Enhanced Analytics

Where Should "Human Capital" Fit in the Sustainability Agenda?

By Dr. Laurie Bassi, Chief Executive Officer, McBassi & Company

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If people are a firm's "most important asset" – as CEOs repeatedly proclaim – why are they only reported as costs? What are the problems caused by this mismatch, and what would ameliorate them? In light of this, what actions can and should investors take?

For starters, CEOs do, in fact, know what they're talking about in this regard – even though their firms' actions are sometimes (maybe even often) inconsistent with their words. Those companies that have consistently prioritized the "people side" of their business are among the best investments you can find. For example, a study by The Boston Consulting Group found that over a 10-year period, companies that appeared at least three times on Fortune's "100 Best Places to Work" list outperformed the S&P 500 by 99 percentage points.[1]

Study after study – by the Sirota Institute, Towers Watson, IBM, Gallup, The Great Places to Work Institute, and countless academics – point to the same conclusion.[2] Companies that make themselves worthy of the best efforts of their employees consistently outperform their less worthy competitors, a trend that has accelerated as the economy has become increasingly knowledge-driven.

Yet despite its growing importance in value creation, the reality remains that the only "human capital" metrics consistently available to investors fundamentally measure people costs. There is very good reason for this: firms do not own people, and hence, people simply cannot be measured as assets in the traditional sense of the word.

Yet this creates a huge disconnect between the reality of people as a firm's most important asset and the measures actually available to investors. This has very real consequences. For example, a firm that is making an unusually large investment in learning and development initiatives to enhance its workforce's capabilities will appear on the balance sheet as simply a "high cost" firm. Its short-run returns will suffer as a result: the firm's investments in workforce development occur despite – rather than because of – pressures from investors. Since workplace learning has very

[1] Boston Consulting Group/WFPMA, From Capability to Profitability: Realizing the Value of People Management (July 2012).

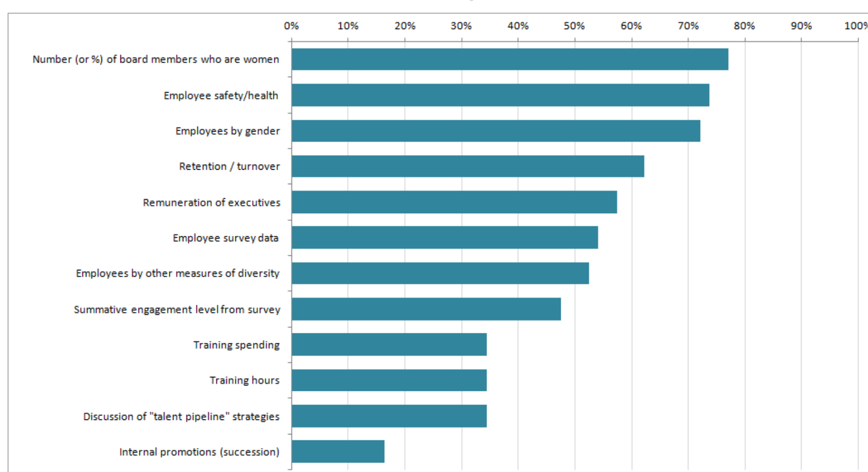
[2] For an excellent summary of this literature see Chapter 2 of Enterprise Engagement: The Textbook, edited by Bruce Bolger, Richard Kern and Allan Schweyer, published for the Enterprise Engagement Alliance by Engagement Enterprises LLC. 2014, Edition 1.0.

Dr. Laurie Bassi is the Chief Executive Officer of McBassi & Company, a human capital analytics firm that helps clients achieve both sustainably profitable and enlightened management of employees. She is the co-author of "A smarter annual report – how companies are integrating financial and human capital reporting" (forthcoming) and "Good Company, Business Success in the Worthiness Era" (Berrett-Koehler, 2012).

significant economic benefits for both employers and employees, the current state of reporting makes everyone worse off.[3] This has broader implications as well. In a world where growing inequality has come to be widely recognized as a threat to social cohesion, it's more than time for human capital to be on the sustainability agenda.

The good news is that progress is being made. In a forthcoming review of Integrated Reports (see Figure 1), my co-authors and I found that firms are voluntarily disclosing a growing number of metrics (with associated discussion) on the people side of their business.

Figure 1
Human Capital Metrics Included in Firms' Integrated Reports



Source: Bassi, Creelman, Lambert, A smarter annual report – how companies are integrating financial and human capital reporting (forthcoming).

Although it's encouraging that a growing number of firms are beginning to disclose more human capital metrics, Figure 1 makes it clear that most of these disclosures fall short of providing a coherent view of what creates, limits or destroys value on the people side of the business. Even on a measure that is now widely recognized as an important indicator of superior financial performance – gender diversity of the Board[4] – there is less than universal reporting among the firms that are leading the way. And other important factors that are known to predict future performance – employee engagement, investments in training and internal promotion rates[5] – are only reported by a minority of these firms.

Providing investors with an abbreviated version of the key information that a firm's Board of Directors should be using to manage human capital risks would go a long way to solving these shortcomings. These risks can be classified into six categories (see Figure 2).

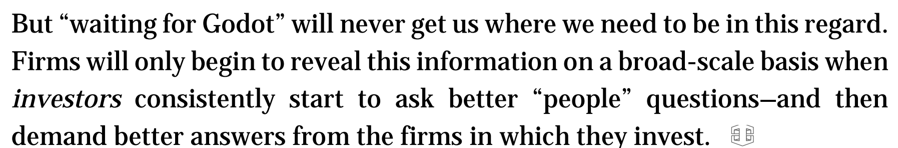
[3] "Employers' Perspective on Human Capital Management and Development," Laurie Bassi and Dan McMurrer, Education Working Paper No. 18, Organisation for Economic Cooperation and Development, Paris, January 2009.
[4] http://www.catalyst.org/media/companies-more-women-board-directors-experience-higher-financial-performance-according-latest.
[5] *Enterprise Engagement: The Textbook*.and "Employers' Perspective on Human Capital Management and Development".

Figure 2
A Risk-Based "People Measurement Framework"[6]

Questions that investors (and boards of directors, for that matter) can use to bring this perspective to light include:

- **Capability Risk**: Do your people have the knowledge, skills, resources, and business processes that will enable them to perform effectively?
- **Alignment Risk**: Do your people really understand your business strategy and goals and do their day-to-day jobs in alignment with those goals?
- **Availability Risk**: Are you finding and acquiring the right people?
- **Turnover/Demographic Risk** – Are you retaining key people? Do you have a pipeline sufficient to replace departing employees?
- **Engagement Risk:** Do your people go the extra mile, and does this show through to your customers?
- **Leadership Risk**: What is the risk that any initiative will fail because you don't have the leadership depth or quality that is needed?

The evidence is clear that long-horizon investors would benefit from having this type of information available. For example, Alex Edmans at Wharton estimated an investment portfolio of the "100 best companies to work" generated 2.3% to 3.8% higher annual returns versus peer companies from 1984 to 2011.[7]



But "waiting for Godot" will never get us where we need to be in this regard. Firms will only begin to reveal this information on a broad-scale basis when *investors* consistently start to ask better "people" questions–and then demand better answers from the firms in which they invest.

[6] This framework was originally proposed by Jim Marchiori, Executive Director, University of Colorado Global Energy Management Program.

[7] Alex Edmans, "The Link Between Job Satisfaction and Firm Value, with Implications for Corporate Social Responsibility," *Academy of Management Perspectives* (November 2012, 1-19), http://faculty.london.edu/aedmans/RoweAMP.pdf.