MEASURING Human Capital

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We analyze the overall economy, industry, markets, assets, liabilities and more, but how much focus is allocated to the "#1 Assets" – employees? "Employees are a company's greatest asset - they're the competitive advantage. The company wants to attract and retain the best; provide them with encouragement, stimulus, and make them feel that they are an integral part of the company's mission"[1].

A company is usually founded by individuals striving to achieve their own or broader goals. Goal achievement related to a company's operations is called business or the business process. There are four basic elements required for a business process: means of production, raw materials, services, and human capital. HC includes the employees' accumulated qualifications and competencies as well as their motivation[2].

Having a robust framework for measuring and accounting for human capital would support a principled approach to workforce management. Such a framework would enable a company to monitor and assess the return on its investments in its employees in the same way it measures returns on financial and intellectual capital. However, given the intangible naturstakeholder leadership, and employee well-being, companies have struggled to quantify the contribution of their human capital assets[3].

The current framework for valuing human capital is outdated and insufficient. Do we

FROM THE US

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avoid the attempt to quantify the human capital because of its subjectivity, complexity, and the general belief that the total value of the human capital is "baked into" the enterprise's overall value? Presently, we account for human capital as if the enterprise "leased" the assets.

Change is on the horizon. Human capital can be a company's greatest asset; it can make or break the business strategy and is a key differentiator. A company's intangible assets, including human capital and culture, are now estimated to comprise, on average, 52% of a company's market value[4].

Efforts to introduce robust measures of human capital into financial reporting have become more frequent in recent years. This can be attributed to a growth in the desire to understand how companies manage and measure human capital to uphold the principles

of stakeholder capitalism. Such work to date, however, often lacks specificity, objectivity, acceptance, context, and comparability.

The most important focus for future guidelines is internal decision-making and ensuring that managers exercise good stewardship over human capital. The external audience is significantly more challenging. A good scorecard needs to be balanced and objective, but beyond the theoretical perspectives, no one has yet figured out how to implement a reliable, auditable quantitative process to value the HC[5].

WHAT IS HUMAN CAPITAL?

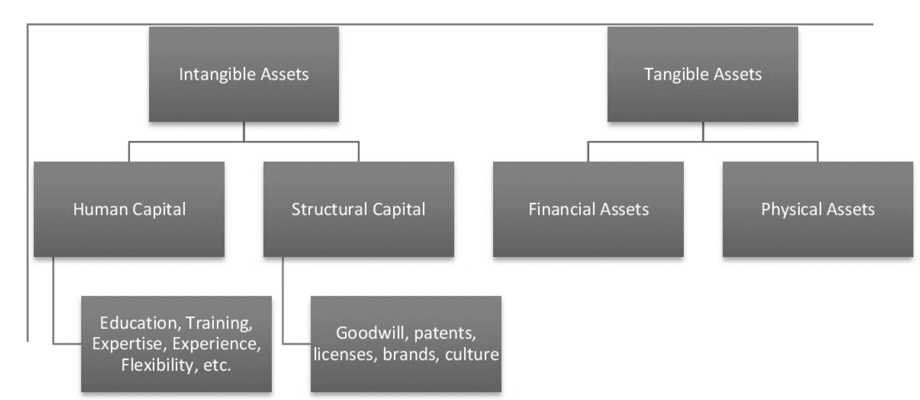
Human capital differs slightly from other forms of standard capital. It is not necessarily like debt or equity capital, which is more easily accounted for on the balance sheet. Rather, it is more closely related to intellectual property and intellectual capital, which are generally harder to quantify. That is because human capital refers to the value of the skills that a company's labor force possesses[6]. Examples of human capital include education, experience, and judgement. Examples of qualities such as strong corporate culture,

Human capital is defined as "the knowledge and competencies residing with the company's employees," and organizational intellectual capital is defined as "the collective know-how, even beyond the capabilities of individual employees, which contributes to an organization"[7]. This definition is interesting because it suggests that the total HC should be greater than the summation of the individual components. When employee's pool their collective expertise, the result is something greater than what can be achieved individually.

Human capital can be extraordinary knowledge or skill sets inherent to certain employees or acquired by a group of employees through special proprietary training[8]. With the right leadership and environment, the value of the total HC of the company would be greater than the summation of the pieces (the individual employees). Therefore, the summation of the components of the HC is not a viable value for the enterprise's HC.

IS HUMAN CAPITAL INTELLECTUAL PROPERTY?

Intellectual capital includes human capital, information capital, brand awareness, and instructional capital. Businesses can increase intellectual capital by hiring better employees, conducting training programs for employees, and developing new patents. Intellectual property is the actual assets or items such as trademarks, patents, copyrights, trade



secrets. Intellectual capital is the value of the intellectual property.

When intellectual human capital is present, an organization may choose to assign an exceptional value to it and thus recognize it as an intangible asset on the balance sheet. This type of intangible asset would be classified with the intellectual property values of patents, trademarks, and other special assets that are assigned an intangible asset value.

For HC to have an intangible asset value, employees must have an exceptional value that exceeds the specific expenses and liabilities. Intangible human capital value may be acquired when a company has very high-profile executives that contribute extraordinary value to an organization. This may come from a family name, positive media reputation, or innovator status[9].

Although the valuation of human capital is complex and often very subjective, some means of quantifying this intangible asset is necessary – even if the information is disclosed in the body of the financial statements and not as a "line-item" on the balance sheet. The problem is that an asset placed on the balance sheet must be measurable. The IASB states that an asset or a liability would only be recognized if the benefit exceeded the cost of measuring it, and it would not be recognized if no measure would give a "faithful representation"[10]. For all practical purposes, this is the old "reliable measurement" requirement under any recognition of an economic benefit.

Over the last few years, we have witnessed a seismic shift in how human capital should be valued. To recognize something in a balance sheet, you must put a number on it; you need to be able to clearly identify it and reliably value it. Generally Accepted Accounting Principles ("GAAP") does allow for the quantification for most intangibles. Intangibles are typically unique and differentiated assets. This is what makes them valuable; but from a valuation point of view, this is also their downfall. With no active market in intangible assets and no market price, valuation has to be an estimate based on uncertain future events.

But if intangibles are bought in a transaction, then there is an identifiable cost and GAAP is much more relaxed about putting them in the balance sheet. In fact, there is quite a lengthy list of intangible assets that GAAP is happy to see recorded after an acquisition or merger. However, the recognition of intangible assets does not include human capital.

The practice of having all the intellectual property on a single line item in the balance sheet is not viewed as a viable solution. This would be no more acceptable than to have all the current assets listed as a single line item. Moreover, if the assets in question cannot be properly quantified, it is better to omit this from the balance sheet and provide meaningful, verifiable disclosure within the notes of the financial statements instead.

WHO IS DRIVING FOR A QUANTIFIED SOLUTION?

Four major groups are driving the demand for change:

#1 REGULATORY BODIES.

Recently, the US Securities and Exchange Commission (SEC) proposed an expansion of reporting requirements to include training hours, worker productivity, and turnover. The agency recently released a final rule requiring companies to disclose a description of their human capital resources and any human capital measures or objectives that are a focus of managing the business when they are material.

The International Financial Reporting Standards (IFRS) and US Financial Accounting Standards Board (FASB) both have requirements in place for reporting employee-employer transaction information related to employee benefits, retirement plans, and compensation.

#2 INTERNATIONAL ORGANIZATIONS.

In late 2018, the International Organization for Standardization (ISO) specified 23 core metrics, including costs and worker productivity. The World Economic Forum's recently released report, Measuring Stakeholder Capitalism Towards Common Metrics and Consistent Reporting of Sustainable Value Creation, sets out core metrics for diversity and inclusion, pay equality and wage levels[11].

#3 INVESTOR COMMUNITIES.

The Human Capital Management Coalition, representing 26 institutional investors, has been instrumental in petitioning the SEC to require human capital metric reporting.

#4 POLICY-MAKERS.

The US Congress is examining the topic of human capital reporting. In addition, the EU's non-financial disclosure requirements are designed to promote greater transparency in organizational efforts related to social responsibility and the treatment of employees as well as board of director diversity.

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