Assess the ‘S’ in ESG - the quality of human capital

Introduction

Intellectual Capital is an intangible asset comprising human capital, relationship (Ssocial) capital, organisational (structural) capital and intellectual property. According to Inkinen (2015), human capital creates and/or influences the other three components of intellectual capital (see Figure 1). This combination of components is an increasingly important aspect considered by investors (Investor Relations, 2020) and is of particular interest to those using environmental, social and governmental (ESG) criteria (Young In, Rook and Monk, 2019).

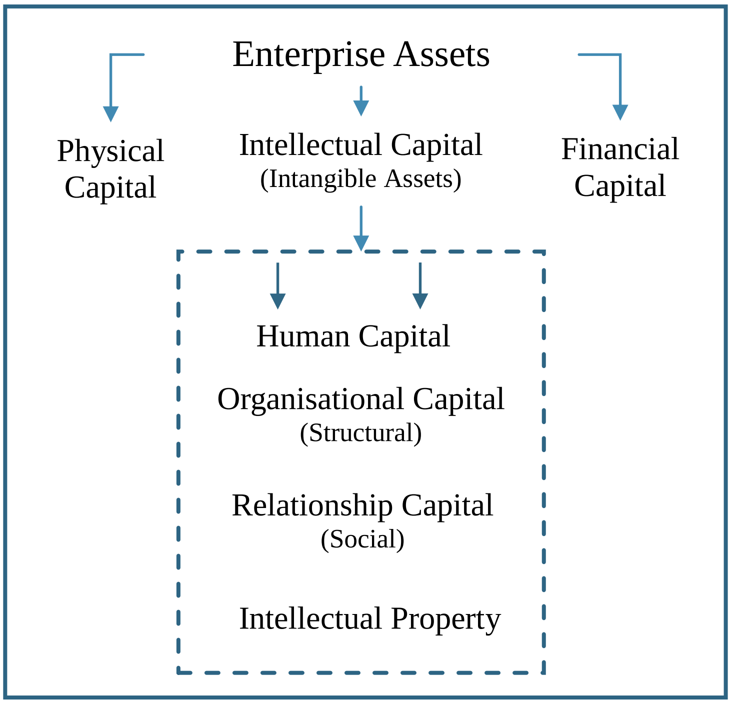

Figure 1. Human Capital creates and influences other components of Intellectual Capital

In this article I outline an approach to assessing human, relationship and organisational capital. Intellectual property is already well covered by investors (Howson, 2017) and consequently has been excluded.

The approach generates a ‘Human Capital Report’. This can be used by both HR and non-HR consultants to produce defensible information which has the ability to influence investment decisions.

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Increasing Relevance of Intangible Assets

Ocean Tomo's assessment of the largest 500 enterprises in the USA (2021) demonstrates that these intangible assets are increasingly contributing to the value of such enterprises. They now make up around ninety percent of enterprise value (see Figure 2 below):

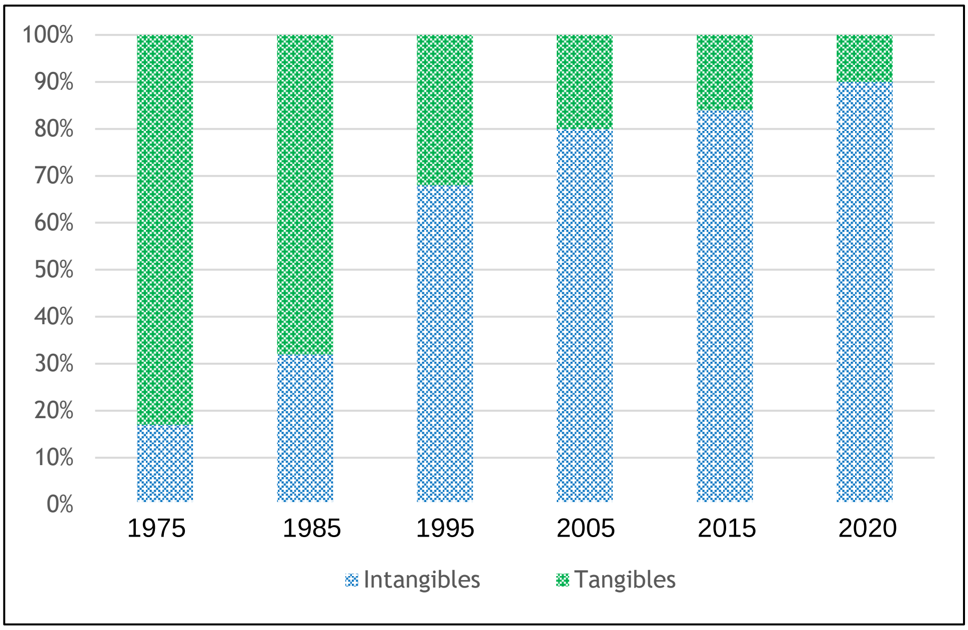

Figure 2. Intangible assets make up 90% of the value of large enterprises in the USA

Their research also covers the largest 350 European blue-chip enterprises and indicates a 70% – 30 % balance in favour of intangible assets (Ocean Tomo, 2021).

Many enterprises are well aware of the value of intangibles. The larger ones use well established approaches to create non-financial performance indicators (e.g. Human Capital Monitor; Workforce Scorecard) and describe them in annual strategic reports and corporate social responsibility reports (Financial Reporting Council, 2018; Jang and Ardichvili, 2020; McCracken, et al., 2018).

However, these approaches can be both time-consuming and expensive to implement and maintain. For example, in the case of Investor in People, most companies expect to complete the process within a year (Smith, 2000; Startups Team, 2021) and there is a need for an audit every three years.

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I argue therefore, that there is room for an approach which enables businesses to portray the quality of their human, organisational and relationship capital comprehensively, quickly, inexpensively and in a way that is trusted by both investors and consultants.

Development of the Approach

I developed the approach by using a literature review; surveying the views of subject matter experts (10), investors (110) and enterprises (209); subsequently designing the draft instrument; piloting it; developing it and then demonstrating that it works.

Information on detailed technical development, is available via Google Scholar (Fargus, 2018). Suffice here to say that it measures what it says it measures (in other words, it is valid). If used twice in the same week by the same management team it generates comparable results (so it is reliable).

The Finalised Instrument

The finalised instrument consists of twelve factors comprising between five and nine descriptors (which specify different aspects of a factor); a flexible scoring mechanism (to cater for a wide range of organisations); opportunities to support the scoring with documentation, and the option of benchmarking data.

Once organisational data has been assembled, it typically takes a senior management team approximately four hours to establish consensus on all twelve factors. Consensus is in the form of <u>how important</u> (0-5) each of the descriptors are to the organisation, and at what <u>stage of development</u> (0-5) they currently are. The factors are:

1. *Strategic intent: initially reviewing the organisation’s overall strategy.*
2. *External relationships: relationships with external stakeholders.*
3. *Organisation integration: structure / operations which maximise employee contribution.*
4. *Workforce composition: headcount and levels of diversity.*

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5. Workforce know-how: the knowledge and skills required to compete.

6. Workforce relationships: inter-departmental / management - workforce.

7. Workforce tenure: years of service found within the workforce.

8. Workforce stability: durability due to favourable health, safety and wellbeing.

9. Workforce adaptability: willingness and ability to learn new practices.

10. Workforce impetus: willingness to work towards organisation goals.

11. Workforce risks: practices potentially causing financial or reputational distress.

12. Workforce investment: investment in developing the eleven factors described above.

Once completed, the scoring mechanism generates a radar chart showing the organisation’s profile and (optionally) that of the benchmark organisations, see Figure 3 below.

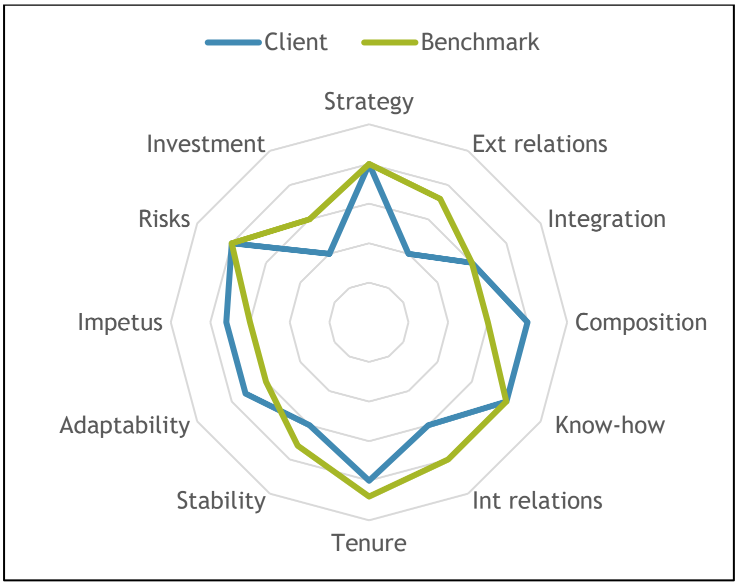

Figure 3: Example radar chart

Based on the scoring mechanism, a report is also generated which indicates organisational strengths and opportunities for improvement. An extract from such a report may be seen in Figure 4 (example limited to two descriptors.)

Workforce Relationships	
Key:	OFI: Opportunity for Improvement
	S: Strength

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Descriptor	Importance (0-5)	Rating (0-5)	Score (0-25)	OFI /S
Appointing someone in the Senior Management Team who is responsible for initiating discussion on people and organisation	5	1	5	OFI
Ensuring regular two-way communication between the Senior Management Team and members of the workforce	5	3	15	

Figure 4: Extract from a report limited to two descriptors

Importance to Investors and Clients

Of the 96 investors who responded to the survey 84% indicated that, if they were in possession of reliable and valid data as described above, they would vary their investment by up to 50%, see figure 5 below.

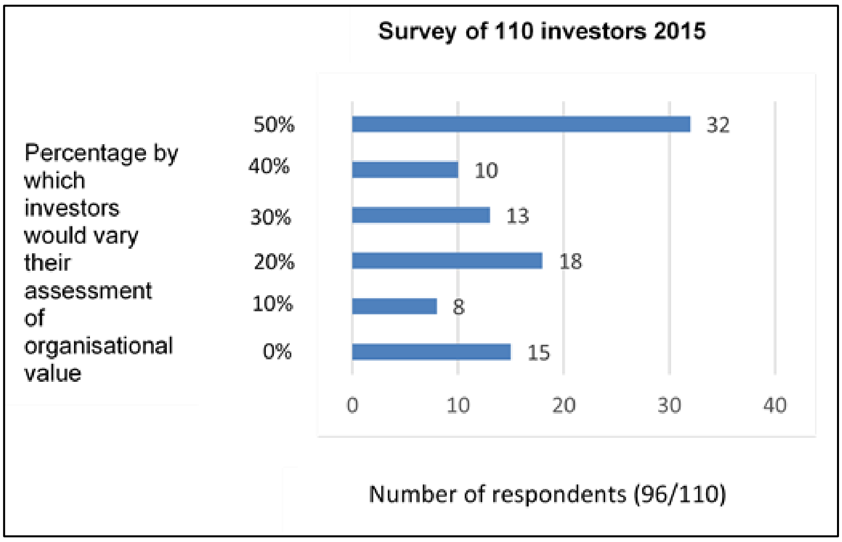

Figure 5: Investors would vary their valuation by up to 50%

This demonstrates that the Human Capital Report is likely to influence investor decisions. Indeed, one investor has indicated that the initial discussion relating to the factors, plus the subsequent scoring would influence his decision whether or not to buy a target organisation (Fargus, 2019).

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Importance to Consultants

Used by Consultants (both HR and non-HR), the approach is a way of facilitating a systematic approach to reviewing or establishing a client’s people management strategy and workforce quality. It can be used as a way of providing added value to investor and/or organisation. This could be as part of a comprehensive consultancy assignment or as a standalone product. Anyone interested can gain access online at www.HumanCapital.Report.

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