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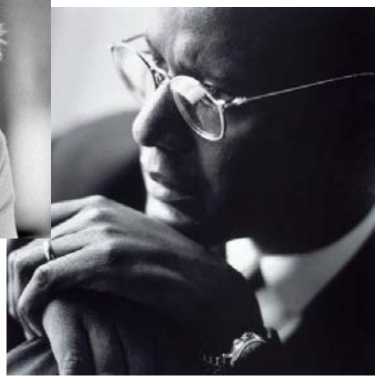
SPOTLIGHT



Cracking The Human Capital Code: The HCC Index

By Nicholas J Higgins, Daniel Clark and Graeme Cohen

Evaluation of organisation performance from a human capital perspective has for too long been focused on misleading or inappropriate attempts to form correlations between simple metrics (e.g. absenteeism) and complex outcome indicators (e.g. share price). This has resulted in distorted approaches to comparing performance across organisations.
This article summarises the limitations of historic attempts, before identifying a new set of measures of human capital performance based on externally reported data, including the comparative concept of Human Capital Intensity. When combined in a composite index, reflecting the multi-faceted nature of people management and organisation performance), these provide deeper insight and comparison than has previously been possible.
Since the inaugural HCC Index, published in 2006, a preliminary review has been conducted into top-ranking and bottom-ranking organisations. Initial findings suggest that bottom-ranked companies are more likely to be taken over, suffer profits decline, divest operating units, restructure and suffer other adverse company events.

Organisations and Human Capital: The search for meaningful comparative measurement

Human Capital Reporting

From a human capital reporting standpoint, we have been concerned, for some time, at the lack of progress and robustness around measurement and reporting. This is despite a number of attempts from within the industry to produce some form of solution.

Our extensive research and work with clients has provided us with a cross-sectional view of the issues and constraints that exist and the prevalent thinking/reasons for measurement and reporting in companies.

We have published a number of papers on HR measurement, some of which challenge certain 'perceived wisdom' that exists. These have asked searching questions around the validity of a number of commonly used/reported HR metrics, and the apparent over-use of benchmarking, given its limitations.

In January 2006, we released our white paper on Human Capital Reporting which included an analysis involving twelve key questions[1].

> ".....our Human Capital Reporting Standards were designed to provide industry with a well-constructed template as a baseline to adopt on an open-source basis."

The answers and insight from these questions provided us with a logical argument from which our proposed baseline reporting solution was based. Given the particularly 'one track' expectation in the market, i.e. a portfolio of ratio based HR metrics, our solution may have caused some surprise with its apparent simplicity.

However, like most reporting solutions, there are multiple layers with deepening complexity. The reporting solution was underpinned with a structured framework in association with operating principles (SHCROPs) for both private and public enterprises. It was designed for both internal and external reporting approaches.

We would acknowledge that there needs to be a distinction between reporting metrics and enhanced analytics, which are more complicated use of metrics to model a more 'in-depth' understanding of the working environment (for example isolating factors that influence employee engagement with performance and/or turnover).

As such, our Human Capital Reporting Standards were designed to provide industry with a well-constructed template as a baseline to adopt on an open-source basis.

To that extent, the solution provided was based on practicality, taking a lead from the way in which organisations report their financial data and subsequent analysis. Our HCR solution was not so much revolutionary as evolutionary, applying well-used principles (from financial accounting) to the emerging discipline of human capital management.

Thus organisations now have a structured framework within which to report, inform and compare human capital related data; and there is an ongoing support structure to help develop and expand this initial framework over time.

However, we have recognised that a dedicated index representing an evaluation of a company's human capital related performance, human capital reporting and human capital management practice will help to 'educate' the process, as well as providing interested stakeholders, such as management, HR functions, analysts, investors, employees, unions and Government with invaluable insight.

The focus on intangibles

For the last decade or so, there has been a market acceptance that organisations are increasingly reliant on intangible assets to derive superior or 'successful' performance.

Though we cannot ignore the importance of tangible assets, intangibles such as human capital, intellectual property, brand, innovation, customer relationships, and knowledge, have become an increasing focus of attention. In fact there are over 38 main classifications of intangibles[2] for valuation purposes. These can be further broken down into over 100 separate categories.

Given that firms combine both intangible and tangible assets and resources to generate earnings, one can see the complexity in drawing a 'working model' to map the 'market value' of a firm (some describe it as being similar to the human genome).

More recently, industry collectively has been engaged in the pursuit of valuing (isolating) human capital as a means of answering a number of searching questions around differentiation of organisational performance.

However, we have to acknowledge that human

[1] See http://www.valuentis.com/Publications/Books/index.htm

[2] See Appendix II on page 77 for an example list

capital though important, is not the only intangible and a number of business models are as (or even more than) reliant on other intangibles/ tangibles to generate superior performance and competitive advantage.

Though evaluating 'human capital', in market value terms, is a worthy pursuit (having settled on the definition), we believe that this is notoriously difficult to achieve and that there are other simpler and more effective ways.

Why market value isn't necessarily a good indicator for measuring human capital

There is a natural tendency for professionals to link market value of a company with human capital as a number of previous attempts would testify. However, there are a number of problems associated with this type of measurement methodology. Main problems associated with this route are:

- As already mentioned the model linking human capital to market value is extremely complex and suffers from many variables, some of which are external to the organisation and not related to human capital. This renders any eventual number fairly meaningless.
- The stock market, itself, is only what is called 'semi-efficient'. This means that it is subject to volatility and distortion from a number of both microeconomic and macroeconomic factors. These affect the particular share-price, whether it is on a specific day or time period, rendering the eventual metric limited in its validity.
- Any market value is subject to time dilation, i.e. the point of value creation or recognition of value creation may not necessarily relate to current period from a human capital standpoint, or indeed there may be a number of time periods.
- Ways of circumventing these problems, for example, taking multiple share-price ranges creates further issues of complexity.
- Market value is, of course, irrelevant for any company that is not listed (unless subject to a bid). It is also problematic for any public sector organisations – a fact that seems to have been overlooked in a number of previous research attempts.

Thus, from a measurement perspective, using market value as an instrument to measure human capital contribution suffers from specificity, ambiguity, reliability, relevance and validity issues.

> "In fact there are over 38 main classifications of intangibles...... These can be further broken down into over 100 separate categories."

> "In essence, providing a working model of the relationship between intangibles and share value is akin to mapping the human genome."

In essence, providing a working model of the relationship between intangibles and share value is akin to mapping the human genome – not impossible but at the current time the industry collectively does not yet have the requisite knowledge.

For these reasons, we would caution that those claiming shareholder value performance as a means of correlating with certain human capital performance are either being statistically dishonest or have a naïve understanding of the complexity of organisation operating models.

Correlational research and findings

Unfortunately, academic research can give the illusion of authenticity given big samples and statistical techniques. Whilst we don't wish to rubbish much existing research, the human capital/intangible field seems to have attracted certain statistical sleights of hand – e.g. given sufficiently large samples, certain correlations can always be found.

This has underpinned a number of studies in the last few years and has ultimately limited their practical application (notwithstanding the appropriateness of techniques in data derivation). Thus, though a particular piece of research may show correlational findings across a sample, further investigation at the next level down, e.g. by sector, invariably invalidates the overall correlation, therefore making its application very difficult.

Issues with previous and current measurement comparisons

We have already shown the difficulties inherent with previous attempts at providing a valid market value/human capital metric. However, there are other metrics which are used or put forward as reliable measures relating to human capital. We would again caution as we believe these suffer from an over-simplification which unfortunately renders them virtually meaningless or irrelevant.

'Revenue per employee', 'profit per employee' and 'value-add per employee' are three common but ultimately unreliable metrics which suffer from a fundamental flaw – they rely on one big assumption that all business operating models are the same from a people perspective.

One cannot draw a direct comparison generically, for example, between a professional services firm and a food supermarket chain unless the numbers are, at least, adjusted to take account of their different utilisation of human capital (i.e. the proportion to which people contribute to revenue generation).

More seriously, they can wrongly encourage management to reduce employee numbers purely to increase these ratios if they are adopted as a leading performance metric.

The problem with revenue per FTE

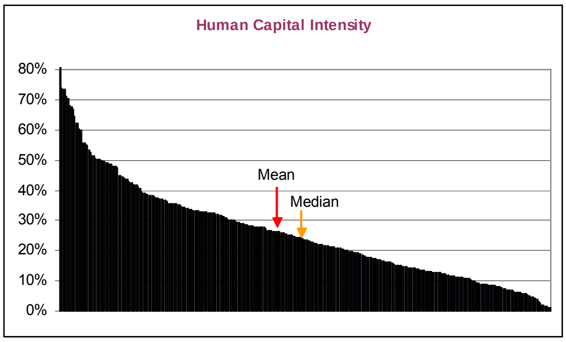
Revenue per FTE has been commonly used as an 'output' marker for human capital productivity. The equation is simple enough, but that is its drawback. Experts in organisational performance will instantly recognise its flaws.

Unless all organisations exhibit the same operating model with the same people cost to operating cost ratio, then this equation will be of no relevance. However, what may be of value is to adjust the revenue per FTE figure to take account of the people cost/operating cost ratio (what we term human capital intensity) to give a more relative comparison.

Even then this figure is only a 'proxy' as organisation operating models that generate revenue contain a multiplicity of inputs. Similarly, 'costs per FTE' suffers the same severe limitations for the same reason. These particular metrics highlight the problem with simplicity, in that dividing any potential financial metric by the number of employees does not necessarily constitute an 'HR metric' – an example of 'denominator misappropriation.

Human Capital Intensity

Human capital intensity reflects the expenditure on people as a proportion of overall operating costs within an organisation. As such, it suggests the relative importance of the contribution of human capital to revenue generation or the achievement of the organisation's key performance indicators.



Organisations with relatively high levels of human capital intensity, logic suggests, should accordingly pay a high level of attention to the effectiveness of their HCM approaches.

The chart below shows the differing levels of employee costs relative to total operating costs, i.e. human capital intensity, of the 300+ organisations reviewed as part of this study.

With a mean 'human capital intensity' of 26%, this suggests that people typically account for one quarter of an organisation's overall costs.

The range in the sample reviewed, however, runs from 1% to over 80% - an enormous degree of variation.

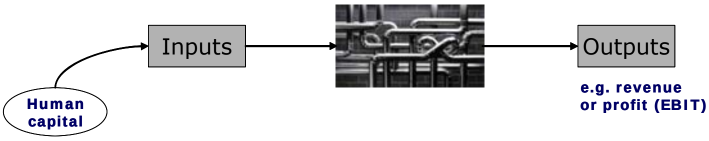
Naturally, what is of prime importance is not so much the degree to which an organisation is reliant on people within its operating model, but how effectively these people are utilised and managed to deliver the company's outputs to the required level of quality.

In the review and calculation of human capital intensity, it is important to utilise appropriate timelines. In line with financial reporting, human capital intensity can be calculated on an annual, biannual, quarterly or monthly basis.

Businesses as input-throughput-output models

Returning to basics, understanding businesses as input-throughput-output models provides us with a baseline for relating human capital to organisation performance.

In reality, the 'throughput' phase is a complex whirl of dynamics, but is represented here in a linear fashion for ease of understanding.



Human capital collectively is an important input to the business model. Typically we measure this in terms of employees (FTEs) or the collective investment that is made in employing people (total people remuneration and benefits).

It is also important to remember the logistics of people support – the related 'ancillary investment or cost' in terms of managing people effectively – i.e. in terms of optimising productivity and efficiency, which is where the HR function comes in. Investment related to the ten core HC management domains reside in this category.

Through its internal processes, an organisation utilises the related inputs to develop 'outputs'. Depending on the nature of the organisation, outputs are everyday products and services we experience.

The value of these outputs is quantified in terms of revenue. Revenues are perhaps the purest form that a business can relate to in measuring its output.

Finally, the difference between the cost of producing the outputs (from a human capital and all other cost perspective) and the sales revenue contributes to the company's profits or earnings. These are typically taken as a proxy for the success of the company in producing desirable outputs at a cost that is lower than the various inputs.

The HCIR Premise

If we return to the premise that if people weren't important or valuable to the organisation, they wouldn't be employed, then for any organisation, human capital has to be of 'value'.

The question is to what degree can we attribute human capital to the output of the firm?

We know that this is not necessarily the same across companies given the context of each organisation's operating model, as explained earlier. The Human Capital Intensity (HCI) metric provides us with a marker.

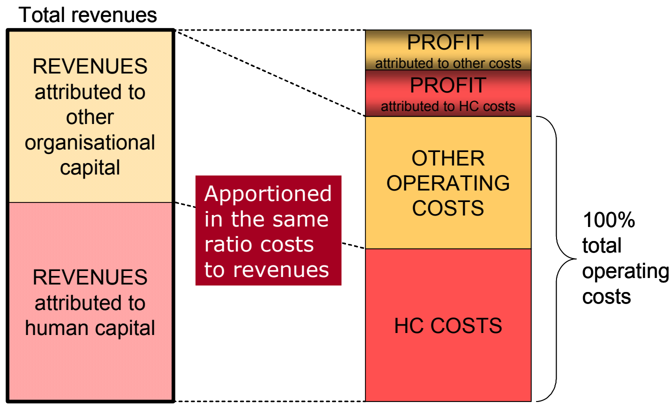
The HCI measures the degree to which human capital as 'input costs' are relative to other input costs – for example, a mining company might have to invest in drilling, mine maintenance and heavy machinery, as well as paying a workforce, whilst a financial services firm might typically find that the cost of its workforce is its single largest overall cost category.

The apportionment of revenues to costs and the human capital proxy HCIR

For the purposes of measurement we propose that the operating costs are the best proxy to reflect the input and throughput of an organisation.

Consideration of the typical costs in a company's accounts will illustrate how they relate to inputs. For example, purchase of raw materials or goods for resale represent key physical inputs into the business, spending on sales and marketing represents sales input and so on.

Depreciation and amortisation serve as a proxy for the use of tangible and intangible fixed assets within the organisation. Organisations will expect to earn a return on these assets that will, in most cases, be based on the relevant depreciation charge. This includes impairment charges to goodwill or other assets. Such charges indicate that the company needs to earn a return on its acquisition.



Payments to staff therefore represent the human capital input into an organisation, and indicate the level of return required to be earned from that input.

On the firm assumption that an organisation's operating model is efficient given market-place forces, our premise is that it is reasonable to apportion revenues earned in the same proportion as inputs.

This also explains why certain items have **not** been included in our analysis as they do not relate directly to the operating model. These are:

1) Interest costs

These represent a return on the financing of the business, not its operations. The return will partly be represented by interest and partly by dividends – the amount paid out under these two headings will reflect decisions related to financing. They do not inherently relate to the business' operations.

2) Profits/losses on disposal of fixed assets, investments etc.

Use of fixed assets and investments is already accounted for via depreciation/ amortisation as noted above. Any gains or losses incurred on disposal will relate to market values and not the operations of the business

Note that our categorisation operates independently of how a company defines 'exceptional items' (there is in any case some inconsistency in definition). Exceptional gains or losses on disposal of assets will be excluded, but goodwill impairment, which is often treated as an exceptional item, is included.

Restructuring costs are generally been included because they relate directly to the operating model. These costs often relate to redundancy or write-downs of assets.

HCIR as a metric

The HCIR metric enables the generic and relatively meaningless 'revenue per FTE' to be recalculated to better represent revenue generation attributed to people.

Though not a perfect match, it is the closest proxy to providing the most accurate representation and comparative benchmark as using asset-based or shareholder value based calculations becomes a trickier operation fraught with complications due to accounting interpretations and inconsistencies.

In the Human Capital Operating Statement (HCOS), the revenue metric is adjusted to take account of the people contribution factor (i.e. percentage applied equal to people cost percentage of total operating costs – referred to as human capital intensity or 'HCI'). The resulting metric is referred to as HCIR per FTE. This provides a far greater measure of comparison by taking account of organisational operating models.

From a human capital perspective, this raises the question as to the investment in people-related areas and whether, given the expanding focus on work-related themes, organisations have potentially been over-investing (as much as under-investing) in human capital management infrastructure, particularly where business cases for investment may not necessarily have been articulated.

This point is very important, when acknowledging the increasing 'trade-offs' that organisations, mainly through their HR functions, face in terms of current spend and expected return with regard to performance.

The same argument holds in terms of minimising risk through compliance. For many organisations and their HR functions this is now a constant challenge.

In conclusion, the use of HCIR provides a comparison across organisations and business models of the contribution of human capital to revenue generation, with linkage to HR functional and human capital management priorities.

We define HCI*R as:

[(Revenue*Human capital intensity) per FTE]

where, human capital intensity is the degree to which people are utilised relative to other operating costs to derive revenue (and therefore proportionate).

For example, if people costs are a quarter of overall operating costs then we attribute a quarter of overall revenues as an indicative output contribution.

The Return on Human Capital (The HC Return Curve®)

The fundamental change

As set out above, we consider HCIR (Human Capital Intensity Revenue) per head to be a significantly more useful measure of human capital performance than revenue per head. By adjusting for companies' different operating models, it provides a measure across most organisations.

Methodology

Within this report and in other VaLUENTiS publications, questions have been raised about the relevance of measures such as Revenue per FTE with linkage to organisational performance.

Our hypothesis is that relating costs, revenue and profit to human capital intensity will provide a more effective measure of corporate performance, and provide more meaningful comparison.

We identified three measures that could be taken as reporting proxies for corporate performance: Revenue per head, HCIR (Revenue attributable to human capital) per head and HC Return (HCIR over Human capital costs).

[N.B. As we have already mentioned our intention is to measure FTE related numbers, something which our HCR Standards encourage. However, this can only be done with more accurate corporate reporting and/or through the use of the VB-HR™ Rating, thus 'per head' is used as the most appropriate proxy].

The next step was to relate HCIR[3] to Human Capital Costs (HCC), which is the total organisation's direct investment in people. Comparison of these two figures allows, for an objective calculation of an organisation's 'return on human capital'.

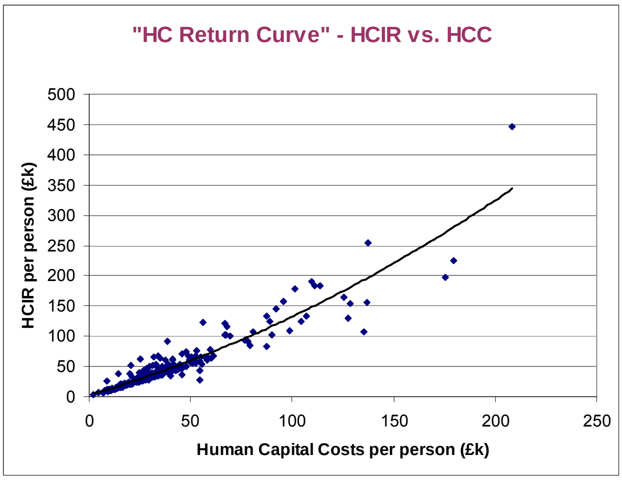
In our calculations, we expressed this return as a ratio, i.e. a score of 1 indicates that a company's HCIR is equal to its HCC – it is generating revenues sufficient to cover people costs, but no margin. A score of 1.2 indicates that, for every £1 spent on human capital, the organisation is generating revenues £1.20, and so on. This ratio is the same whether calculated per head or for the organisation as a whole. Expressed as a formula, the calculation is as follows:

$$\frac{\text{HCIR per head}}{\text{HCC per head}} = \text{Return on human capital spend}$$

In order to analyse companies' typical return on human capital, we plotted HCIR per head versus HCC. In so doing, we discovered the existence of

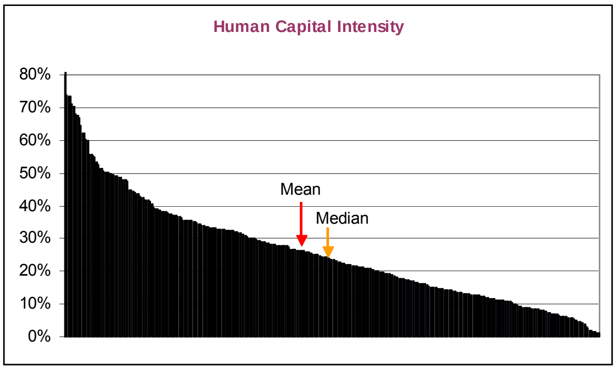
[3] See appendix IV on page 80 for information and adjustments

a normative return on human capital ('efficiency frontier') - the HC Return Curve® (see below).



As can be seen there is a large clustering towards the lower end of the curve.

The related human capital intensity (i.e. the proportion of people costs to overall operating costs) distribution for the sample was:



For the purposes of analysis we split the respective firms into five bands of human capital intensity:

Band

1-10% (i.e. for every £10 input costs, £1 spent on human capital)

11-20%

21-30%

31-40%

40%+ (i.e. for every £10 spent on input costs, £4 or more is spent on human capital)

Within each of these five bands, the mean and standard deviations were calculated for the three corporate performance reporting proxies. Results are shown in the table below.

	Revenue per head		HCIR per head		HC Return	
HCI %	Mean (£k)	SD	Mean (£k)	SD	Mean	SD
1-10	1,134	909	58	38	1.2	0.3
11-20	267	252	38	31	1.2	0.3
21-30	166	251	40	53	1.2	0.2
31-40	130	96	44	32	1.2	0.3
40+	115	84	64	56	1.3	0.3

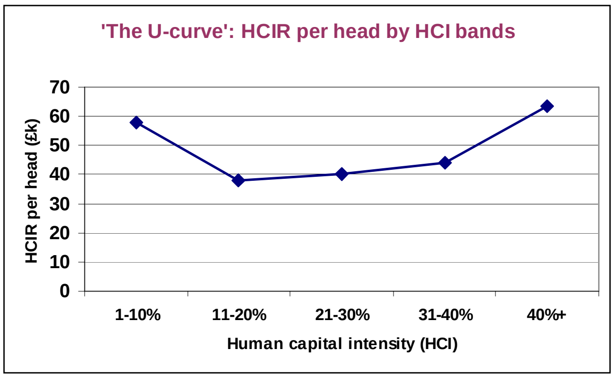
Revenue per head

Not surprisingly, revenue per head shows a vast range of potential values with an extremely large standard deviation. This reinforces our view that as a metric it is not reliable when considered that it relies on all companies possessing the same human capital intensity (which is plainly not the case).

It is also interesting to note that the standard deviation is dramatically reduced the higher the human capital intensity, somewhat reinforcing our view that 'HCI' related metric provides a more robust measure.

HCIR per head

Findings relating to HCIR per head show a 'U' curve pattern.



This suggests the following key insights:

- Business models that are highly reliant on human capital, as well as business models that have a low reliance, are relatively cash generative through some apparent function of their operating model
- The two thirds of organisations that fall within the 11-40% categories display high 'volatility' as indicated through their standard deviations
- This suggests that organisations in this category are more or less effective at generating a return on the same relative level of human capital intensity – in other words, effective human capital management practice appears to be the contributing factor in performance differentials for these organisations.

HC Return

HC Return displays striking levels of consistency across means and standard deviations, suggesting that this measure is effective in 'flattening' the differences between operating models.

This suggests that, irrespective of the reliance on human capital within the operating model, organisations display relatively similar comparative levels of efficiency in terms of human capital spend – in other words, the 'market', collectively, is generally efficient at setting salaries for roles in relation to their revenue generation (from the perspective of human capital contribution).

Comment and observations

The HC Return curve provides a very good 'efficiency frontier' (R^2 = 89%) to compare organisation performance from a human capital perspective.

The existence of this curve means that, given a certain level of HC costs, we can predict a company's expected HCIR with around 90% accuracy.

All organisations can be assessed in relation to it and all organisations can be ascribed a Human Capital return β to express whether that company's return on human capital is above or below the market norm, and by how much.

It is important to note that this measure, like a financial β, is relative to the market as a whole. As with a financial β, it is also possible to construct a 'sector' curve to compare companies to the norm for their sector only.

However, by using HCI in this way, we allow for different operating models to make the comparison between companies much more meaningful. We are also able to focus more closely on the 'people return'.

The HCI data emphasises the problems with regard to metrics such as Revenue per head, whereas HCIR per head and HC Return present more realistic and reliable measures which provide a more accurate evaluation of performance from a human capital management perspective.

Notes to data calculation

FTSE350 company sample

The starting point for our sample was to take all members of the FTSE350 index, plus a sample of the 20 largest privately-owned companies in the UK (as a precursor to a larger index).

FTSE350 company exclusions

We have excluded specialist asset-based companies such as investment trusts and real estate based companies. These companies by nature derive revenue from sale/purchase of assets and their operating models are quite different to the rest of industry.

In essence, these companies require a different model to reflect the contribution of human capital which is not subject to this analysis. Note that this exclusion does not apply to companies who are producing assets or carrying out advisory work, e.g. fund managers and housebuilders are included.

here were also a number of companies which could not be included in the analysis due to the fact that meaningful historic annual reports were not readily available. Some had recently demerged and/or listed, whilst others' accounts were simply unobtainable.

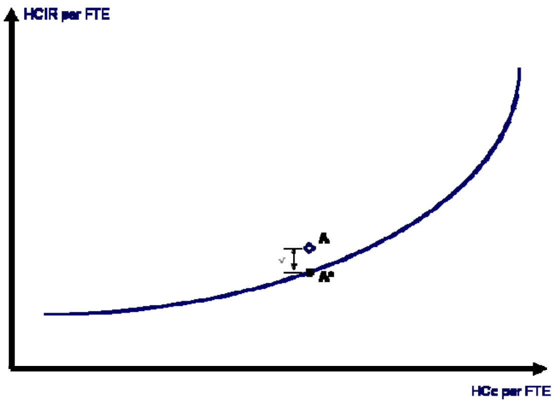
The addition of unlisted private companies

As noted a number of well-known private companies were selected for analysis as a precursor to a more expanded volume planned. Companies included are detailed in Appendix VI.

A model to explain the HC Return Curve® Beta (performance variation)

Background

As we have seen, the HC Return Curve® sets out a normative return on human capital. This suggests a strong relationship between human capital revenue contribution and the overall cost of human capital.



This relationship can be expressed by the following curve, representing an 'efficiency frontier':

Thus companies can find themselves in one of three places with respect to the curve. These are:

- Above the curve and therefore performing above the norm set by the efficiency frontier (β greater than 1). This suggests a greater than expected return on human capital, relative to other companies.

- On the curve, suggesting that their return on HC performance is in line with company norms as set by the efficiency frontier (β = 1)
- Below the curve, indicating that their return on HC performance is below the norm and therefore 'underperforming' (β less than 1).

Underlying formula

This suggests that variations in human capital performance will exist, relative to the market norm (as expressed by the beta).

The underlying construct for this variation 'V' can be expressed as follows:

For any listed company ***'c'***

$$R_c - R_{EF} = HCM_P + HC_P + HC_D + APC_E + O_L + AT_A + M_E + \varepsilon$$

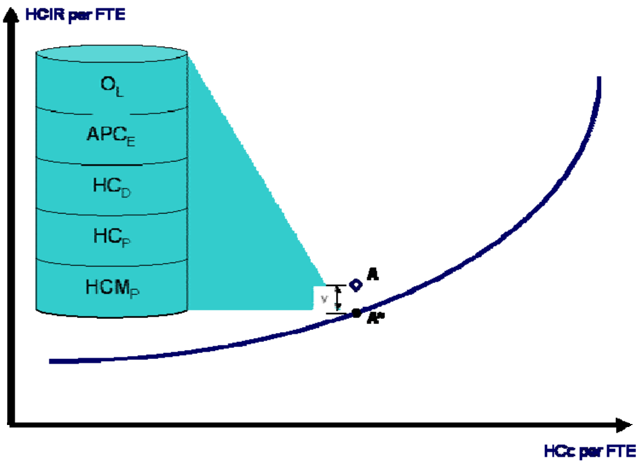
where

R_C	=	HCIR/HCc per FTE
R_{EF}	=	HCIR/HCc perf FTE value provided by the efficiency frontier
HCM_P	=	Human Capital management performance
HC_P	=	Human Capital performance
HC_D	=	effects of human capital disruptors
APC_E	=	effects of ancillary people costs
O_L	=	effects of organisation leverage
AT_A	=	effects of accounting adjustments
M_E	=	General market effects
ε	=	Non-attributable residual

Thus, the equation can be rearranged to exclude constant elements, giving

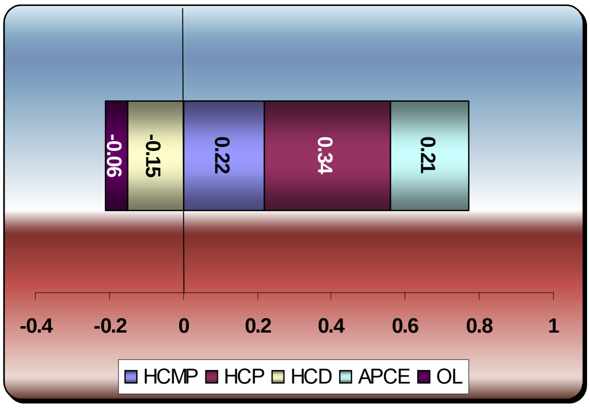
$$V = [R_s \pm AT_A] - R_{EF} = [HCM_P] \pm [HC_P] \pm [HC_D] \pm [APC_E] \pm [O_L]$$

In other words, having adjusted for any accounting inconsistencies or exceptions and that ε, the non-attributable residual can be regarded as equal for all companies, and therefore ignored; we can ascribe the performance variation as the sum of the remaining five variables, as shown overleaf.



It should therefore be possible to quantify each of these five elements to determine their positive or negative contribution to the overall beta performance.

The performance variation model can be viewed in the following way:



Quantifying beta variation

We have seen that beta variation arises through:

- Human capital management performance
- Human capital performance
- Effects of human capital disruptors/ inhibitors (for example, aspects of the business model)
- Effects of ancillary people costs
- HC leverage effects.

Similarly, effects of accounting adjustments, general market effects and residual effects can be reconciled or ignored, as representing a 'constant' effect or systematic/ unsystematic risk.

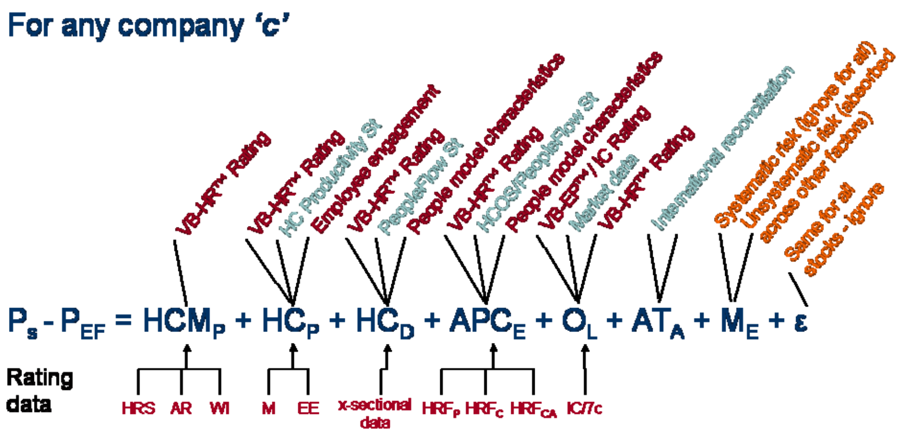
We put forward the view that the means exists of quantifying the five measurable elements of beta variation through the VB-HR™ Rating, its associated database of value driver performance and through evaluation of metrics contained within the Human Capital Reporting Standards.

For this reason, the Human Capital Composite Index includes an evaluation of external human capital reporting (in current format) and the VB-HR™ Rating score (to be incorporated on adoption).

Not only does the VB-HR™ Rating therefore provide an evaluation of current human capital management practice, but the scores provided can be compared against the VB-HR™ database to measure differences in practice.

Through use of the equation set out below (referring to specific VB-HR™ human capital value drivers), company performance differentials can be quantified, explained and addressed.

Given the potential implications of these scores, we would expect that organisations would seek to have their VB-HR™ Rating externally audited at Level 3 adoption (see www.vbhr.com for related materials).



HC Reporting: A review of OFR and CSR practice

Background

Within the past five years, considerable efforts have been focused on the area of human capital reporting. With a number of high-profile working groups and related academic attempts at defining standardised approaches, the awareness that understanding the 'contribution' of people within an organisation is a matter of interest and relevance to a wide range of stakeholder groups.

Despite these efforts, however, no 'magic bullet' has emerged from working groups and official guidance (for example that relating to the UK's OFR), beyond the assertion that certain human capital metrics may or may not be meaningful and/or comparable across sectors.

This failure of any top-down approach to provide the required clarity has resulted in pragmatic attempts by organisations to report something, rather than nothing, in the area of human capital.

On one hand, we would acknowledge that this is a big 'ask' for organisations, equal to asking them to develop their own accounting standards without expert guidance in support.

> "We have, in our earlier HCR white paper, argued that HC Reporting should not be part of the CSR, as good human capital management is not a matter of 'social responsibility' but of organisational performance."

On the other hand, any evaluation of organisational performance through a 'human capital lens', should include a structured evaluation of current attempts at human capital reporting.

This allows for an objective evaluation of the sophistication of current approaches (both quantitative and qualitative) and acknowledges where good practice exists.

Companies effectively have two means of reporting human capital – either through the Operating and Financial Review (OFR)/Business Review or through the Corporate Social Responsibility (CSR) Report.

We have, in our earlier HCR white paper, argued that HC Reporting should not be part of the CSR, as good human capital management is not a matter of 'social responsibility' but of organisational performance.

However, we recognise that a number of organisations have used this channel as a means of reporting human capital related information. Thus we have reviewed both in the context of providing a true assessment.

Parameters of assessment

In light of the absence of any previous human capital reporting framework, we set out the following parameters for assessment, closely connected to the 'best practice' guidelines laid out in our model HC Reporting template[4]:

- Structured approach to human capital reporting
- Narrative reporting of human capital policies (which in practice is already carried out by most companies)
- Narrative reporting of specific human capital initiatives or programmes
- Utilisation of the Standard Human Capital Reporting Operating Standards (Human Capital Operating Statement, PeopleFlow™ Statement and the Human Capital Productivity Statement)
- Quantification of human capital key performance indicators (KPIs)
- Segmental analysis of human capital reporting (i.e. breakdown across business units and/or geographies)
- Additional or enhanced ratio reporting or investigation into specific domains of human capital management (which in practice is not being carried out for external reporting by any company in our sample)
- Utilisation and reporting of the VB-HR™ Rating score awarded, as an external assessment of current human capital management practice.

These parameters cover all aspects of how human capital reporting is treated within public disclosures; use of suitable quantified approaches and take account of depth of insight provided to external stakeholders.

Within each assessment parameter, four separate levels have been identified in line with the levels established in the Human Capital Reporting White Paper: *Pre-Standard*, *Standard*, *Intermediate*, *Advanced*.

The difference between the levels is one of comprehensiveness with the 'Standard' level providing what is considered an acceptable informative level of disclosure.

Each assessment parameter has been evaluated through review of published annual reports and, where relevant, Corporate Social Responsibility reports (CSRs).

Where a company has provided more detail within a particular parameter, this is acknowledged through an additional weighting within the scoring system. The companies have then been ranked according to the overall quality of their human capital reporting, which feeds into the overall HCCI™ ranking (see Chapter 7 for further detailed analysis).

The following observations set out the key findings of the review.

Findings

[4] See VaLUENTiS' Human capital reporting white paper, 31 January 2006

No organisation reaches the 'Standard' level

As noted above, four levels of sophistication exist within each parameter. No single organisation reviewed reaches the 'Standard' level, despite a few examples of good practice on aspects of narrative and, in one case, the development of an approach with similarities to the PeopleFlow® statement, including segmental reporting.

This suggests that, despite the attention paid to this area, companies, left to their own devices, have not developed sufficient approaches to human capital reporting to provide meaningful insight to external stakeholders.

Current approaches are typically unstructured

We advocate that human capital reporting should exist either as a separate document or as a separate section within the Annual Report, to provide it with the coherence and recognition required.

No organisation reviewed is producing a separate human capital report, although, of the 308 organisations reviewed, 25 reported people data in a designated section of the OFR or Business Review.

Many more organisations reported people information as part of their CSR report. As noted above, we see human capital reporting as having a focus and purpose that is quite different to usual CSR content, such as impact on the environment and charitable activities.

On the other hand, it is encouraging to see that most organisations at least acknowledge human capital in some form. However, the lack of structure seen in most reports does limit their usefulness.

Current approaches are predominantly narrative

Most reporting consists of policy information and anecdote, which suggests that organisations have adopted a highly conservative view towards their approaches towards quantifying aspects of their human capital management practice.

When quantified, these aspects typically lack context or fail to add interpretative insight.

For example, the findings of employee surveys (at a macro level) are reported by certain organisations – it is unusual, however, to be given the response rate, frequency of survey and linkage between the survey and any outcomes such as action taken, or incidence of turnover or customer quality. Another example of a frequently reported statistic which provides very little value without context is the gender split of the workforce.

Such narrative-based reporting has a tendency to be anodyne. Without a structured approach towards reporting base data, such as the

SHCROPs[5], any narrative efforts can appear 'ungrounded' and add limited value for the external reader.

As we have previously argued in our Human Capital Reporting White Paper, HC needs to follow financial reporting in reporting 'base numbers' as a starting point.

Current approaches provide questionable insight

It is understandable that, in the absence of a consistent approach, organisations may choose to err on the side of caution in presenting any human capital metrics.

It is less clear, however, why the presentation of segmental reporting (similar to financial statements) is not prevalent. Through providing internal comparatives to metrics such as turnover and absenteeism (and through use of the SHCROPs), organisations can showcase their ability to measure human capital inputs and outcomes, and demonstrate their activities and initiatives to manage the outcome.

On the grounds that 'what gets measured gets managed', the impact of reporting differentials externally both suggests that organisations are 'on top' of the issue and equally are more concerned with how to address it internally than whether their absenteeism is on average a percentage point higher than a competitor.

While many organisations are at least experimenting with approaches to human capital reporting, many efforts are extremely light. Twenty-six companies within our sample do not report human capital information at all beyond the minimum requirements, i.e. basic comments on employee involvement and treatment of disabled staff in the Directors' Report.

Conclusions

In light of this review, we would strongly advocate that organisations need to move on from their current, disparate and predominantly qualitative approaches and to adopt a structured and consistent approach towards human capital reporting (such as that established in the Standards).

The time for awards may be when many more companies are at least reporting to a defined base standard – until then it is pretty much 'all talk'. Without this adoption, organisations run the risk of investing considerable effort, for all the right intentions, to produce reports of questionable value for external stakeholders.

Levels of HC Reporting

Level of HC reporting	*Part of existing document*	*Separate dedicated HC Report*	*HC Policies*	*HC Initiatives*	*Company practice specifics*	*HCO Statement*	*PeopleFlow statement*	*Productivity statement*	*KPIs*	*Segmental analysis*	*Enhanced ratio reporting*	*Additional HC domain reporting*	*VB-HR™ Rating or equivalent*	*VB-HR™ Rating narrative*	*HC Value statement*
Standard	()	()	☑	☑	☑	☑	☑	☑	☑	☑	()	()	-	-	-
Intermediate	-	☑	☑	☑	☑	☑	☑	☑	☑	☑	()	()	☑	()	-
Advanced	-	☑	☑	☑	☑	☑	☑	☑	☑	☑	☑	()	☑	☑	()

()	Optional
☑	Mandatory
-	Not applicable

The three levels are designed to provide organisations with flexible options given their intent to publish human capital related information.

Reporting Solution

The reporting solution is designed in such a way as to provide organisations with a progressive level of reporting, containing three classes: ***'Standard'***, ***'Intermediate'*** and ***'Advanced'***. The difference between the levels is one of comprehensiveness with the 'Standard' level providing, what is considered, an acceptable level of disclosure.

[5] Standard Human Capital Reporting Operating Principles

The VaLUENTiS Human Capital Composite Index (HCCI™)

Purpose

The Human Capital Composite Index provides a framework that evaluates organisations from a human capital perspective across three dimensions, Performance, Practice, and Reporting.

The Human Capital Composite Index provides an evaluative framework that measures human capital related organisation performance.

The index is designed to provide a 360 degree view of organisation performance through a human capital lens, human capital management practice and human capital reporting.

The nine components are combined in a composite ranking system. Each component is given a weighting based on the relative importance of each indicator.

1. **HCIR Return (ratio)**
2. **HC return beta**
3. **VB-HR™ Rating**
4. **HCIR/head**
5. **HCIP per FTE**
6. **HC Reporting score**
7. **HC leverage beta**
8. **Total HCC (ECI)**
9. **Tax paid per FTE**

Increased weighting

In selecting a 'composite' index, we seek to acknowledge the multiple parameters required to assess effectively differences in organisational performance and human capital management within companies.

Unlike previous attempts at constructing a meaningful index or ranking, which typically focus on a single parameter (e.g. employee satisfaction, work environment, value contribution), this enables different perspectives to be incorporated into a single assessment.

Through weighting each of these components through a forced-ranking evaluation, the output of the Human Capital Composite Index ('HCCI™') accordingly contains:

- External assessment of company performance and contribution (derived from information in the public domain)
- Internal indicators of company performance (derived from information not in the public domain).

The nine sub-indices are set out below, with brief explanation of each.

Note that the current version of the HCCI™ excludes the VB-HR™ Rating and HC leverage beta figures, as these relate to data that is not publicly available and only a certain sample of the FTSE350 have carried out such an exercise.

As such, organisational rankings as reported are based on 78% of the total composite index.

We are currently constructing a shadow index for those companies that have undergone further internal assessment (as that provided by the VB-HR™ Rating).

Explanation of the components of the index

The nine components are each in turn defined:

HCIR Return

This index evaluates the adjusted revenue return an organisation receives on its investment in people (people costs). A ratio of 1.0 indicates that revenues generated only covers the investment in people costs. Ratios of greater than 1.0 indicate a return on their human capital investment. A ratio of below 1.0 indicates a loss generating scenario.

HC return beta

The HC return beta evaluates the relative performance of the HCIR Return curve (efficiency frontier). Those companies positioned above the 'curve' display over-performance as opposed to those below the 'curve' who display under-performance. This difference is known as the beta.

A positive beta therefore indicates a greater-than-expected return on human capital, with a negative beta indicating a lower-than-expected return (suggesting misalignment between staffing levels, average compensation and organisational performance).

HCIR per employee

This index assesses the contribution to revenue generation attributable to each employee: a more meaningful measure than 'revenue per employee', as this accounts for differences in operating models. By reviewing the ratio of people costs to total costs, the human capital intensity can be calculated – a proxy for the relative importance of people in the operating model. A high HCI suggests that people a more important component in an organisation's revenue generation.

HCIP per employee

A similar approach to HCIR per employee, but in this case assessing profit/EBIT (earnings before interest and tax) per employee attributable to human capital. Adjustments are made to strip out exceptional gains and losses not relevant to the operating model (e.g. gains/losses on disposed companies) whilst including those relevant to the organisation's people model (e.g. redundancy costs).

HC Reporting score

Based on a construct introduced in VaLUENTiS' Human Capital Reporting White Paper in January 2006, the Reporting score evaluates the current state of external human capital reporting adopted by the organisation. This is taken as an indication of the extent to which an organisation focuses on its people element and therefore its appreciation of human capital. The reporting link with performance is through the old adage 'what gets measured (reported) gets managed'.

Tax paid per employee

This is incorporated as a measure of the contribution made by an organisation to human capital (society) in general, above and beyond the contribution made by an organisation to its employees in terms of salaries and other compensation. A higher number indicates a greater contribution to an economy in this context, whilst taking into account the size of an organisation.

Total HCC/ECI

The total HCC is an organisation's total people costs, an absolute figure representing the overall value generated by an organisation that is then distributed to employees.

We take this as representing a human capital Economic Contribution Indicator (ECI), effectively a macro-economic indication of the value to an economy generated by the organisation. The figure used in the ranking is the total per organisation and therefore acknowledges the greater contribution (or not) of larger firms.

VB-HR™ Rating

VaLUENTiS launched the VB-HR™ Rating in 2005 following an initial benchmark exercise with 100 organisations. The Rating assesses the effectiveness of human capital management practice within organisations linked to productivity.

This assessment evaluates the degree to which components of an integrated human capital management system combine and/or conflict. The Rating also provides more detailed assessment of reported numbers (for example FTEs) as well as HR spend and other operational HR metrics.

HC leverage

Whereas other cost-driven indices are based on people costs, the HC leverage beta evaluates HR budgetary spend and related human capital ancillary costs (e.g. recruitment), relative to the revenue generation attributable to human capital.

Whilst these cost figures are core aspects of the Human Capital Operating Statement set out in the 'open-source' SHCROPS, they are not currently publicly reported. As such, this index is not currently included within the HCCI™, although ongoing adoption by organisations will lead to their introduction within the HCCI™.

Advantages of the HCCI™

There are a number of advantages to the HCCI™:

- The HCCI™ provides a unique composite picture of organisational performance from differing human capital perspectives and by linking financial and HC measures
- As such, it carries far more weight when compared to other published indices
- It is focused on an organisation performance basis not on an individual experience basis
- Its composite nature makes it very difficult to ignore as the data provided here doesn't lie
- The data appeals to all stakeholders as there is 'something there for each group'.

HCCI™ ranking: a preliminary investigation into its predictive nature

The inaugural HCCI™ Ranking exercise was carried out in August 2006, reviewing most recent full-year accounting information for FTSE250 and top UK private companies.

As a precursor to the 2007 evaluation, a review was undertaken with the aims of identifying the extent to which a high or low ranking in the HCCI™ had predicted positive or negative organisational outcomes, in terms of financial or other performance.

Accordingly, analysis was performed on the top 30 companies and the bottom 50 (from a total of 308). This was taken to represent a statistically significant sample of high and low performing organisations (as per the HCCI™ ranking).

Analysis included review of organisational press and media releases as published on each company's website. 'Top-line' financial data were additionally reviewed to identify significant changes in full-year performance.

Top-ranked organisations are more likely to acquire other companies, announce product extensions and renew the composition of senior management/boards.

Bottom-ranked organisations are more likely to be taken over, suffer profits decline, divest operating units, restructure and suffer other adverse company events.

The table below provides additional insight into these findings.

Bid initiation	• Top ranked companies are eight times more likely to have launched a bid for a competitor
Acquisition target	• One in ten bottom ranked companies had been acquired within the period following assessment, with no high ranked company being taken over • Similar proportions of top and bottom ranked companies have been bid targets but retained their independence
Profitability	• All companies reporting a significant decrease in earnings before tax (excluding exceptional items) are located in the bottom of the ranking • HCCI™ ranking is not a predictor of high profit growth (greater than 10%) with similar proportions of top and bottom ranked organisations reporting this
Divestment/ restructuring	• 30% of bottom ranked companies has divested operating units or carried out material restructuring exercises, as opposed to 20% of top ranked companies
Product extension	• Top ranked companies are nearly twice as likely to launch product extensions (defined as new products, innovative services, additional sites etc. to allow for different operating models)
Adverse company event	• One in eight bottom ranked companies experienced a material 'adverse company event' (including identification of malpractice, material JV losses, legal settlement, shareholder activism, referral to Competition Commission) • No 'adverse company events' were observed in top-ranked companies
Senior management appointments	• Top ranked companies are twice as likely to have made new senior management or board appointments within the period • Bottom ranked companies are nearly twice as likely to have had an unexpected senior management resignation

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