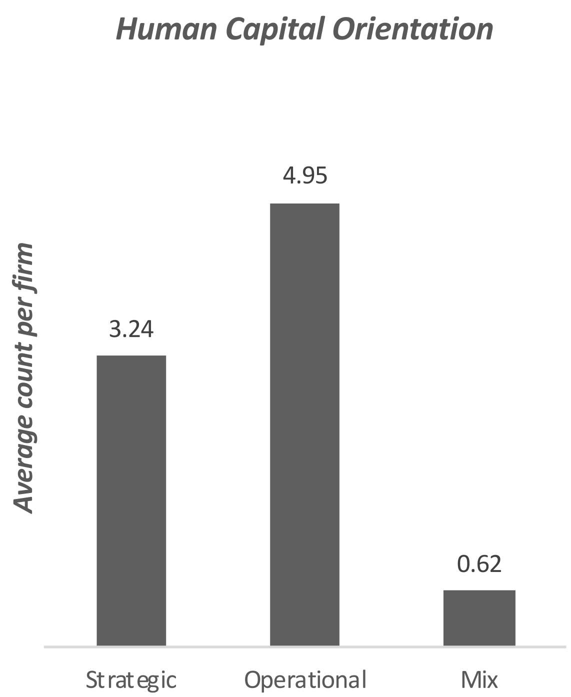
Human Capital Disclosure – Narrative Reporting

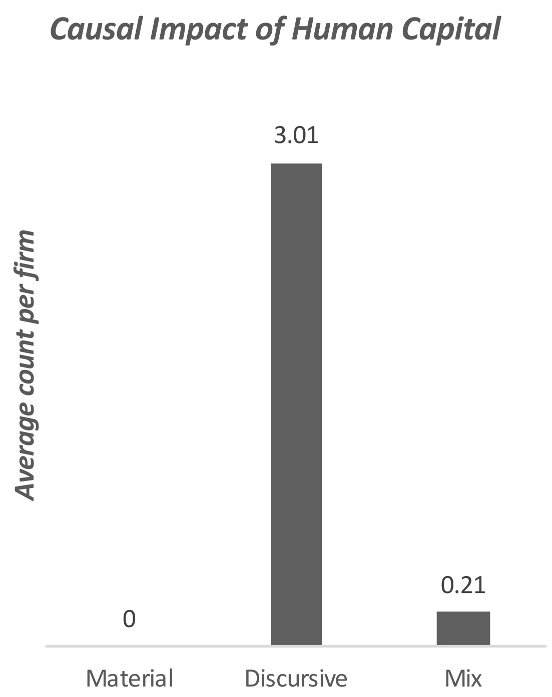
US: Narrative content analysis

N=100

Source: S&P, Compustat & firm publications, Analysis by Lancaster University Management School for EPIC



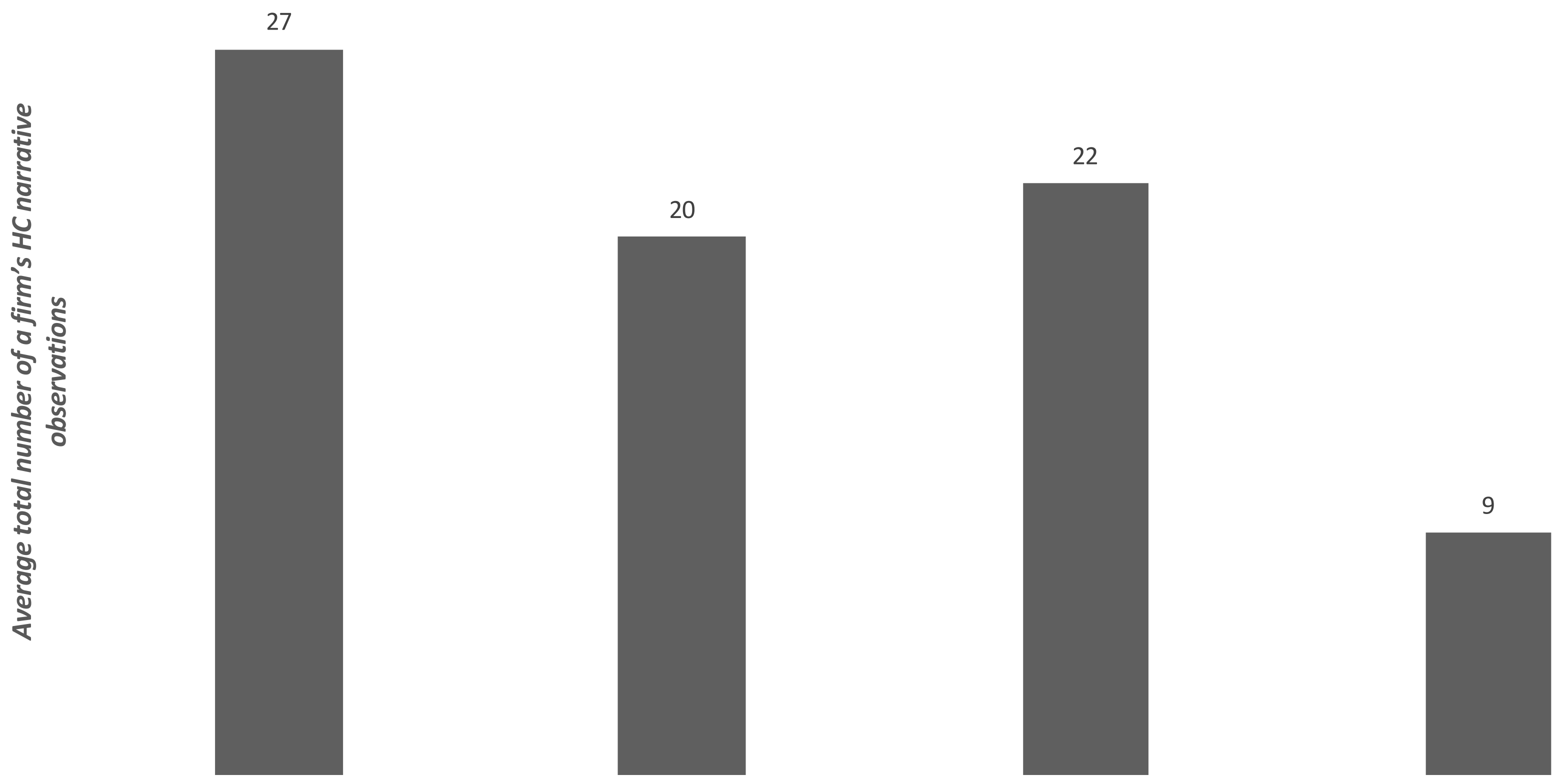




Our analysis of the narrative elements used in in Annual Reports, Form 10-ks, and other firm publications reveals a clear emphasis on text as opposed to number to convey human capital information. The narrative form is preferred to number when reporting on human capital factors and in relation to the causal impact of human capital interventions. There is an orientation to operational description as opposed to conveying the strategic importance of human capital interventions.

US: HC disclosers let the numbers do the talking

N=100

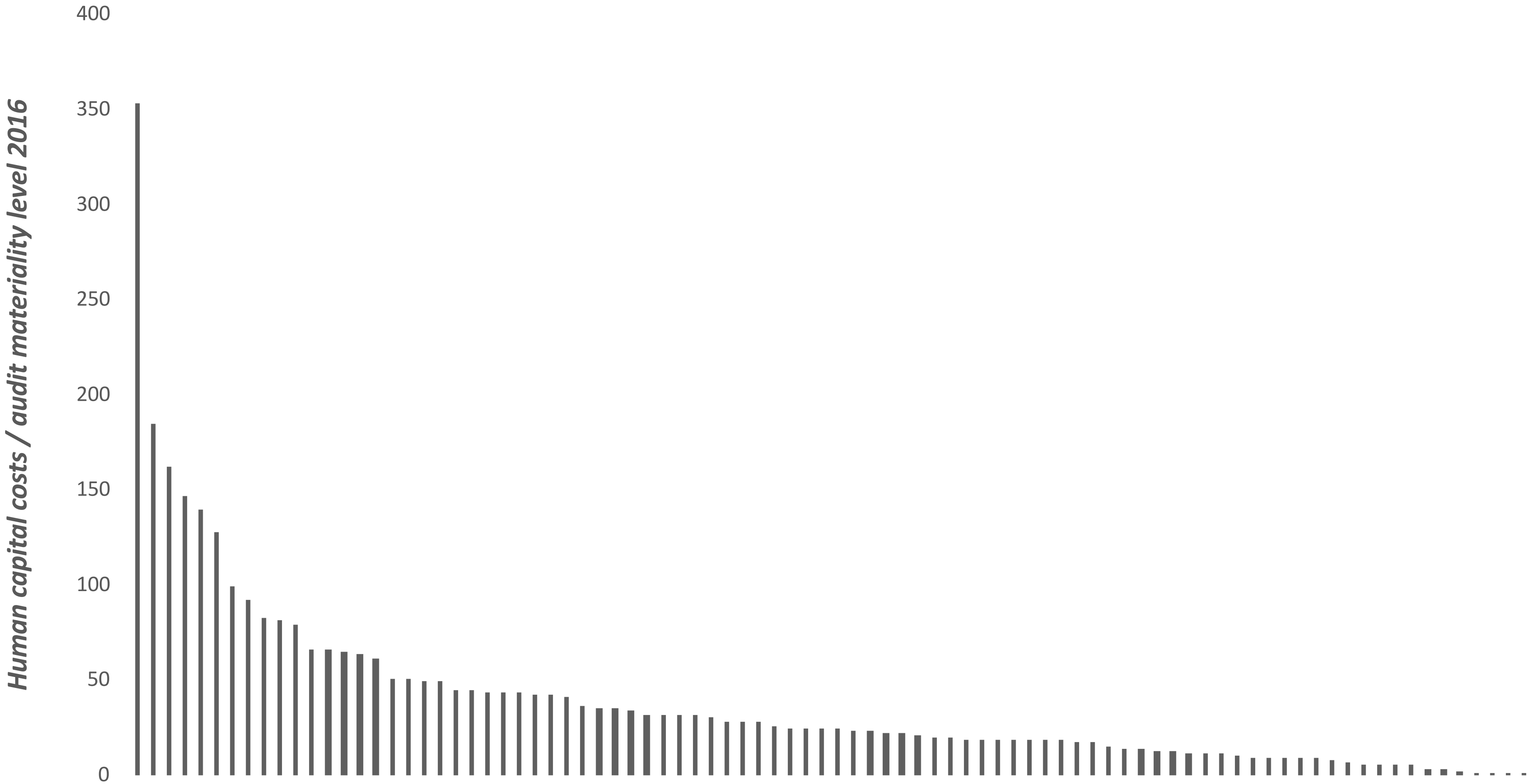


Examining the total number of narrative observations relating to their human capital deployment, we can clearly see how those firms in the upper quartile of human capital disclosure (right hand side), make fewer narrative observations. Clearly, these firms are letting their human capital deployment numbers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

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

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.

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

Questions/Comments?

E: A.Hesketh@lancaster.ac.uk
M: +44 7932 585634
T: + 44 1524 510919