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Integrated Reporting and Human Capital: Next Steps for the Private and Public Sectors in BC

By David Creelman | 2015

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Many managers have not even heard the term "integrated reporting" so they might be surprised that Mark Carney, now Governor of the Bank of England, is earnestly urging its adoption. Integrated reporting is a big, sprawling topic, so this white paper will hone in on what we think is most important for British Columbia.

First, let's answer the question, "What is it?" Integrated reporting is a smarter kind of annual report that integrates financial and non-financial data to show how the organization creates value for various stakeholders. The two biggest elements of non-financial data are human capital data and sustainability data.

At this point, some readers will have noted the words "annual report" and will think, "This doesn't have anything to do with me because I'm in a family-owned firm, or in the public sector, or a non-profit." If integrated reporting were only meaningful to corporations, then it would be of limited interest. Integrated reporting matters to us all because if we only consider financial data we will miss the bigger picture of value creation. The type of organization you are in does not really matter; the top management team needs to have a clear idea, backed by data, about all the important elements that drive success.

Let's take a concrete example. The future of a privately-held video game company may depend entirely on its ongoing ability to attract talented game designers. If information about talent attraction is not in front of top management, along with the financials, then they may overlook a strategic talent issue. Or consider the public sector: delivering services may depend to a large extent on the quality of labour relations. If useful information on labor relations is not in front of top management, then their ability to serve stakeholders may be at risk.

In this report, we will focus on building human capital into integrated reporting. Of course, this is our area of expertise; however, if companies understand how to handle human capital, then the rest of integrated reporting will come fairly easily.

One last point needs to be made: integrated reporting does not have to be a huge project. Even a small initiative to explore a topic like "human capital risk" is a meaningful step in the right direction. Companies that have created integrated reports talk about it in terms of an iterative learning process. You can move toward integrated reporting one step at a time; as wonderful as it is when firms go all in (we'll talk later about Deutsche Bank), we imagine that most BC organizations will adopt a gradual approach.

Key Points

- Powerful people in the regulatory community (Mark Carney) are urging organizations to adopt integrated reporting.
- The fundamental spirit and value of integrated reporting is relevant to all kinds of organizations.
- Integrated reporting brings together financial and non-financial data in a coherent story. The main non-financial data is human capital data and sustainability data.
- An integrated reporting initiative can be done one step at a time, with each step adding immediate value.

Does Integrated Reporting Have Sustainable Momentum?

Just because integrated reporting seems to be a good idea does not mean it will be adopted. Furthermore, reporting on human capital is hardly a new idea. Associations, academic institutions, regulators and many others have been waving that flag for years.

The story, this time, is that integrated reporting has substantial backing; Mark Carney is among many significant influencers prodding organizations down this road. CEOs and CFOs should be paying attention. Other leaders of the American group pushing for more integrated reporting: the Sustainability Accounting Standards Board (SASB). The Financial Accounting Standards Board (FASB) is the designated organization in the private sector for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental organizations. The former chair of FASB, Robert Herz, is on SASB's board; even Herz may not be as influential as SASB's Vice-Chair, former SEC chief Mary Shapiro, who is working hand-in-hand with the even more influential Michael Bloomberg, Chair of SASB. Mr. Bloomberg owns nearly 90% of the financial data giant Bloomberg and incidentally was the 108th Mayor of New York City. SASB also gets substantial support from the big accounting firms.

SASB is the American group; on the international stage, integrated reporting is championed by the International Integrated Report Council (IIRC) based in London, with the Prince of Wales as a spokesperson. The IIRC has garnered considerable international support within the UK, Europe and Southeast Asia. The big surprise is South Africa, which has already adopted integrated reporting as a standard.

The two groups are philosophically well aligned, although SASB leans toward drilling down to specific prescriptive metrics (different for each industry sector) while IIRC leans toward providing broad principles. They are not the only players in improving reporting. The B-Team, which is an assemblage of the good and the great, such as Richard Branson, supports improved reporting, and GRI is well-established in giving guidance on how to report on sustainability factors.

We could continue talking about different groups with an active interest in this area, such as the Ministry of Economics, Trade and Industry (METI) in Japan, which has been working with firms to produce their own brand of integrated reporting for a number of years. However, the question that titles this section is "Does integrated reporting have sustainable momentum?" and we are ready to give the definitive answer of "Yes."

"Yes" does not mean that there won't be delays and setbacks. Anything big in HR takes time; The Gap made several attempts to set up an HR analytics group over ten years and it was only on the third attempt that it stuck. There will be ups and downs, but at long last the tide is coming in on this one, and we can expect reporting to change.

A Few Misdirections

A number of things about integrated reporting can lead people in the wrong direction. The best way to stay on track is to keep focused on the true goal: better understanding of how an organization creates value that leads to better value creation for all stakeholders. However, it helps to know the mislabelled intersections that can lead to wasted time on the way to better reporting.

One mislabelling is the term "human capital." We use that term frequently and usually without apology because it is well accepted and emphasizes that people are an asset, not a cost. However, the term leads people to think that we should put a dollar value on human capital and place it on the balance sheet. There are two reasons why that's the wrong way to go. One is that human capital is an umbrella term that covers many different things including the skill of individuals, their commitment, organizational culture, employment brand and organizational structure. Human capital does not boil down to a single number like financial capital does. Another complication of human capital is that it is a multiplier rather than something that has value on its own. If the elements under the umbrella of human capital support strategy, then it multiplies success; if the elements are weak, then they can derail an otherwise well-placed strategy.

Another possible source of confusion is that, as with all successful initiatives, there are multiple and somewhat disconnected stakeholders that support the initiative for different reasons. Thought leaders, environmentalists, regulators and reporting experts all have their own views on why integrated reporting matters.

Thought leaders embrace integrated reporting because we have long believed that an undue focus on financials misrepresented how value was created and led to suboptimal decisions. For example, my co-author, Laurie Bassi, showed in her seminal research that companies that invested heavily in training were punished by the stock market because it showed up as a cost rather than an investment. Later, when the returns of the investment rolled in, these firms outperformed the stock market. Thought leaders simply think that integrated reporting makes sense.

Environmentalists support integrated reporting because they see it as an opportunity to bring more focus on how firms help or harm the natural environment. This group of stakeholders is more predominant that those interested in human capital. In fact, people from the sustainability world often see human capital through the lens of human rights asking, "Are you treating people well?" Human rights matter, but that's a very different question from whether you have the talent and culture to reach organizational goals. Environmentalists are not at odds with thought leaders on integrated reporting; they just have a different focus.

Regulators like Mark Carney care about integrated reporting because the whole UK establishment was appalled by how badly the financial world behaved leading up to the 2008 crash. They want to improve governance and add a long-term perspective to decision making. Good governance matters, but again that's a different focus from environmental concerns or the belief that non-financial data is relevant to understanding company performance.

There are also the experts in reporting who have long been unhappy with existing annual reports. The leader in this area is Harvard's Bob Eccles, author of *One Report: Integrated Reporting for a Sustainable Strategy* (2010). Eccles feels that the existing reporting method is broken and wants to fix it.

These different stakeholders will talk about integrated reporting in different ways and emphasize different outcomes. However, all these groups are aligned on the way forward and we repeat the advice we gave at the start of this section: the best way to stay on track is to keep focused on better understanding of how an organization creates value.

Getting Started On Integrated Reporting

The first step for HR is to identify who in the corporation has an interest in integrated reporting. The best case is when the CFO and CEO see value in working on this; in fact, that's the only scenario that will take you toward a true integrated report. If that's a non-starter, then the corporate responsibility or sustainability group may be interested in partnering with HR to get better human capital information in a sustainability report. In fact, the 2014 CBSR (Canadian Business for Social Responsibility) conference emphasized the need for closer ties between sustainability and HR. Finally, HR may decide simply to embrace the spirit of bringing more clarity to how human capital creates value for its own purposes. Even if "all out" integrated reporting in not on the horizon, HR should have a good grasp of the biggest HR risks and the main places it impacts strategy—with some data to back that up. A "strategic HR analytics report" or "people plan" would create much of the value an integrated report is meant to bring.

The second question is what human capital elements to report on. There are two approaches to getting a handle on the strategic impact of human capital:

- Demand side: What does strategy demand of human capital?
- Supply side: What human capital capability do we have?

The demand side is most easily understood in terms of risk. Ask yourself what elements of human capital could derail strategy. For example, a US telecom firm was unrolling a new product and was projecting revenue presuming that rollout was successful. However, the new product needed to be installed by trained technicians who were in short supply. Revenue projections were dependent on HR's skill in filling those jobs; HR recognized that this was a strategic issue so they made sure that they had adequate resources to deliver.

The supply side is quite familiar to HR leaders; it includes things like engagement, training, employment brand, leadership depth and turnover. What is too often missing from supply side data is an indication of what the data means. Is engagement of 70% good, okay or poor? HR needs to go the extra step in bringing insight to the data; if there is no associated insight, there is no reason to report the data.

If we want to make a financial analogy, the demand side asks what investments we need to make to achieve a specific end result, while the supply side asks about the strength of our balance sheet.

Deutsche Bank has gone all out and issued a standalone human capital report in 2013, which covers both the demand side and the supply side. They start by noting that loss of trust in the banking system is a critical strategic issue and go on to show HR's role in addressing the issue—that's the demand side. They also include good data on traditional supply side measures like investment in training, the number of women in management positions and employee commitment. As a nice illustration of providing insight, not just data, Deutsche Bank explains that a decreased investment in training is the result of efficiencies, not a cutback in the amount of training delivered.

What Integrated Reporting Means to the Public Sector

Most of the talk about integrated reporting emphasizes better value creation for investors. This might lead people in the public sector to feel it's not for them. However, the spirit of IR is about articulating value creation in different spheres for different stakeholders. In that sense it may have a more dramatic impact on the public sector where value creation is harder to articulate.

In getting started, HR should include both the demand side and the supply side, but aim for relevance, not comprehensiveness. It is far better to talk intelligently about a few key factors than it is to take on a sprawling project that no one will be able to digest. OMERS (Ontario Municipal Employees Retirement System) restricts the HR scorecard it shows to the Board to ten metrics. If someone suggests a new metric, then they have to say which existing metric it should replace. This discipline of keeping a tight focus on what is most relevant helps HR to have more impact.

Once you have assembled the team, and decided what to report on, then the third step is to get the data. Some of the firms I contacted in my work on reporting said that they could generate all the basic data they needed in half a day—it was all in the HRIS system. Other organizations will find they will have to temper their reporting ambitions based on what data is realistically available. However, the good news is that any movement in the direction of providing more insight on how human capital creates value is worthwhile. Terry Fox said that he didn't think about running across the country, just making it to that next telephone pole. If we can make it to the next telephone poll in reporting on human capital, then that's a success worth celebrating.

What Are Companies Reporting on Human Capital?

Laurie Bassi, Andrew Lambert and I did a study, *The Smarter Annual Report: How companies are integrating financial and human capital reporting*, where we looked at 61 companies that have produced "integrated reports." (We add those quote marks because there is considerable variation in how companies handle integrated reporting. That variation is partly by design; the IIRC was well aware that they did not have all the answers and encouraged experimentation.) Nearly 80% of the integrated reports we studied have a separate "people section." This section goes by a variety of names, such as "our people," "investing in employees," "winning with people" or, more prosaically, "human capital report" or "labor practices." The length and depth vary greatly. At one extreme, Enel provided 13 pages of employee data, but many others had just a few pages.

The topics covered included:

- Absenteeism
- Culture and values
- Demographics and diversity
- Employee and engagement surveys
- Governance (human capital factors)
- Health and safety
- HR/people strategy and goals
- Labour relations
- Leadership
- Organization structure
- Recruitment and talent acquisition
- Reward
- Spending
- Talent retention
- Training and talent development

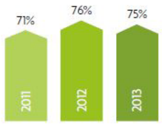
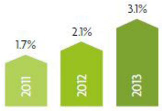
This long list is not meant to imply that you should be covering all these topics; it just indicates the range of things that companies are actually reporting on.

Here are some specific examples from around the world. Think about whether you would be able to produce similar data and whether it would be relevant in your organization.

Trusworth, a fashion retailer in South Africa, includes a substantial amount of data on their training initiatives. In their context, an economy where the labor force is under-skilled, training is a strategic factor and they illustrate that with data, while also highlighting how it integrates with their commitment to diversity.

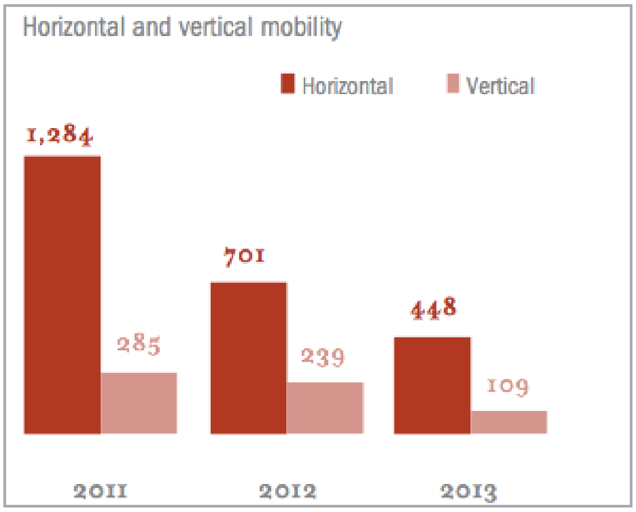
Skills development summary		2013	2012
Skills development expenditure	(R million)	83	81
Skills development expenditure as a % of payroll	(%)	8.6	9.6
Number of employees trained		9 408	9 829
Black employees as a % of employees trained	(%)	93	93
Number of employees trained in scarce skills		8 006	5 686
Black employees as a % of employees trained on scarce skills	(%)	95	90
Number of learnerships completed		168	209
Number of employees on internships		194	109

VanCity does a very nice job of conveying information in a useful way. They show a goal with a specific target, trends in an easy-to-read graphic, a final result and an explanation. In the context of the report, it is also clear how these human capital goals relate to the overall strategy.

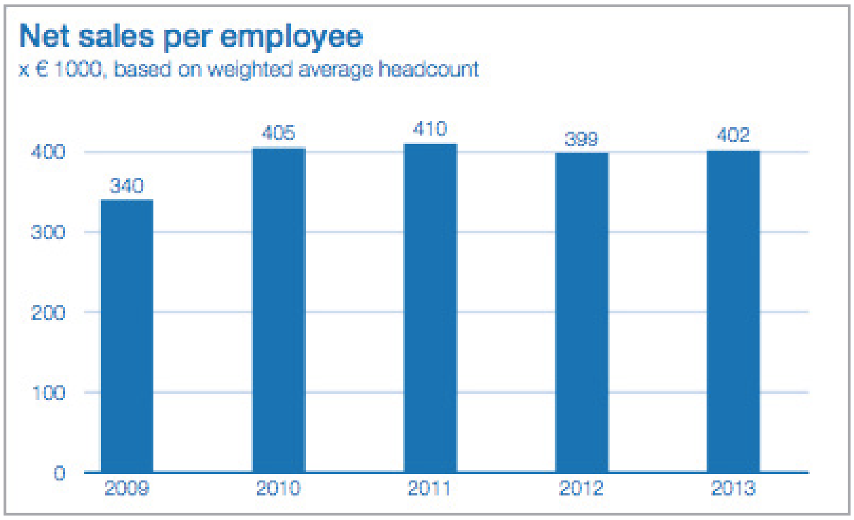
Integrity targets	Progress	Status
The employee engagement score is at least 77 per cent[2].	 75% employee engagement score	X DID NOT MEET While we did not reach our target, our engagement score remained high—75 per cent compared with 76 per cent in 2012. See p. 33 for details.
People with a disability represent at least 2.4 per cent of our workforce (based on self-disclosure in an employee survey).	 3.1% employees have a disability	✓ EXCEEDED 3.1 per cent of employees surveyed identified themselves as having a disability. See p. 35 for details.

Barclays Africa Group shows not just turnover but regretted losses. This is a big step in the right direction, as it shows the data that will be of most relevance to the leadership team. This case also illustrates the transparency that is a feature of good analysis: their regretted losses are increasing, which is bad, but not as bad as if it were happening but they swept it under the carpet.

Atlantia, which operates concession stands on Italy's highways, reports on employee mobility. They explain that employee mobility is important for getting the right talent in the right place and to develop competencies. They do well in showing the trends but fail to explain them; it is hard to know whether the mobility in 2011 was too high or that in 2013 it was too low. It's a good start, but it illustrates that we all have some way to go when it comes to articulating the meaning of human capital metrics.



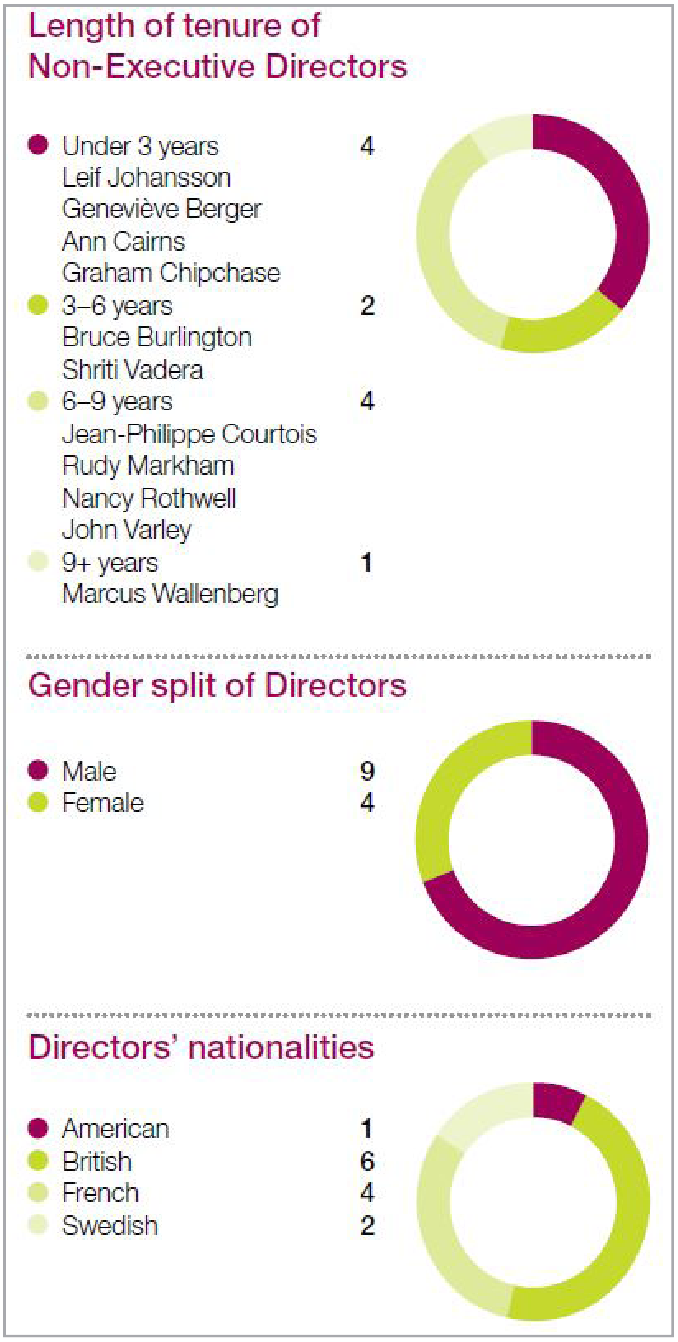
Royal DSM, a science-based company active in health, nutrition and materials that is headquartered in the Netherlands, reports on net sales per employee. When you speak to CFOs, this is the kind of data they are most interested in. The number is worth watching because organizations have a naturally tendency to add staff right across the board; if net sales per employee falls, it may be a sign of bloat.



Sometimes, rather than tables or graphs, information is best presented simply as text. For example, the insurance company Aegon explains some changes to the organizational structure, emphasizing globalization and a need to improve decision-making speed.

> **Improving coordination and management at corporate headquarters**
> We have appointed a new Management Committee, bringing together members of AEGON's Management Board, and other senior managers from local businesses, and AEGON headquarters. The objective is to improve coordination and speed up decision making.
>
> **Taking a more global approach to key business areas**
> In 2011, we created AEGON Global Technology, bringing together all IT operations. We are also putting management of other key areas on a more global footing, including Human Resources, Brand and Sustainability.

AstraZeneca, a global biopharmaceuticals company, reports on board composition, an indicator of their attention to good governance.



These are just a few examples; many more can be found in our *Smarter Annual Reports* study. However, this should serve to give a flavor of what is reported and how it is presented. It should leave you with a sense of confidence that improved reporting on human capital is doable, and something that can be built up step by step.

Next Steps

Integrated reporting is coming. It fits well with the trend toward HR analytics and evidence-based management. It sounds daunting at first but when you look at what companies are including in their integrated reports, it is clear that there is nothing magical going on; it is just a serious attempt to do a better job of conveying strategic insights about human capital.

But what does it mean to you personally?

The decision is whether to get involved. There are various reasons an individual, and their organization, might choose to invest in integrated reporting. For a number of reasons, Creelman Lambert along with the Human Resources Management Association (HRMA) urge organizations to invest in integrated reporting.

- One is that it simply fits the spirit of the organization; VanCity is an example of a firm that strives to be integrated into the communities within which in operates. Their integrated reporting appears to be a natural way to articulate to themselves, and to their stakeholders, what the organization is all about.
- Creelman Lambert has close ties to people within the Deutsche Bank. For this organization, it is more about advancing excellence in managing people (if that doesn't sound too pretentious). They care a lot about people management at the bank and their integrated reporting is a means for them to get clarity about priorities and connect to other stakeholders about those priorities.
- Some people feel there is a need for more integrated thinking and see this as a good means for convening the right people 'around the table'. Azola Lowan, Head of Strategy and Investor Relations at PPC, a cement manufacturer, claims that bringing the team together to think through issues was clearly as important as preparing a report.

For many organizations, it is integration of their people, capital, leadership and intellectual property that will set them apart from their competitors. It is critical that HR leaders work with their financial counterparts, as well as other firms to determine the indices, metrics, factors and best practices that paint a comprehensive picture of what constitutes success for their organizations.

Learn More

You can download a copy of *The Smarter Annual Report: How companies are integrating financial and human capital reporting* at **http://tinyurl.com/pxt4cum** (with a word of thanks to Halogen Software for supporting this research).

If you have any questions or would like a copy of our companion report *Boards & HR: How board oversight of human capital works*, please email **research@creelmanlambert.com**.