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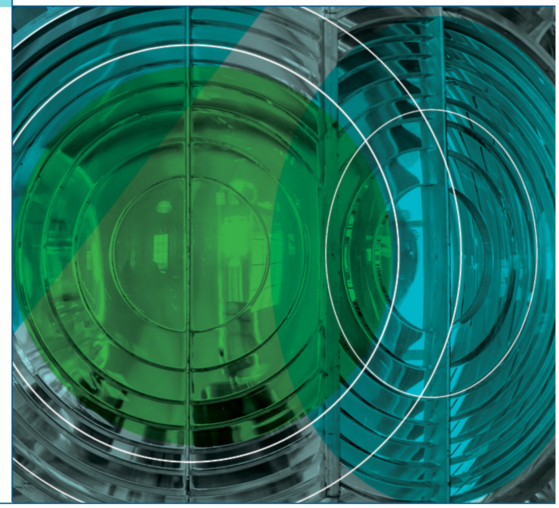

Enhancing Investor Confidence:

THE IAC'S PUSH FOR COMPREHENSIVE HCM DISCLOSURE

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Based on letters to the Securities and Exchange Commission (SEC), investors have been asking for more detailed human capital disclosures since at least 2017.

But it wasn't until August 2020 when the SEC made considerable changes to required disclosure of human capital matters under Item 101 of Regulation S-K. While this update expanded requirements to include human capital risks and resources, it fell short of investors' previous calls for clarity, specificity, and thoroughness. In fact, professors at the University of Waterloo[1] conducted a study in 2022 that found the SEC's newly introduced principles-based rule was unlikely to generate human capital disclosures sufficient to investors' needs. The same study showed that current rules did not yield the more specific, quantitatively-backed disclosures that investors had been seeking.

Investors also indicated to the Financial Accounting Standards Board (FASB) an interest in more detailed disclosure data on the cost of sales along with selling, general and administrative expenses that would enhance their comprehension of a company's cost framework and their ability to predict future cash flows. In July 2023 the FASB issued its own proposal requiring companies to reveal employee compensation costs included in the income statement.

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[1] *The University of Waterloo used textual analysis to extract the linguistic features and numerical intensity of human capital disclosures for more than 3,600 public companies. The public companies were all filers of 10-Ks and reporting for the first time under the new regulation since enactment on November 9, 2020, through to early November 2021.*

In response to investor concerns, the SEC Investor Advisory Committee (IAC) (a specialized body comprised of experts across law, finance, and academia whose input helps inform the SEC's rulemaking and practices) drafted a separate proposal in September 2023 that aims to further improve human capital management (HCM) disclosures.

In this article, we will explore the IAC's recommendations, why they could be a big deal for investors, and questions boards can ask to prepare for these potential changes.

IAC's Recommendations for Strengthening HCM Disclosures

1 **Detailed Employee Breakdown:** The IAC argues that existing disclosures are inefficient and inconsistent, as they often omit international workers and frequently overlook contingent labor. The IAC proposes that the SEC requires companies to disclose the number of employees, categorized as full-time, part-time, or contingent workers.

RELEVANCE TO INVESTORS: This breakdown offers investors valuable context regarding workforce composition and changes. For instance, it helps in identifying unusual changes in the number of employees as potential indicators of financial inaccuracies or shifts in demand for a firm's products. In addition, the transition of a significant number of employees to part-time roles can signal a decline in operations, whereas the prevalence of independent contractors offers valuable insights into organizational model choices.

2 **Turnover Metrics:** The IAC emphasizes the financial importance of disclosing turnover metrics and the potential for numerical comparability across companies as a metric for human capital and workforce stability.

RELEVANCE TO INVESTORS: According to a study by Morgan Stanley Investment Management[2] and another by university academics[3], turnover is directly linked to financial performance, with higher retention rates associated with higher stock returns. The Morgan Stanley Investment Management study specifically found that companies with better retention saw 25% higher cumulative stock returns. Conversely, higher turnover can negatively impact profitability and incur substantial replacement costs.

3 **Comprehensive Workforce Cost Breakdown:** Human capital expenditures aren't broken out in the income statement. To help investors assess the efficiency of each dollar invested in human capital, the IAC suggests disclosing the total cost of the issuer's workforce, broken down into major compensation components—salary, equity, etc.

RELEVANCE TO INVESTORS: Labor costs often represent a significant operating expense, particularly for companies with many knowledge workers. However, labor costs are rarely disclosed. This lack of transparency makes comparisons across companies challenging. Disclosure of workforce costs would help investors understand these costs, assess the effectiveness of human capital investments, and evaluate organizational choices. This information could then help investors determine how a company's investment in its workforce could be integrated into its models.

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[2] *Using monthly captured employer data from over 300 million employees between 2011 and 2022, Morgan Stanley Investment Management partnered with MSIM Data & Analytics and Morgan Stanley Artificial Intelligence Center of Excellence Teams to conduct systematic analysis of nearly 2,000 publicly traded companies that included identifying a correlation between retention and stock returns.*

[3] *Academics from Hong Kong Polytechnic University, the University of California, Irvine, and the University of Illinois at Chicago analyzed turnover and the return on assets quarter after quarter at over 3,600 firms between 2008 and 2018.*

4 **Workforce Demographic Data:** The IAC contends that current disclosures are often generic, qualitative, and varied with respect to the level of detail. Instead, the IAC calls for companies to provide "decision-useful" workforce demographic data, including diversity at senior levels.

RELEVANCE TO INVESTORS: Data on diversity at every organizational level can assist in evaluating talent pipelines and gauging the effectiveness of diversity, equity, and inclusion (DE&I) efforts.

How Boards Can Get Ahead of Potential New HCM Disclosures

The IAC's recommendations represent a significant step forward in improving HCM disclosures, allowing investors to make more informed decisions. While we don't know if these specific requirements will be adopted into an SEC proposal and final rule, companies can begin thinking about how to collect and present the data sooner rather than later and start the discussion with their boards. Below are some questions boards can ask now.

1 **Do we have the right data?** Companies will need robust data collection systems to accurately gather and report the required HCM metrics. This may involve collaborating with HR, finance, and business unit leaders to ensure data accuracy and consistency.

2 **Does our organizational model tell a story that makes sense? Where might we need to fill in the blanks?** Are there weaknesses that our organizational model exposes? For example, a company that hires contractors as associates will look different than one that employs store associates full-time.

3 **Where are we experiencing the worst turnover and the best retention?** How does turnover compare to peers? What are the key factors in both turnover and retention? Does the turnover reflect any business vulnerability that will need to be discussed with investors?

4 **Where are the biggest sources of human capital costs and do they align with the business strategy and the parts of the organization the company should be investing most in?** With greater transparency into workforce costs, companies need to continuously evaluate the return on investment in human capital.

5 **Are our current DE&I efforts enough? Are we seeing good progress year-to-year?** Some companies may want to strengthen their efforts to improve diversity and inclusion, as this information will be increasingly scrutinized by investors. However, companies should consider the potential legal pushback that intensifying DE&I efforts could cause following the Supreme Court's decision to overturn affirmative action in college admissions. DE&I programs not tied to strategy or specific outcomes could become an easy target for legal challenges, so companies should consider seeking legal advice when navigating DE&I-related issues and opportunities.

6 **When we look at all the data in its entirety, will the market understand how our HCM practices align with our business strategy? How do we communicate this to investors?** Boards can engage in discussions on the strategic alignment of HCM practices with overall business objectives. Understanding how labor costs are viewed as investments in growth or operational maintenance is critical. Finally, companies should be prepared to address inquiries and provide context for their HCM data.

The need for greater HCM transparency is expected to rise, especially as intangible assets play an increasingly pivotal role in the valuation of public companies. While there may be some reluctance from boards to disclose more data, the benefits of fostering strategic discussions on these matters could outweigh concerns about the burden of additional disclosure. To start, boards can engage management to ensure the company proactively prepares for potential changes to meet regulatory requirements and enhance its strategic approach to HCM.

Given the tight timeline for implementing Pay vs. Performance disclosures for this past proxy season, we suggest companies be prepared for a potentially short turnaround time if the SEC proposes rules that are finalized and implemented. There should be additional guidance in 2024 as proposed rules are developed and comments come in. Therefore, boards are likely to have ample time for preparation, as the potential timeline for implementation will likely be in 2025. Even if these don't become the final rules, the strategic conversations prompted by this exercise will still be important.

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