

Lee S. Webster
Founder, 1st Chair & 3rd Secretary
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Materiality of Human Capital Metrics

“If I had to run a company on three measures, those measures would be customer satisfaction, employee satisfaction, and cash flow.”

—Jack Welch, Former General Electric CEO, author and chemical engineer.¹

Since the advent of scientific management in the late 19th century, investors have remained unpersuaded if not dismissive of human capital measures when determining the cumulative financial value of publicly traded companies. This reluctance stems from a perceived arbitrariness and empirical uncertainty that has attached to the measurement of workforce contributions to organizational value. Past critics of the use of human capital metrics frequently claim these measures are unproven, unserious, and immaterial disclosures that fail to meet the standard of relevant information for investors to consider. Contemporary management and investment experts challenge that reasoning and offer a more expansive and inclusive perspective of what investors need to know to make informed decisions. The publication of *ISO 30414:2018 Human resource management - Guidelines for human capital reporting for internal and external stakeholders*² recommends that stakeholders revisit the relevance of human capital measurement in both American and international board rooms, investment banks, regulatory agencies, and

¹ Available at: <https://www.paypie.com/blog/2018/09/12-thought-provoking-cash-flow-1uotes-and-expressions/>

² ISO 30414:2018 - Human resource management - Guidelines for human capital reporting for internal and external stakeholders. International Organization for Standardization. Geneva, Switzerland. (Dec 2018)

security markets. These stakeholders now have the means to explore whether human capital measures can provide faithfully and rigorously derived material information for investors.

When disclosing the value of publicly traded companies in US security markets to investors, the controlling federal statutes in this matter are the Securities Act of 1933³ and the Securities Exchange Act of 1934⁴. Both Acts codify Congress' urge to curb the "outrageous conduct of securities promoters" that led to the stock market crash in 1929.⁵ The 1933 Act established and advanced a regulatory system that required full disclosure among participants. This "blue sky" disclosure framework provides that "investors are adequately protected if all relevant aspects of the securities being marketed are fully and fairly disclosed. The reasoning is that full disclosure provides investors with sufficient opportunity to evaluate the merits of an investment and to fend for themselves."⁶ Since trust in securities markets vitally depends on the nature of disclosures by the seller and access to this information by buyers, the 1934 Act established the Securities and Exchange Commission ("SEC") to oversee and enforce the implementation of federal securities laws.

Among the key responsibilities of the issuers of securities in capital markets is their legal obligation to disclose information and facts that are *material* to the issuance of a stock. One of the challenges in determining whether human capital measurements are material to investors is the unsettling vagueness of the term. In Section 17(a) (2) of the Securities Act of 1933 the Congress states that it was unlawful for any person in the offer of sale of any securities "to obtain money or property by mean of any untrue statement or material fact or omission to state a material fact necessary in order to make the statement made"⁷ Although Congress' goal was to reduce fraud and deceit in securities transactions, the absence of a clear definition of what material means from the vantage point of securities issuers, regulators, purchasers, or the courts

³15 U.S.C. Sec. 77a et seq.

⁴15 U.S.C. Sec. 78a et seq.

⁵ Hanzen, L. (1996). *The Law of Securities Regulation* (3rd ed.). St. Paul, MN: West Group. Section 1.2, page 6

⁶ *Id.*, page 7

⁷ Securities Act of 1933 Section 17(a), 15 U.S.C. Section 77q(a), Rule 10b-5 of the Securities Exchange Act of 1934 defines material similarly. 17 CFR 240.10b-5 (2014)

has produced some confounding and confusing interpretations of that term.⁸ In an attempt to provide clarity, the SEC has defined material information in this way:

Material. The term material, when used to qualify a requirement for the furnishing of information to an issuer, limited the information required to those matters to which there is a **substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered.**⁹ (emphasis added)

The Congress, the SEC and securities markets eventually looked to the US Supreme Court to refine the definition of materiality. In a case that dealt with proxy solicitations on a merger approval vote, Justice Harlan wrote for a unanimous court that:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote **It does not require proof** of a substantial likelihood that the disclosure of **the omitted fact would have caused the reasonable investor to change his vote.**¹⁰ (emphasis added)

This Supreme Court ruling, and subsequent court cases and regulatory decisions, established certain tests of materiality that, however imperfect, serve as a basis for determining the materialness of investor disclosures. Relying on the preceding definitions of materiality, we can distill this concept into basic testable elements. Comparing these elements of materiality with ideas presented in *ISO 30414:2018* will reveal how well HCM metrics align with the disclosure requirements that have been dictated by common law and public policy,

HCM Metrics are not Puffery. Puffery are statements that are “optimistic, general, broad or so vague that they are considered immaterial as a matter of law. . . .”¹¹ For example, a marketing advertisement that states, “Better Ingredients. Better Pizza,”¹² is considered an

⁸ Oesterle, Dale A., The Overused and Under-Defined Notion of 'Material' in Securities Law (February 28, 2011). Ohio State Public Law Working Paper No. 145. Available at SSRN: <https://ssrn.com/abstract=1772725> or <http://dx.doi.org/10.2139/ssrn.1772725>

⁹ 17 CFR Section 230.405 (2014) SEC rule 12b-2 similarly defines the term material. 17 C.F.R. Section 240.12b-2 (2014)

¹⁰ *TSC Industries, Inc v Northway, Inc.*, 426 U.S. 438, 449 (1976) In a later Supreme Court decision, Justice Blackmun expanded the definition of materiality to a shareholder deciding whether to sell or buy securities as well *Basic, Inc. V. Levinson*, 485 U.S. 225, 231-32 (1988)

¹¹ Osovsky, Adi, Puffery on the Market: A Behavioral Economic Analysis of the Puffery Defense in the Securities Arena (May 5, 2015). Available at SSRN: <https://ssrn.com/abstract=2603051> or <http://dx.doi.org/10.2139/ssrn.2603051>

¹² *Pizza Hut, Inc. v. Papa John's International, Inc.* 227 F.3d 489 (5th Cir. 2000)

immaterial expression that a reasonable investor should not rely on when making an investment decision. *ISO 30414:2018* presents reportable human capital metrics that are serious descriptions of workforce value and not offhand comments or promotional statements. It is commonplace for these HCM measurements to be introduced into courts of law, submitted to regulatory bodies as evidence of compliance, or used by management to operate their businesses. Through outlets like the Bureau of Labor Statistics (BLS) and the UN, the most sagacious workforce policy leaders in the world rely routinely on this information when developing business plans and strategies.

Beyond required disclosures. Companies that intend to register a new stock must disclose information in a manner that is similar to companies that are currently publicly owned. While registered public companies use 10-Ks and annual reports to inform owners, new registrations must provide a prospectus to potential investors. Except for the cash and noncash compensation paid to the top five officers and paid to officers and directors as a group, there are typically no additional HCM measures provided to investors in 10-Ks, annual reports, or prospectuses. Rule 408 of the Securities Act of 1933 require issuers of stock to provide not only information that is normally required in the issuance of stock, but also “there shall be added such further material information, if any, as may be necessary to make the required statements . . .”¹³

Implementation of Rule 408 offers issuers a pathway to reveal workforce information to investors that *ISO 30414:2018* regards as a fundamental understanding of organizational value. Therefore, visionary firms have an opportunity to expand the boundaries of reportable information to share with their securities customer. Moreover, issuers may use this opportunity to educate their customers about uniquely relevant facts and their relationship to organizational performance, like employee engagement, that could affect the value of their investments.

Knowable and obtainable. Rule 409 of the Securities Act of 1933 states that “information required need be given only insofar as it is known or reasonably available to the registrant.”¹⁴ The metrics recommended in *ISO 30414:2018* are commonly available within organizational HRIS. Management routinely seeks and uses this information when making plans concerning its

¹³17 CFR Section 230.408 (2014)

¹⁴17 CFR Section 230.409 (2014)

workforce. For example, the metrics in *ISO 30414:2018* that correspond to human capital costs are limited to:

- Total workforce costs
- External workforce costs
- Ratio of the basic salary and remuneration
- Total costs of employment
- Cost per hire
- Recruitment costs
- Turnover costs¹⁵

HCM is important to the “reasonable investor.” The definition of a reasonable investor¹⁶ is a tricky subject in public policy and common law. For some, the term includes anyone who invests, while others’ descriptions that are more stringent require that a reasonable investor possess sophisticated, but not necessarily professional, knowledge of the issuing company, its market place, and act of investing itself. The HCM measures in *ISO 30414:2018* offer important information to investors, regardless of their level of sophistication. “The HCR [Human Capital Reporting] framework discloses financial and social value created by an organization and provides evidence of underlying strengths or risks that might otherwise be overlooked”¹⁷ In those businesses where highly skilled talent is in short supply, a successful execution of a human capital talent acquisition plan is essential and its progress would be important information to both management and potential investors. At minimum, the workforce information that organizations provide routinely to regulators, occasionally to courts of law, or sporadically to employees might still be important to investors.

HCM Metrics would likely affect the total mix of information. An expansion of business operations, to provide more products and services to a given area, is frequently driven by the forecasted gains in market share and the organization’s capacity to build the infrastructure

¹⁵ *Ibid*, page 9

¹⁶ According to the Statistical Abstract of the United States:2011, the number of families having direct or indirect stock holdings increased from 31.7% in 1989 to 51.1% in 2007. See U.S. census Bureau, the 2011 Statistical Abstract tbl 1210 (2010) available at <https://www.census.gov/library/publications/2010/compendia/statab/130ed/banking-finance-insurance.html>

¹⁷ *Ibid*, page 4.

necessary to implement this plan. Managers who can comfortably explore the specifications of the physical storefront or analyze the spending patterns of a choice demographic often overlook an adequate study of available key competencies in local labor pools. The decision to “buy” (recruit) versus “build” (train) versus “rent” (outsource) employees can dramatically affect the pace of a business expansion and often determines whether organizational goals will be achieved. This expansion example represents a myriad of strategic decisions that the introduction of HCM metrics would influence and thereby alter the “total mix” of material information that an investor considers.

HCM Metrics will affect decisions, which may affect outcomes. As stated earlier, HCM measures will have an unavoidable impact on investment decisions. The Courts have decided that an investment outcome, regardless of affect, might not determine whether the information that was disclosed was indeed material. Information that has limited effect on the overall performance of the company, may nonetheless still be materially important to the decisions of an investor. Hiring talent from the local community, may be far more materially important to the investors who live in that community than anticipated market growth in the next quarter.

International aspects of materiality. The international perspective on materiality encompasses a variety of views and approaches. In broad terms, materiality represents, “the amount by which the financial statements must change in order to change the decisions made by users of the financial statements.” The type (for example, the compensation of company officers) or the value (for example, a percent increase or decrease in a specific financial measure) can represent these changes.¹⁸ Like the SEC, other global regulators of securities also believe “the interaction of qualitative and quantitative consideration in materiality judgements . . . could have a material effect on the financial statements.”¹⁹ Meanwhile, the International Accounting Standards Board recently clarified its view of the term materiality. Codified in October 2018 in *International Accounting Standards 1: Presentation of Financial Statements* (“IAS1”) the new definitions states:

Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial

¹⁸ https://en.wikipedia.org/wiki/ISA_320_Audit_Materiality

¹⁹ 17 CFR Part 211 SEC Staff Accounting Bulletin: No. 99 - Materiality. 12 August 1999

statements make on the base of those financial statements, which provide financial information about a specific reporting entity.²⁰

Although these international definitions expand the boundaries of materiality to include all financial statements and imbues any interest party with the right to receive material information, they nonetheless follow an intellectual pathway that mirrors the positions of the US courts and the SEC. Users of HCM measures can then reasonably anticipate that these metrics would be understood and valued similarly in other countries that encourage adoption of *ISO 30414:2018*. The development of this standard itself, reflects a global expert consensus that these measures are useful and can be confidently embraced by investors in all international settings.

Empirical rigor, relevance, and compatibility. Although not expressly stated, the elements above rest on a foundation of trusted and comparable methods to calculate metrics. The presence of *ISO 30414:2018* responds to validity need by promoting measures comprised of simple, commonly known algorithms. These calculations describe the workforce subjects unambiguously. Besides being valid, they are also reliable and can be replicated by any organization wishing to determine the same information. Being a global standard, *ISO 30414:2018* is the perfect vehicle to assure that any organizations who adopt it, can report transparent and comparable HCM metrics to its investors.

The momentum to reveal human capital information to investors continues to build. Recently the SEC studied the need for a rule on this subject with great interest.²¹ It seems clear that HCM metrics can survive scrutiny endured by more traditional measures of organizational value in financial instruments. A chorus if not a consensus of stakeholders is forming around the idea that human capital measures often meet, if not exceed, the thresholds of valuable information to investors. The challenge before us is not the rigor or availability of these measures, but instead the willingness of those involved in the securities markets to embrace the introduction of human capital measures into their market places and their ability to hear and to exploit positively the valuable messages they reveal.

²⁰ “IASB clarified its definition of material.” 31 October 2018. Available at: <https://www.ifrs.org/news-and-events/2018/10/iasb-clarifies-its-definition-of-material/>

²¹ “Rulemaking petition to require issuers to disclose information about their human capital management policies, practices and performance.” File 4-711. 6 July 2017. SEC Petitions for Rulemaking. Available at <https://www.sec.gov/rules/petitions.shtml>