

The value of metrics and narratives in reporting workforce and human capital information



An investor and users of annual report perspective

Introduction

NEST first held a roundtable on the workforce and human capital in 2013. Over the subsequent years our work has expanded, and other investors have also started to play a vital role in raising interest levels. On 17 October 2017 NEST, People's Pension, and the Financial Reporting Council's (FRC) Financial Reporting Lab (Lab) partnered in organising a roundtable on '*Metrics and narratives to report Human Capital*'.

The aim of this roundtable was to bring interested groups together to discuss opportunities and barriers to company reporting on workforce and human capital, with the possibility of taking any agreed ways forward into a future FRC lab project. Roundtable participants included corporations, pension plans, asset managers, the FRC, and industry organisations.

What we mean by workforce and human capital

By workforce we mean the group of people who work for a company. By human capital we mean the collective capability, knowledge and skills of the people that are employed by an organisation (CIPD, 2017). Capability, knowledge and skills influence the workforce's productive capacity and the earning potential of the company.

With the support of the roundtable participants, this paper is principally designed to inform a future FRC Lab project, the 2018 consultation on the Corporate Governance Code, and the work of the Department for Business, Energy and Industrial Strategy (BEIS) on the Strategic Report and pay ratios.

Our paper adds to the body of recent research on workforce and human capital by adding vital practical detail from the perspective of investors and users of annual reports. Recent practitioner research includes; *Managing the value of your talent (Valuing your talent, July 2014)*¹, *The Materiality of Human Capital to Corporate Financial Performance (IRRC, May 2015)*², *Where is the workforce in corporate reporting? (PLSA, June 2015)*³, *Creating Value: The value of human capital, reporting (IIRC, June 2016)*⁴, *Long Term Reporting Guidance (Investment Association, May 2017)*⁵, *Human capital metrics and analytics (CIPD, May 2017)*⁶, and *Hidden talent: What do companies' annual reports tell us about their workers? (PLSA, November 2017)*⁷.

This paper is based on the outputs of the half-day roundtable event and organised as follows. Section 1 rehearses the enduring reasons why workforce and human capital reporting is so valuable to investors and other users of the Annual Report. Section 2 sets out UK public reporting requirements for quoted companies on workforce and human capital. Section 3 discusses the main outcomes from the roundtable debate, and Section 4 concludes.

¹ https://www.cipd.co.uk/Images/managing-the-value-of-your-talent-a-new-framework-for-human-capital-measurement_2014_tcm18-9266.pdf

² https://lwp.law.harvard.edu/files/lwp/files/pension_paper_materiality_of_human_capital_042015.pdf

³ <https://www.plsa.co.uk/portals/0/Documents/0439-Where-is-the-workforce-in-corporate-reporting-An-NAPF-discussion-paper.pdf>

⁴ http://integratedreporting.org/wp-content/uploads/2015/12/CreatingValueHumanCapitalReporting_IIRC06_16.pdf

⁵ <https://www.theinvestmentassociation.org/assets/files/press/2017/Long%20Term%20Reporting%20Guidance.pdf>

⁶ https://www.cipd.co.uk/Images/human-capital-metrics-and-analytics-assessing-the-evidence_tcm18-22291.pdf

⁷ <https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2017/7160%20Hidden%20Talents%20research%20report%20v4.pdf>

Summary of roundtable outcomes according to each section

In the first section workforce and human capital reporting is found to have a strong human-interest element, to help the achievement of investment objectives, to support the development of investment products that savers want, and at times to be material not in isolation but when combined with a mosaic of other information about a company.

In the second section on required workforce and human capital reporting, three out of the five required Annual Report items are found to be based on the number or cost of employees. These can be found in the Financial Statements at the back of the Annual Report. There is no requirement to report on activity, action, contribution, conduct, or performance. There was strong interest from roundtable participants to report on these areas within the front of the Annual Report.

The third section finds that enhancing the guidance to current reporting requirements is all that is needed to achieve better workforce and human capital reporting in the Annual Report. Addressing the workforce and human capital knowledge gap would benefit savers, companies, and the national economy. The section appraises some of the main metrics, measures, and narratives that investors would find most meaningful. In doing so, solid foundations are laid for a potential FRC Lab project. We find no structural impediments that prevent companies from additional workforce and human capital reporting. We do find complexities that standard setters and users of Annual Reports need to remain sensitive to.

Section 1: Enduring reasons why workforce and human capital reporting is so valuable

The value of good reporting on workforce and human capital cannot be emphasised enough. As all companies use labour as an input, there is a systematic, even systemic, quality about the workforce. Accordingly, pension plans, insurance companies, and asset managers are interested in the application of workforce and human capital information to their investment portfolios.

The level of interest already present among these investors is further raised because the very members, customers, and clients of pension plans, insurance companies, and asset managers are typically part of a workforce. The human-interest angle is one that millions of savers can in particular relate to, through reporting to them and through the investments made for them.

The double coincidence of interests outlined above leads many investors to want to take-in workforce and human capital information as they seek to achieve sustained, long-run, investment returns as well as meet the demands of wider objectives. However, current approaches to company reporting do not yield the information needed to achieve these goals.

Of course, it does not follow that just because investors desire information from companies that this should be made available. In response to that challenge, roundtable participants proposed the following three reasons why additional workforce and human capital reporting should be made available:

- There would be an improvement in the overall quality of company reporting. In particular, key performance indicators (KPIs) and statements about workforce and human capital would help to:
 - sharpen the explanation and description within the Strategic Report.
 - add important context to the Viability Statement.
 - improve shareholders' assessment of how the directors have discharged their duty under section 172 of the Companies Act 2006 to promote the success of the company.
- Workforce and human capital information passes the important objective test that a reasonable person would want to know that information to identify and invest more in companies that take opportunities to train and develop their workforce. End investors benefit when their financial capital is directed to its highest value use, and the lower cost of capital for well-managed companies will help to achieve a more efficient allocation of capital.
- Disappointing financial numbers reported in the annual accounts are usually outcomes - the news they convey concern previous actions and behaviours. Changes in workforce and human capital patterns speak to investors about root cause where they're more likely to find clues that may later crystallise in financial numbers.

Summary

In this section, workforce and human capital reporting was found to have a strong human-interest element, to help the achievement of investment objectives, to support the development of investment products that savers want, and to be material not in isolation but when combined with a mosaic of other information about a company.

Section 2: Reporting requirements for UK quoted companies on workforce and human capital

This section sets out UK public reporting requirements for quoted companies on workforce and human capital. The companies the roundtable participants had in mind were the approximately 600 names in the FTSE All Share. For all companies with a premium listing of equity shares that are incorporated in the UK, the following reporting requirements apply to workforce and human capital:

Narrative reporting within the front of the annual report

UK quoted companies are required each year to collect gender diversity data and publish within the Strategic Report the number of directors, senior managers, and employees in the group as a whole of each sex^{8 9}.

The Directors' Report must contain information on the company's policy on employment of disabled persons and a description of actions in relation to informing and involving employees¹⁰.

The Directors' Remuneration Report must contain a statement of how pay and employment conditions of employees of the company and of other undertakings within the same group as the company were taken into account when determining directors' remuneration for the relevant financial year¹¹.

A new proposed reporting area for companies with a premium listing, whether they are incorporated in the UK or elsewhere, is the 2018 revised Corporate Governance Code. This is likely to ask for an explanation of the company's approach to investing in, developing, and rewarding the workforce, and what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company policy¹².

Finally, the Government has plans to introduce secondary legislation on pay ratios. Roundtable participants generally welcomed the introduction of pay ratios, but there was some concern that the requirement to produce the information without supplying wider context may have possible unintended consequence of pushing workers into agency contracts rather than employment contracts.

Notes to the Financial statements

Financial Reporting Standard 102 requires a presentation within the notes to the financial statements on¹³:

- The average number of persons employed in the financial year in total and analysed by category selected by the directors, having regard to how the company's activities are organised¹⁴.
- Wages and salaries paid or payable to the persons employed
- Social security costs incurred by the company on their behalf
- Private pension costs incurred by the company on their behalf

For group accounts, the requirements apply as if the undertakings in the consolidation were a single company.

⁸ Companies Act 2006, for quoted companies, provision 414C(8)(c),(9)and(10)

⁹ EU directives and European Court of Justice rulings have been the major source of progress on workplace reporting in the front end of the annual report. The Equality Act 2010 mirrors and implements four major EU Equal Treatment Directives and is designed to protect people in the workplace from discrimination on various grounds, including age, disability, race and sexual orientation.

¹⁰ The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 schedule 7 10(3) and 11(3)

¹¹ The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 schedule 8 part 2 4

¹² FRC, December 2017, Proposed Revisions to the UK Corporate Governance Code. Accessed at <https://frc.org.uk/getattachment/31897789-cef6-48bb-aea9-f46b8cf80d02/Proposed-Revisions-to-the-UK-Corporate-Governance-Code-Dec-2017-1.pdf>

¹³ Companies Act 2006, for quoted companies, provision 411

¹⁴ Part-time and full-time persons on employment contracts (excludes self-employed, contractors, consultants, non-executives). Calculated by sum of number of employed persons each month / 12.

The table below summarises the reporting requirements currently in force.

Item	Workforce and human capital reporting requirement
1	Gender diversity of directors, senior managers, and employees
2	Policy on employment of disabled persons
3	Description of actions in relation to informing and involving employees
4	Average persons employed by category selected by directors
5	Costs of salaries, social security, and pension costs

Summary

In this section on required workforce and human capital reporting, three out of the five required Annual Report items in the table above are found to be based on the number or cost of employees. These are located in the back-end of the Annual Report, in the Financial Statements. There is no requirement to report on activity, action, contribution, conduct, or performance. There is strong interest from roundtable participants to report on these areas within the front of the Annual Report.

Section 3: Main outcomes of the roundtable debate

This section organises the roundtable discussion into themes that are tackled through providing answers to four linked questions:

- Where would additional reporting go?
- What benefits do additional workforce and human capital reporting give investors?
- What workforce and human capital metrics and measures would investors find helpful?
- What barriers do companies perceive?

Where would additional reporting go?

The consensus among roundtable participants was that the current nature and extent of reporting being asked of companies on workforce and human capital is insufficient. There is not enough information to assess differing company approaches thoughtfully. The new Strategic Report was believed to be the most appropriate section to apply additional workforce and human capital. The reason given was that the Strategic Report already offers the flexibility for a wide range of workforce and human capital information to be provided.

The new Strategic Report provides an opportunity for a board to present a single, coherent narrative which explains the company's performance¹⁵. The Strategic Report section also puts more focus on the director's duty under section 172, 'Duty to promote the success of the company', where directors must have regard to the broader matters specified.

Currently there are very few items of required content for the Strategic Report. The revised guidance sets out a requirement for KPIs but does not say what specific KPIs are necessary. For this reason, roundtable participants believed the application of company specific workforce and human capital KPIs and narratives would make statements less vague and generic, bring balance to the Strategic Report, promote discussion by companies of effects, and contribute to more evaluation and explanation of impacts¹⁶.

The other section mentioned by roundtable participants where workforce and human capital information provision would add value was within the corporate governance statement. There was strong support from investors across the industry for the Corporate Governance Code to incorporate a workforce and human capital reporting requirement. Doing so would help strengthen shareholders' ability to evaluate how companies have applied the Principles of the Code in the following two ways:

- Provision C.1.1 of the Corporate Governance Code mentions that, taken as a whole, the annual report and accounts should be fair, balanced and understandable in order to provide the information necessary for shareholders to assess the company's position and performance, business model and strategy¹⁷.
- The 2018 proposed (but not final) Corporate Governance Code asks for an explanation of the company's approach to investing in, developing, and rewarding the workforce, and what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company policy.

¹⁵ Content analysis of Strategic Reports by the Pension and Lifetime Saving Association finds that the new Strategic Report has so far brought little in the way of new or higher use value information (PLSA 2015, 2017).

¹⁶ Companies Act 2006, for quoted companies, provision 414C(7)(b)(i), (ii) and (iii). Directors are to provide information on the environment, employees, social, community, and human rights issues to the extent necessary for an understanding of the development, performance or position of the business. A company may choose to omit information and instead provide a statement that information has not been included, including the type of information excluded. If the directors determine the information above is not applicable to the company there is no requirement for inclusion.

¹⁷ UK Corporate Governance Code Provision C.1.1

What benefits would additional workforce and human capital reporting give investors?

As a result of limited workforce and human capital reporting, the roundtable revealed that investors are left with an information gap. Investors' ability to tackle the workforce and human capital knowledge gap depends on the types of portfolio they invest in and their ability to access individualised disclosure. Large investors that held few stocks in portfolios obtained much of their workforce and human capital information from direct engagement with companies. Investors with more expansive portfolios found that even with the application of effort, it was not practicable to obtain the intelligence needed across the number of companies they invest in. Due to differences in the ability to obtain individualised disclosure there was a wide distribution in investors' knowledge on workforce and human capital. Additional reporting would greatly help to level the playing field as well as provide the following other benefits:

- Ability to respond to rising client demand for investment strategies and products that incorporate workforce and human capital information.
- Reduced concern regarding reputation and performance of companies held in portfolios.
- Improved adoption and incorporation of the theme within portfolio construction, security selection, and evaluation of expected risk and return.
- A clearer rationale when voting on the remuneration report and policy.
- A clearer rationale for further stewardship work.

What workforce and human capital metrics and measures would investors find helpful?

Roundtable participants mentioned five areas where the implementation of workforce and human capital metrics and measures would lend strength.

1. The first area mentioned by roundtable participants was the provision of a base of common metrics. A base of common metrics will help comparisons to be made between companies and are valuable in helping gather and make sense of a large number of companies. This could include a comply and explain approach. Participants believed that common reporting can help improve markets and be especially effective in improving actual workforce and human capital performance among the worst companies. A few participants mentioned the risk of asking companies to report on frameworks that may not fit their business. This might be possible to overcome through an additional layer of common sectoral reporting.
2. Building on the base of common metrics, the second area of interest was company specific metrics and measures. The consensus among roundtable participants was that in order to develop an understanding of what companies think is strategically important, companies need to be able to develop their own reporting framework, hopefully with consistency and comparability over time. Heavily prescriptive information was to be avoided. Participants supportive of this approach believed that giving companies flexibility to report internally what is most important to them and then reporting a version to investors will ensure a low burden on business. Giving companies freedom to report will help investors to see the differences between companies and help them to differentiate companies from one another. A small minority of investors believed in limiting the flexibility of company specific reporting. Their proposed approach was to adopt a common standard, or high-level framework, while allowing companies to tell a story around the high-level framework using measures of their choosing.

3. A majority of roundtable participants wanted to receive improved information about the make-up of the workforce globally. One set of measures mentioned was how labour was distributed between full time, part time, permanent, fixed term, agency, zero hours, and other contracts. There would be turnover data, especially divisional data, and turnover broken down into different workforce grades, for example director, assistant director, president, vice president, manager, assistant manager. If turnover is increasing investors wanted explanation. Investors wanted to avoid a possible swing door effect at companies, and this led them to value metrics on joiners and leavers in the past 12 months, as well as retention and internal versus external senior manager hires. The aim was to identify and distinguish those companies that rely more on external recruitment and accept higher leaver rates from those that train, develop, and promote - a distinction referred to as 'transactors' versus 'builders'. Companies would have the opportunity to report on material differences between the intended strategic make-up of the workforce and the actual.
4. Investors believed that information on training, development, progression, and promotion of the workforce was important, but companies believed that this was challenging. Companies mentioned that training and development data are very hard to capture in a single figure because in one sense it is all around so hard to log and commit a number to. Companies felt it would be difficult to report a consistent year-on-year total amount because any estimate would carry a wide confidence interval. Investors wanted data to cover who in the workforce is receiving, whose skills are being enhanced and by how much, as well as an estimate of the distribution or allocation of training and development across levels of the workforce, divisionally and globally. A majority of roundtable participants wanted companies to report metrics that show how samples of staff across the lower and middle ranks have progressed through the workforce over a set period of time, for example three years. Such metrics are intended to provide insight into advancement and progression while at the same time taking the focus away from pay.
5. Roundtable participants strongly believed that conduct and culture metrics play a pivotal role in shining a light on what it's like to work in companies. Participants agreed that the employee engagement survey is a good starting point. Employee engagement is very time consuming to do well but the prize is vital data from the heart of the workforce. Investors did not believe that publishing a part of the employee engagement survey would burden business. A large majority of participants believed that a similar set of information could probably be published by every company around prescribed themes. One suggestion from investors was to take 3 to 5 very similar questions from employee engagement surveys that proxy for the same construct, such as would you recommend..., are you satisfied....? A second suggestion was to encourage the British Standards Institution (BSI) to develop an index of 4 or 5 common employee engagement survey questions. Companies would be asked to report on a pre-agreed 4 or 5, or report what other 4 or 5 are being used, and the motivation and justification for reporting something different. A majority of participants valued data on whistleblowing, but were aware that companies are wary of reporting on it, and besides the interpretation of the data can be highly ambiguous. One way round this was to have companies report service metrics that describe, for example, the channels through which the workforce can raise concerns anonymously, and the use and non-use of those channels.
6. The penultimate area mentioned by roundtable participants during the discussion was health and safety. The law on occupational safety and health (OSH) requires employers to monitor and review arrangements for managing OSH risk. Many organisations already report internally on OSH, for example by producing statistics on accidents, incidents and ill health, but there's no requirement for an organisation to include OSH in externally published reports. Having already prepared information, many companies could fairly easily report OSH data publicly, though investors mentioned that few currently do.

7. The final area, which received less discussion time, was metrics and measures on employee outcomes and effects. For example, where the company performed better or less well around human capital initiatives, what challenges were faced and how were they overcome, how does the company recognise people that develop themselves, and what is the value of the workforce's contribution to the business? A minority of investors thought this was important and mentioned that a key differentiator could be understanding which boards are asking the hard questions about workforce and human capital and those that are not. Companies mentioned that reported data come from the board, so if companies are encouraged to report on workforce and human capital then what gets reported is a fair indication of what information and data on workforce and human capital boards are asking for. This type of information takes us a long way from most research provider measurement, which tends to focus on and effectively reward companies for the reporting of policies and procedures, not outcomes and effects.

What barriers do companies perceive?

It is unlikely to be a coincidence that companies report more on governance and the environment than they do on social frameworks. There is something about social factors that make them difficult to package for investor use. While no obvious impediment was mentioned, companies did cite several barriers. Companies are international, and different information technology systems in different jurisdictions and divisions present aggregation challenges. Companies do have much of the data already but at the same time preparing, packaging, and reporting that data is costly, while some information is commercially sensitive. Some companies do not fully understand why investors want the information, worry about frequently changing goal posts, and perceive that some investors want to micro manage them.

Summary

This section found that enhancing the guidance to current reporting requirements is all that is needed to achieve better workforce and human capital reporting in the Annual Report. If better reporting was achieved, a major knowledge gap would be addressed with benefit to savers, companies, and the national economy. The section appraised some of the metrics, measures, and narratives that investors would find most meaningful. No structural impediment was uncovered that would prevent a company from additional workforce and human capital reporting, but complexities were found that standard setters and users of Annual Reports need to remain sensitive to.

Section 4: Conclusion

We have seen that current approaches to reporting do not yield the information investors need. Proposed revisions to the Corporate Governance Code are expected to lead companies to report what is easiest and most convenient, but not necessarily what is most meaningful to them or others.

Overall, the consensus among roundtable participants was that metrics and measures about the workforce and human capital are vital because they give precisely the type of information that enable investors to take the long view. With them, investors better understand how value is created, competitive advantage achieved, and the contribution companies make to national economic performance. But it's not all about metrics. There is always going to be a role for narrative reporting. For example, it may be useful to know the staff turnover metric, but investors also 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 staff have become more dissatisfied over the past year? Reporting requirements should encompass the entire workforce, regardless of location, to provide investors with the most complete picture of a company's workforce and human capital practice. Taken as a whole, we hope this paper helps to contribute to an improvement in workforce and human capital reporting for the benefit of savers, workers, companies, and the national economy.