Terawatt

How CFOs View Human Capital

A Terawatt White Paper

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Executive Summary

At Terawatt, we see a potential sea change in how our customers evaluate coaching. Typically in our sales process, we work with Learning & Development (L&D) leaders who are responsible for evaluating employee development programs and vendors within the silo of the Human Resources (HR) department.

This process may be in flux due to new federal regulations. In 2020, the Securities & Exchange Commission (SEC) announced a requirement that all filing companies must include a discussion on human capital risk reporting in the narrative section of their Form 10-Ks. The SEC allows each company to define "human capital risk" for itself. In the long term, SEC experts predict that the SEC will eventually require filing companies to report specific human capital metrics. As of June 19, 2023, the SEC hasn't refined its 2020 human capital guidance.

How does the SEC's human capital reporting requirement influence the evaluation of employee development programs and vendors? Public company CFOs are responsible for the integrity of all reported company metrics, data, and the processes used to derive them.

This responsibility isn't theoretical–both CFOs and Chief Executive Officers (CEOs) are designated fiduciaries and, thus, liable for the accuracy of their company's filings. Because the processes and output of professional development programs now fall into SEC reporting requirements, we believe there may be a future where the finance and HR departments share responsibility for evaluating professional development programs and vendors.

Given this regulatory environment, we surveyed 83 CFOs about their opinions on human capital and its relationship to company goals.

Below is a list of the key responses:

- **61% is the average** return given by CFOs as a worthwhile return on investment (ROI) for human capital activities
- **95% of CFOs agree** that the Finance Department should be involved in selecting human capital development.
- **64% of CFOs agree** that employers who support employee development should allocate a percentage of each employee's salary to budget for the learning experience.
- **57% of CFOs surveyed** report their organization publishes an annual environmental impact report.
- **47% of CFOs agree** that human capital metrics are strongly linked to a company's health.

Introduction

Within accounting, there's a concept of an intangible asset, defined as a non-physical asset with a monetary value. Examples of intangible assets include copyrights held, goodwill (the difference between the book and the sell-value of your company), and patents. U.S. exchange-traded companies must disclose and value all of their owned intangible assets.

Over the years, a subset of intangible assets, "human capital," has seen increased interest from U.S. and international regulatory bodies, academics, pensions, think tanks, and unions. Since 2017, the SEC has been collecting public comments and recommendations on how publicly traded companies should disclose human capital management policies and performance. Many stakeholders–investors, unions, academics, and more–have made the case for years that publicly traded companies should be more transparent about their relationship with their employees. You can read all of the public comments here.

As former SEC Chairman Jay Clayton noted in a 2020 speech, over the past 30 years, the ratio of Intangible Assets to Market Capitalization has increased 300%--due entirely to human capital (source). In that same speech, Clayton announced that 10-K filers must describe all material Human Capital resources, measures, and objectives. The SEC didn't specify how companies must define what is material within human capital, but rather the SEC gave companies broad discretion in reporting. As a result, for the past four years, each company discussed its human capital risk differently, with some firms using metrics and some only describing their workforce.

The regulatory change from not addressing human capital risk to now addressing it is noteworthy because the focus on human capital is likely to trickle down to private companies. Take the precedent of sustainability & environmental reports. Many groups have long argued about the importance of understanding publicly traded companies' relationship to the environment and the related risks. Because of the broad stakeholder interest, 90% of the companies on the S&P 500 voluntarily publish sustainability reports (source). And in this Terawatt survey, we're seeing similar numbers among private companies. Ultimately, we expect that human capital will become commonly reported.

In September 2023, the SEC's Investor Advisory Committee (IAC) recommended that publicly traded companies disclose a slate of metrics and specific human capital data in their annual 10-K filings, ending the wide latitude enjoyed by companies to define human capital materiality. The SEC has not yet acted on the IAC recommendations, but many SEC experts expect at least a portion of the recommended slate to be adopted.

The IAC recommended the following Human Capital disclosures:

- **Employee headcount, broken down by full-time, part-time, and contingent workers**
- **Employee turnover**
- **Total cost of people spend, broken down by compensation type**
- **Workforce demographic data**
- **Discussion of how labor practices, compensation incentives, and staffing fit within the firm's broader strategy**

Given this change in reporting, we were curious about how CFOs and the Finance Department viewed their relationship with human capital. We conducted a six-question survey to learn about their opinions.

Methodology

Our six-question survey asked two pre-screening questions and six questions to 83 pre-screened CFOs.

The two pre-screening questions:

1. Are you currently employed as the CFO of an organization that employs more than 50 people?
2. How would you describe your understanding of the new human capital reporting guidance from the SEC and SASB/ISSB?

For the survey to record their answers to the below dix questions respondents have to respond to #1 with a “yes” and to #2 with at minimum a basic understanding of the regulations.

The six-question survey:

1. Does your organization publish an environmental impact report?
2. Do you see a relationship between human capital metrics and a company's overall financial health?
3. As the SEC noted in 2020, over the past 30 years the ratio of Intangible Assets to Market Capitalization has increased 300%, due to Human Capital. As a result, several bodies are now exploring how organizations should report company-level human capital metrics.

Given the current interest in human capital metrics as a window into an employer's operations, how, in your opinion, should the Finance Department participate in the selection of human capital development?

Please finish this sentence, "The Finance Department ..."

4. If your company were to invest in human capital development, which of the following goals would be most important to address?
5. If your organization were to make new investments in human capital and its results were financially measurable, what rate of return would entice you to support such an investment? Enter a percentage return (number) below, for example, 15%, 50%, 200%, etc.
6. Given the current interest in human capital reporting, how should employers think about structuring human capital investment?
    - **A. Employers should allocate a set dollar amount per employee to impactful human capital programs**
    - **B. Employers should allocate a percentage of each employee's salary to impactful human capital programs**

We wrote the above questions to elicit answers that would be most pertinent to L&D leaders working with CFOs as a new stakeholder.

We sourced and vetted the CFOs through the polling website, Pollfish.

Findings

As the SEC noted in 2020, over the past 30 years the ratio of intangible Assets to Market Capitalizatioin has increased 300%, due to Human Capital. As a result, Several bodies are now exploring how organizations should report company-level human capital metrics. Given the current interest in human metrics as a window into an employer's operations, how in your opinion should the Finance Department participation in the selection of human capital devolopment?

Please finish this sentence, "The Finance Department ...

51%

ADVISORY ROLE

"... should provide an advisory role to HR/People, but HR/People should retain ownership as the unltimate decision- maker in the selection of human capital devolopment. "

9%

SOLE DECISION MAKER

"... should be the sole decision-maker, but the Finance Department should allow HR/People to advise on human capital devolopment."

38%

50% RESPONSIBILITY

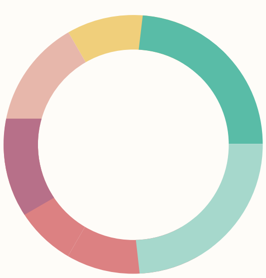
"...should share 50% of the decision-making responsibility with HR/People in selecting human capital development

1%

NOT INVOLVED

"...should not be involved at all in the selection of human capital development."

If your company were to invest in human capital development, which of the following goals would be most important to address?

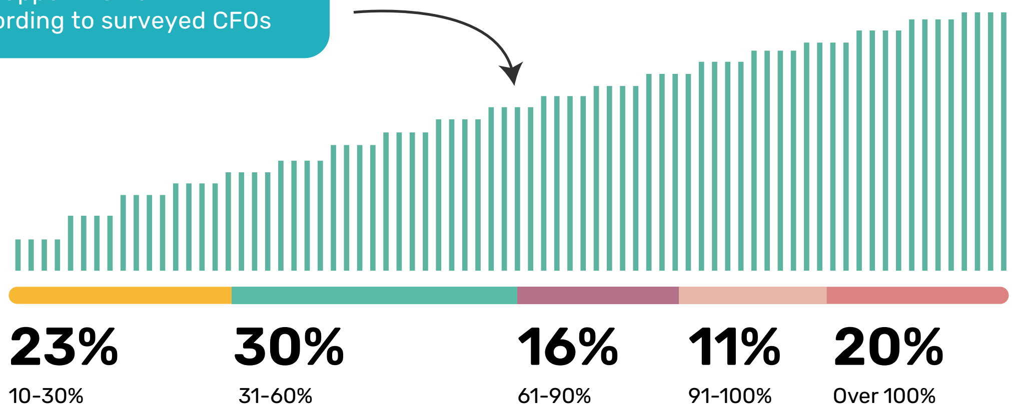


28%	Accountability		15%	Innovation	
18%	Change & Flexibility		10%	Leadership	
16%	Retention		8%	Burnout	

If your organization were to make new investments in human capital and its result were financially measurable, what rate of return that would entice you to support such on investment?

51%

Average ROI needed to support human
Capital investment, according to surveyed CFOs



Given the current interest in human capital reporting, how should employers think about structuring human capital investment?

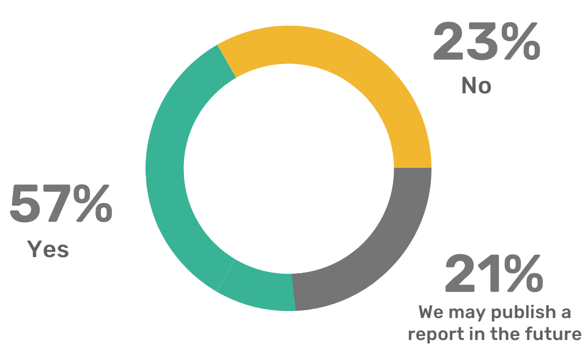
64%

Employers should allocate a **percentage of each employee's salary** to impactful human capital program

36%

Employers should allocate a set dollar **ammount per employee** to impactful human capital program

Does your organization publish an enviromental impact report?



*Note: We asked this question because environmental reports are optional. Human Capital reports are not.

Do you see a relationship between human capital metrics and a company's overall financial health?

Implications

Terawatt believes that adding human capital metrics to the CFO's reporting responsibility will impact the relationship between CFOs and Human Resources (HR)/L&D leaders. We believe future CFOs will insist on having a voice in the selection of outside vendors and/or programs and that these purchases will be looked at through a lens of return on investment (ROI).

We expect this to be a change in the way outside vendors are purchased. It's been Terawatt's experience selling to the HR/L&D leaders that low cost has been the most important factor. Going forward, ROI will become the most important factor.

Another implication for our survey results is that CFOs and HR/L&D leaders will develop new metrics that connect internal HR policy to company goals.

Further, we believe that working more closely with the finance department will lead to L&D leaders a deeper understanding and usage of statistics and return on investment (ROI).

Recommendations

Given our expectation that CFOs will demand proof of program ROI, we recommend that all HR/L&D leaders work to estimate ROI for an outside vendor or program and develop beta programs that work to rigorously test the impact and compare it to control groups within the company.

In addition, we recommend that the Finance Department and Human Resources create a working group list to develop processes for gathering information that will go into the annual reports.

Conclusion

In conclusion, our survey determined that CFOs overwhelmingly care about the ROI of human capital spend, and we expect that this perspective will lead to a dramatic change in L&D responsibilities and goals.

References

01. Securities & Exchange Commission, SEC.gov, “Comments on Rulemaking petition to require issuers to disclose information about their human capital management policies, practices, and performance,” Link Here

02. Securities & Exchange Commission, SEC.gov, “Modernizing the Framework for Business, Legal Proceedings and Risk Factor Disclosures” by Former Chairman Jay Clayton, Link Here

03. Wikipedia definition of sustainability reporting Link Here

Appendix

Below is the survey given to recipients.

PSQ1. Are you currently employed as the CFO of an organization that employs more than 50 people? (single selection) (Screening question)

- Yes
- No
- None of the above

PSQ2. How would you describe your understanding of the new human capital reporting guidance from the SEC and the SASB/ISSB? (single selection) (Screening question)

- Excellent, I understand the guidance well, and I have opinions on it.
- Good, I understand the guidance, but I haven't yet formed an opinion on it.
- Fair, I understand the gist of the guidance, but I don't see any urgency to delve into the details.
- I don't anticipate it is important to my company, so I haven't been paying attention.
- I haven't heard about any changes from the SEC
- None of the above

Q1. Does your organization publish an environmental impact report? (single selection)

- Yes
- We may publish a report in the future
- No
- Other

Q2. Do you see a relationship between human capital metrics and a company's overall financial health?

Please note: In this survey when we use the term, "human capital" we refer to "the skills, knowledge, and experience possessed by an individual or population, viewed in terms of their value or cost to an organization or country."

When we use the term "human capital metrics," we are referring to key data points that help organizations measure the effectiveness of human resources initiatives. (single selection)

- Yes
- We may publish a report in the future
- No
- Other

Q3. As the SEC noted in 2020, over the past 30 years the ratio of Intangible Assets to Market Capitalization has increased by 300%, due to Human Capital. As a result, several bodies are now exploring how organizations should report company-level human capital metrics.

Given the current interest in human capital metrics as a window into an employer's operations, how, in your opinion, should the Finance Department participate in the selection of human capital development?

Please finish this sentence, "The Finance Department ..." (single selection)

- Should not be involved at all in the selection of human capital development.
- Should provide an advisory role to HR/People, but HR/People should retain ownership as the ultimate decision-maker in the selection of human capital development.
- Should share 50% of the decision-making responsibility with HR/People in selecting human capital development.
- Should be the sole decision-maker, but the Finance Department should allow HR/People to advise on human capital development.
- Other

Q4. If your company were to invest in human capital development, which of the following goals would be most important to address? (single selection)

- Burnout
- Accountability
- Change & Flexibility
- Culture
- Innovation
- Leadership
- Retention
- Other

Q5. If your organization were to make new investments in human capital and its results were financially measurable, what rate of return would entice you to support such an investment? Enter a percentage return (number) below, for example 15%, 50%, 200%, etc. (OpenEnded)

Q6. Given the current interest in human capital reporting, how should employers think about structuring human capital investment? (single selection)

- Employers should allocate a set dollar amount per employee to impactful human capital programs
- Employers should allocate a percentage of each employee's salary to impactful human capital programs
- Other