Strategic Human Capital: Closing a material gap in corporate disclosure

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Long term investor value preservation and growth have never before depended so fundamentally on effective management of human capital. Rapid technological change and intensifying competition in an increasingly borderless commercial environment are reshaping modern business, requiring new organisational and strategic responses. While effective deployment of people has always been important to business success, a strategic approach to human capital is now critical. This is because increasingly radical responses are required for businesses to mitigate risks and pursue opportunities associated with accelerating business model innovations, rapid advances in automation, big data, machine learning, and artificial intelligence.

Given the potential for both value destruction and growth arising from such disruption, information about human capital strategy is material, as it is highly relevant to ensuring markets are adequately informed of risks and future prospects. In Regnan's analysis, disclosure practices on human capital management have not kept pace with the changing business landscape. We therefore regard it as incumbent on company directors and managers to ensure markets are informed of organisational and human capital approaches, where these provide material information relevant to business strategy and outlook. Further, we question whether listed companies are fully meeting their obligations to keep markets informed of material human capital issues and risks.

Accelerating business disruption gives greater urgency to communication of human capital responses, especially where business models are vulnerable to lower-cost competition, technology-led structural change or competing business models. The immediate steps which companies can take to improve market transparency of strategic human capital responses are the subject of this paper.

STRATEGIC HUMAN CAPITAL MANAGEMENT

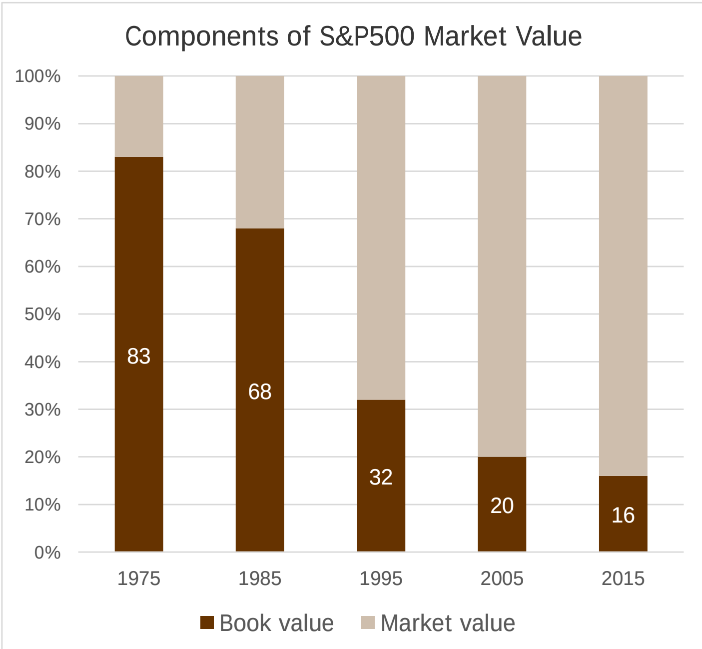
We see human capital as constituting the knowledge, skills and abilities that reside in individuals, as well as the shared knowledge of employees as a group. The ways in which knowledge, skills and abilities are organised to achieve corporate objectives – strategic human capital management – is an increasing determinant of corporate value.

We distinguish strategic human capital management from day-to-day management of human resources based on its focus on evolving external risks, threats and opportunities faced by the business. As such, strategic human capital management is a key underpinning of strategy execution.

However, strategic human capital is generally not well disclosed, resulting in poor integration of this information into consensus views and valuations. Enhancing this would promote more efficient capital allocation, and would support enterprise value through a time of disruptive change. This paper provides suggestions on how to enhance strategic human capital disclosures for an investment audience.

HUMAN CAPITAL MANAGEMENT AND INTANGIBLE VALUE

Today, intangible assets – including strategic human capital – represent a significant proportion of the value in Australian listed companies. That the value of intangibles is largely ignored by corporate accounting rules helps explain the huge and growing gap between market value and the value recorded in financial accounts. Accounting value now represents only around half of market value for the S&P/ASX200 and less than 20% for the S&P500 (chart).



Source: Ocean Tomo

This unrecognised proportion of market value has grown with the decline of manufacturing and resource sectors, and the increasing representation of businesses that create significant value from intellectual property, brands and human capital.

Because human capital, its management, and the levers by which these translate to financial value in companies are less easily quantified, it receives relatively scant attention in corporate communications to investors. Given the limited information available to inform investor judgements about human capital actions material to value and outlook, the market's recognition of and reward for investment in superior practices remain imprecise and unevenly distributed.

The share of market value explained by the financial accounts is now a tiny proportion for most firms.

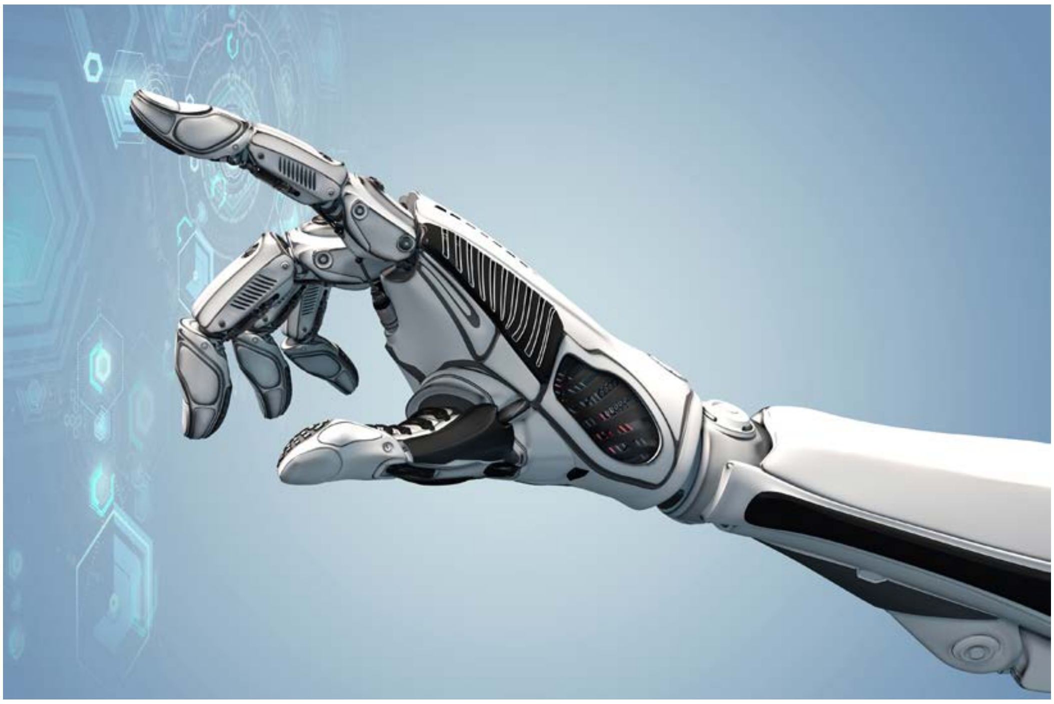
THE HUMAN CAPITAL LINK TO DISRUPTION RISK

We see strategic human capital management as an area for both practice improvement and enhanced corporate communication to markets, given the scope for significant value destruction from disruptive forces affecting most industries. While the retail sector has received particular attention due to online competitors expanding their presence in the Australian market, business models are at risk across multiple sectors in the ASX.

Acquisition of technical capability through capital expenditure is only one line of defence to disruption risk; in most cases, greater organisational agility is required to preserve and grow markets. In addition to acquiring and integrating new capabilities, the strategic application of human capital may be directed toward, for instance, redeployment of existing capabilities or more fundamental reorganisation.

For example, the announcement by one of Australia’s largest banks that it would comprehensively restructure its work organisation in 2018 by removing hierarchies and bureaucracy – adopting organisational structures like those used in fast moving tech companies – is a direct response to disruption risk. While yet to be tested, reorganisation of work on this level is directed at increasing the responsiveness of the organisation to business threats, identifying opportunities in new markets, products or services, and reducing the time required to bring new products and services to market, (or all of these). Similar responses are emerging across ASX companies where business models are highly vulnerable.

The example above illustrates the expanding scope of human capital management to core strategic considerations, well beyond the traditional role of human resource functions. The quality of strategic human capital actions, in many cases, will determine whether ASX companies survive, thrive or struggle in our view. The market will continue to form views on the viability of business models, indeed, some business models are more amenable to transformation. Informative disclosures which provide a basis for gauging the quality of companies’ actions on this front would promote more effective assessments by investors across the market.



COMMUNICATION OF HUMAN CAPITAL MANAGEMENT TO MARKETS

The increasingly important link between human capital management and corporate value provides a strong case for better communication to investment markets. Over many years of research, Regnan has observed progress on management and communication of material environmental, social and corporate governance (ESG) risks by ASX200 companies, but progress on human capital management has lagged, and remains highly variable across and within industry sectors.

Disclosure on human capital in ESG reporting is typically focused on factors only loosely connected to strategic considerations (e.g. policies on freedom of association or compliance with international labour standards, which are less relevant in OECD economies with established labour laws). Another common problem is disclosure of human capital metrics at highly aggregated levels, limiting visibility into the more material issues. For example, employee turnover disclosed at the company-wide level provides little insight into attraction and retention of high performing employees in strategically important business segments, which may be material to business prospects.

We question whether listed companies are fully meeting their obligations to keep markets informed of material human capital issues and risks.

The challenge for issuers is to ensure market disclosures include human capital information where material, and report this information to illuminate execution risks and opportunities. These are new areas for reporting, but reflect growing demand for qualitative information disclosure alongside financial disclosure. Additions to statutory reporting and listing requirements in other international jurisdictions reflect similar trends, the furthest advanced being the Strategic Reports in the United Kingdom and integrated reporting expectations for companies listed on the Johannesburg Securities Exchange.

In keeping with these reporting trends, we believe there is a case for enhanced disclosure of strategically-oriented human capital management information within the Operating and Financial Review (OFR) reporting requirements introduced in Section 299A of the Corporations Act to address the lack of contextual information. In this regard, ASIC guidance on OFR reporting (RG247, updated in 2013) states that an operating review is "designed to enhance the periodic financial reporting regime so that other useful and meaningful information can be made available regularly for the benefit of shareholders".

Investor needs for greater transparency and contextual reporting are also reflected in the Group of 100 Guide: Review of Operations and Financial Conditions, and the IFRS Management Commentary Practice Statement. OFR disclosure requirements represent a partial response to the increasing international attention to integrated reporting formats.

OFR guidance states disclosure should "contain information that shareholders would reasonably require to make an informed assessment of the entity's operations, financial position, and business strategies and prospects for future financial years" (RG 247.31–RG 247.33). Especially within the contemporary business environment for ASX companies, human capital management is material to an entity's operational status, and forms a core element of business strategy – the successful execution of which is material to future prospects.

ASIC has highlighted its greater focus on disruption risk not only in relation to fair valuation and impairment testing, but also to management discussion and analysis (strategy, prospects and risks) and continuous disclosure requirements. Insufficient consideration of disruption risk was a factor in a number of cases where listed company accounts were revised as part of ASIC's surveillance program on 2016 financial accounts.

DISCLOSURE RECOMMENDATIONS

In this section, we outline high level guidance for human capital disclosure, recognising the wide variation in company circumstances, business models and risk factors.

Disclosure of human capital information in the operating and financial review (OFR) is relevant where human capital management is material to operational status, strategy and prospects. We expect companies will make assessments as to the sensitivity of specific human capital strategies, and shape disclosure accordingly (refer to ASIC guidance RG247).

Disclosures on human capital are likely to be largely qualitative, supplemented with relevant metrics where quantitative data provides a more complete picture of trends.

The examples provided are not intended to be exhaustive. We expect disclosure on human capital management to address company-specific exposures and opportunities. The overarching aim is to identify human capital information to enhance market understanding of corporate health, and strategies to protect and grow value.

Disclosure of some strategies and risks will be problematic, given sensitivity of this information to affected people. In these areas, disclosures of the governance structures supporting strategic human capital management can offer partial assurance for investors. For example, disclosure can answer questions such as: What objectives are being targeted internally? Who is accountable for setting these objectives? Who for meeting them?

Operational status

Within OFR disclosures, human capital related disclosures are relevant wherever such information provides clarity on operational issues or business model risks and exposures not otherwise recognised in financial statements. For example, this may include:

- Information on key employee movements relevant to the operational performance of the business (or segment) wherever operations have been affected by attraction and retention of people (e.g. loss of key management personnel or critical skills necessary to achieve operational performance objectives or targets).
- Progress on integration of employees from mergers or acquisitions (e.g. work role synergies, milestones achieved relating to employee training).
- Availability of specialised skills where this may have affected capability to address business model threats (e.g. IT skills to build or expand online services).
- Availability of skills related to industry cycles (e.g. availability of professionals or skilled labour in target locations).
- Progress on corporate reorganisation initiatives linked to strategic objectives.

Strategy

We see scope for listed companies to provide enhanced human capital management information where effective deployment of people is fundamental to execution of strategies. While strategy execution always relies on management of people, execution risks are significantly greater for companies exposed to material and imminent disruption risks, or in companies where a high proportion of intangible value is held in people.

ASIC OFR guidance encourages companies to “outline the entity’s key business strategies, including significant plans that are a part of those strategies”. Human capital disclosure may include:

- Significant reorganisation plans (e.g. restructure of human capital to deliver a strategic objective).
- Acquisition of skills to enhance capabilities necessary to deliver strategy, either via new hires or merger/ acquisition of an entity with appropriate capabilities.
- Strategies to retain key management personnel and critical employees.
- Strategies to integrate human capital in mergers or acquisitions.
- Strategies to retrain or redeploy employees, where for example skills shortages limit access to specialised skillsets needed to deliver strategy.

The quality of strategic human capital actions, in many cases, will determine whether ASX companies survive, thrive or struggle.

Prospects and risks

OFR disclosures are intended to provide better visibility into the entity’s prospects for future financial years, taking into account its disclosed business strategies and other relevant factors. To ensure balance, material business risks that could adversely affect the achievement of the financial prospects for those years should be provided. Human capital management risks should be addressed where these could have an adverse impact on the achievement of the financial performance or outcome, or alternatively, could materially improve the financial prospects disclosed. Example human capital disclosure risks could include:

- Risks to delivery of organisational restructuring (e.g. clear articulation of milestones, achievement of timelines).
- Risks to attraction and retention of crucial employees or talent (e.g. whether attraction or retention is likely to increase or decrease and reasons).
- Risks to attraction and retention of specialised skills (e.g. IT skills to build digital capability).
- Risks to integration of employees from recent mergers or acquisitions (e.g. functional integration, cultural integration).
- Mitigation arrangements for all of the above.

CONCLUSION

This paper seeks to provide a rationale for enhancing disclosure of strategic human capital to improve market efficiency in the context of rapidly growing disruption risks and opportunities, and the growing value of intangibles that are dependent on people. This is also consistent with the investor-driven push for integrated reporting formats which offer a more complete, representative set of indicators of corporate prospects and outlook. We argue that operating and financial review (OFR) reporting requirements under the Corporations Act provide an existing structure for enhanced disclosure of strategic human capital. Indeed, where human capital reporting is absent and strategic human capital risks are material, companies may not be fully meeting their disclosure requirements.

As a less evolved area of reporting, strategic human capital disclosure will require multiple year effort by companies to fully develop and to integrate such disclosure with both statutory and voluntary reporting tasks. This will require formalised commitment, and the involvement of multiple internal functions.

The scope of human capital reporting is also likely to extend to wider reputation concerns as corporates adopt new technologies with the potential to displace large numbers of employees. Whilst beyond the scope of existing disclosure obligations addressed in this paper, workforce adaptation to technological change, for example via workforce redundancies, retention or redeployment, is likely to be increasingly scrutinised by community and government stakeholders, along with those investors concerned with the implications of employment levels for the economy. Establishment of strategic human capital reporting structures, including for OFR requirements, should provide a foundation to develop better informed workforce strategies and to communicate strategies to these wider stakeholder groups.

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Regnan was established to investigate and address environmental, social and corporate governance (ESG) related sources of risk and value for long term shareholders in Australian companies.

Its research is used by institutional investors making investment decisions, and also used in directing the company engagement and advocacy it undertakes on behalf of long term investors with $73 billion, or ~4.5%, invested in S&P/ASX200 companies (at 30 June 2017).