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Human Capital Management and Reporting: Key Considerations for Institutional Investors and Directors

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The idea that an organization's workforce is an asset rather than just a business cost is widely accepted by business leaders. Yet in annual reports to shareholders and those routinely shared with directors, meaningful information about the workforce and how it is managed—"Human Capital Management" (HCM)—remains remarkably sparse.

This omission has not gone unnoticed. In recent years, there have been serious efforts to get HCM out of the reporting shadows. Some have emanated from the accounting world, and some from the environmental, social, and corporate governance (ESG) domain. In addition, various investor groups, whether they are government or private pension funds, shareholder activists, or responsible investment (RI) organizations, have been pressing hard to get more meaningful human capital reporting standards put in place.

Many of the recent initiatives are motivated by concerns about corporate social responsibility. For example, pressures from shareholder activists and regulators to promote greater gender diversity and pay equity for women have produced a spate of company disclosures about gender representation and pay, particularly from companies in the technology and financial services sectors. But the push for increased disclosure increasingly is emphasizing the economic value of greater transparency about HCM for shareholders and the investment community in general. For example, in July 2017, the Human Capital Management Coalition, a group of institutional investors led by the UAW Retiree Medical Benefits Trust, with $2.8 trillion in assets, filed a petition with the US Securities and Exchange Commission (SEC) to “require issuers to disclose information about their human capital management policies, practices, and performance.” Citing and summarizing a wealth of empirical evidence on the business impact of HCM, including its relationship to shareholder value, they argued that deeper and more comprehensive workforce information is required to enable investors to take proper account of HCM in firms when making their investment choices.

Careful attention to HCM is clearly warranted in view of current economic realities. Rapid technological change, increased competitiveness and economic globalization, and generational and cultural shifts are shortening the life cycle of products and business designs for many businesses. Companies are obliged to constantly adapt. It is often human capital that enables effective adaptation to these new realities yet it is at the greatest risk of sudden depreciation in the face of change. The proliferation of workforce and business data combined with advances in workforce analytics make it possible for organizations to anticipate and address these issues and to manage their human capital in the more disciplined, quantitative way of the kind they bring to other assets. Modern HCM is, in fact, becoming an asset management discipline.

In view of these realities, what do directors need to know about their organization’s HCM and what specific information should they be demanding from their executive teams?

1 This article draws on content first published in Haig R. Nalbantian, “When it Comes to Human Capital Reporting, Mum’s Still the Word,” Risk & Compliance Magazine. Financier Worldwide Ltd., October-December, 2016.


Why directors should care about HCM

A significant body of scholarly research has demonstrated strong empirical links between HCM and business performance, including shareholder value. Our own research has uncovered an important channel through which HCM can affect shareholder value—workforce productivity.\(^5\) Statistically analyzing 20 years of census data on manufacturing establishments in the United States, our research found that, all else being equal, companies that consistently maintain superior workforce productivity in their plants in comparison to their peers also achieve higher market value (as measured by Tobin’s Q\(^6\)). In effect, sustained premium workforce productivity becomes an intangible asset.

In analyzing the running record of productivity and performance data of client organizations, we find that effective HCM is often a major driver of persistent productivity advantages. To give an example, in a US regional bank, from 10 to more than 40 percent of the variation in branch productivity and performance was attributable to human capital factors depending on the performance measure tracked, as seen in Figure 1:

By far, the biggest predictor of branch success was the tenure of employees in the front-line jobs. We estimated that each additional year of average tenure across the branches was worth $40 million to the bottom line.

Of course, the relative magnitude of HCM’s impact varies across industries and companies. But seldom is the impact negligible. Moreover, even small increases in workforce productivity, if sustained, can generate substantial value to the firm.

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\(^6\) Tobin’s Q Ratio is defined as a company’s market value divided by the replacement value of its assets.
This example also points to significant risks associated with the people side. The research shows that unwanted turnover would be particularly damaging to this business. Valuing productive incumbents would be essential to protecting against the materialization of this risk. Unfortunately, by paying top dollar to recruit new kinds of talent, the organization was inadvertently devaluing their seasoned incumbents. The “return to tenure” for these employees was flattening. Not surprisingly, turnover among higher performing, tenured staff was rising. The very asset that was creating value was starting to walk out the door. Management had to act to address this emerging risk.

This work highlights that directors should have a strong interest in learning more about how companies determine if they have secured the right workforce to achieve their business objectives and whether they are managing that workforce effectively. This is an increasingly urgent question, as rapid technological advances and the infiltration of digitization into all aspects of production and/or service delivery are changing the very nature of work and the kind of human capital companies must access to drive business success. If business transformation is not supported by corresponding workforce transformation, short-term performance will likely decline and shareholder value will be threatened.

The flip side of optimizing workforce management is minimizing and efficiently allocating “human capital risks.” Human capital risks are often among the most serious threats to shareholder value. Directors need to know if and to what extent these risks exist and what is being done to address them.

**Should there be standardized HCM metrics for reporting?**

The quest to produce a standardized set of human capital metrics for public disclosure is problematic. One-size-fits-all, standardized human capital metrics can be dangerously misleading because of the highly contextual nature of human capital management.

For example, streamlined organizational layers and relatively large managerial spans of control may signal operational efficiency in one business, but represent weak supervision and inadequate opportunities for career advancement and learning in another, thereby hurting business performance. Similarly, reliance on incentive compensation plans may signal the application of “pay for performance” in one company but in another may represent an inefficient mechanism to shift business risk from shareholders to employees, upending established principles of effective risk management and actually weakening performance incentives.

Even the most basic human capital metrics can be problematic. For example, high or rising voluntary turnover can be a signal of serious problems in talent management. On the other hand, in times of business transformation, higher turnover may be precisely what's needed to speed adaptation of the organization's workforce to new business requirements. Without it, the organization will be unable to deliver on its strategy without exploding its labor costs. Focusing on voluntary turnover without regard to the business context in which it is taking place can be dangerously misleading.

Great care needs to be taken when comparing and interpreting human capital metrics across companies. Human capital reporting requirements that fail to recognize this hazard and permit tailoring and contextualization of published metrics can do more harm than good.

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A proposed approach

Human capital reporting must provide information with which directors and investors can gauge whether the organization is securing the right workforce—the right mix of skills, capabilities, and experience—and whether it is managing that workforce in a way that drives productivity. Investors need to have some knowledge about the methods and processes used by company management to ensure human capital is, in fact, being effectively managed as an asset.8

From the standpoint of workforce optimization, critical questions include these:

1. Does the organization have in place an explicit workforce strategy that defines the talent requirements necessary to achieve strategic goals and a set of mutually reinforcing management practices to ensure this talent is secured and productively managed?

2. What are the core elements of this workforce strategy?

3. On what is this workforce strategy based? Specifically, what kind of quantitative and qualitative information is management relying on to inform its workforce decisions?

4. What measures are in place to track whether the strategy is being executed effectively and hold executives and line leaders accountable for results?

From the standpoint of human capital risk, key questions directors should pose include these:

5. Does the organization have in place a disciplined workforce planning process to identify looming talent gaps and other risks associated with business or technological change?

6. On what data sources and methods does the workforce planning process rely to identify and measure potential talent gaps? Specifically, how does the organization forecast future talent needs? How does it assess the ability of the internal or external talent supply to meet those talent needs?

7. Does the organization have in place a plan to mitigate any risks identified?

Rather than mandate a specific set of metrics to be reported by all, it is preferable to oblige management to provide directors and, ultimately, shareholders, with responses to process questions such as these, backed by hard data to substantiate their answers. This would enable directors to gauge whether management is pursuing a disciplined asset management approach to human capital that can maximize economic value and identify and mitigate human capital risks.

Basic Descriptive Metrics

Absolute metrics are critical when reporting the demographic composition of the workforce. Given outside pressures and the potential business value of workforce diversity, accurate information on employee demographics, including generational mix, is vital.

A simple, highly useful device for conveying workforce composition is the Internal Labor Market (ILM) Map. The map offers a systems view of the workforce, both how it is distributed across career levels and how talent flows into, through, and out of the organization over time. It provides a summary rendering of the workforce that is easy to understand and potentially revealing of potential talent issues or challenges facing the organization. The ILM Map can be segmented in a variety of ways, for example by gender, as shown in the bipartite map in Figure 2.

Understanding the Baseline Data
An Internal Labor Market (ILM) Map

<table>
<thead>
<tr>
<th>CAREER LEVEL</th>
<th>TOTAL HIRES</th>
<th>AVERAGE REPRESENTATION AND TOTAL PROMOTIONS</th>
<th>TOTAL EXITS</th>
</tr>
</thead>
<tbody>
<tr>
<td>LEVEL 7</td>
<td>Females 0%</td>
<td>7% 93%</td>
<td>Females 0%</td>
</tr>
<tr>
<td></td>
<td>Males 2%</td>
<td></td>
<td>Males 4%</td>
</tr>
<tr>
<td>LEVEL 6</td>
<td>Females 1%</td>
<td>16% 84%</td>
<td>Females 2%</td>
</tr>
<tr>
<td></td>
<td>Males 3%</td>
<td></td>
<td>Males 3%</td>
</tr>
<tr>
<td>Buying male</td>
<td>LEVEL 5</td>
<td>Females 3% 4%</td>
<td>Females 3%</td>
</tr>
<tr>
<td>talent here</td>
<td></td>
<td>Males 5%</td>
<td>Males 5%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LEVEL 4</td>
<td>Females 5%</td>
<td>47% 53%</td>
<td>Females 7%</td>
</tr>
<tr>
<td></td>
<td>Males 6%</td>
<td></td>
<td>Males 8%</td>
</tr>
<tr>
<td>Women face</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a glass ceiling</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LEVEL 3</td>
<td>Females 8%</td>
<td>73% 27%</td>
<td>Females 13%</td>
</tr>
<tr>
<td></td>
<td>Males 7%</td>
<td></td>
<td>Males 10%</td>
</tr>
<tr>
<td>LEVEL 2</td>
<td>Females 11%</td>
<td>89% 11%</td>
<td>Females 11%</td>
</tr>
<tr>
<td></td>
<td>Males 10%</td>
<td></td>
<td>Males 16%</td>
</tr>
<tr>
<td>Buying female</td>
<td>LEVEL 1</td>
<td>Females 17% 16%</td>
<td>Females 16%</td>
</tr>
<tr>
<td>talent here</td>
<td></td>
<td>Males 17%</td>
<td>Males 22%</td>
</tr>
</tbody>
</table>

Source: Mercer. Disguised case example.
Conclusion

In today’s economy, an organization’s human capital is indeed an asset, often the single largest and most important investment the organization makes. The effectiveness with which that asset is assembled and managed is central to creating value for shareholders and mitigating significant business risks. Careful attention to decisions about HCM therefore becomes a critical part of good board governance.

The information commonly available to directors is often inadequate for them to fulfill this duty. This must change. Advanced workforce analytics and easily accessible workforce data are enabling the flowering of workforce management as an asset management discipline. As such there is no longer an excuse for organizations to keep their directors and investors in the dark about the people side of operations.

Directors can encourage the advancement of this discipline in their own organizations by asking the kind of questions articulated in this article. In doing so, they can lead the way to enhanced transparency about HCM for investors and help their organizations maximize the contribution of HCM to shareholder value.
