Pearl Meyer

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The New Human Capital Management (HCM) Disclosures Require More Evaluation Than is Apparent



Deb Lifshey

MANAGING DIRECTOR



Mark Rosen

MANAGING DIRECTOR

Start Your Due Diligence Now

Nearly two months have passed since the SEC released its new HCM disclosure requirement but we haven't heard much from our clients or many professional colleagues about how to tackle this new disclosure challenge. With very little and vague guidance available, this isn't surprising. While the new rule looks more like a general corporate detail to be reported in the 10K or 10Q under "Description of Business," it's highly likely to be yet another item that lands on the compensation committee's to-do list. After all, in the past few years we've seen many companies expand the traditional compensation committee nomenclature to include some variation of human capital management, talent management, or leadership development. With this in mind, directors, along with senior management, should be prepared to dive into the analysis of this requirement as soon as possible. We sense that some view this disclosure as a "non-event" and plan to disclose as little as possible, but we also believe more serious due diligence should be undertaken to fulfill the SEC mandate.

So where to begin? The wording of the rule provides some limited parameters. It instructs companies to provide information about *human capital resources* that are *material* to an *understanding of the company's business taken as a whole*

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Let's look at each of these terms in turn.

"Human capital" is a broad topic that can capture any number of items relating to people. Many companies are already quite transparent about their human capital initiatives in their corporate sustainability reports (CSRs) in the context of their environmental, social, and governance (ESG) commitments. In many cases, companies are also including human capital themes in their proxy statements or letters to investors—especially this year in response to growing social justice concerns. We also can find basic quantitative and specific human capital measures as required in mandatory EEO-1 reports. While these documents are all different, the human capital management issues generally fall into major categories that include workforce demographics, diversity and inclusion, hiring, promotion, retention and turnover, training and development, and general culture and engagement. However, it would be inappropriate to cut and paste the sometimes voluminous content contained in these disclosures because so much of it is simply not material.

"Materiality" has no clear definition. Securities attorneys, accountants, and other professionals spend a lot of time trying to determine what is material. What may be material for one company may not be for others. Looking to other sources of authority on the matter, we found several pieces of guidance:

- The Supreme Court has opined that a fact is deemed "material" if there is a substantial likelihood that it would have been viewed by the reasonable investor as having significantly altered the total mix of information available.
- Other securities rules have indicated that "material" includes information where there is a substantial likelihood that a reasonable investor would attach importance to it in determining whether to buy or sell the securities registered.
- Accountants have opined that the omission or mis-statement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

With these definitions as general rules of thumb, perhaps a useful way to help determine if a human capital issue is material is for companies to ask themselves whether an investor would have made a different decision if the information was available at the time they were making investment decisions.

And finally, we must also consider the "understanding of the company's business taken as a whole." Some human capital information may be material to one business but not another. Take, for example, the case of large multinational manufacturing firm. Human capital measures about breakdowns of national, international, part-time, and full-time demographics, as well as certain workforce safety measures, may be very material to business strategy and therefore to investors in making decisions. On the other hand, consider the workforce issues of a domestic real estate investment trust (REIT), which typically employs few individuals and only at certain levels. In this case, the measures that

were deemed material for the multinational manufacturer may be immaterial and even irrelevant to the REIT investors. Then, there may be measures that are equally material to both organizations. For example, diversity and inclusion and training and development.

Understanding human capital issues, the concept of materiality, and unique business strategies are starting points. In order to strategically and fully comply with the new HCM reporting rule, we believe just as much due diligence is needed to support a finding that a measure is immaterial as it is determining it to be material. In other words, the full universe of human capital measures should be presumed material unless and until they are discussed and vetted for materiality by executives and/or compensation committee members.

This exercise is not unlike the compensation risk reviews many companies already perform under Item 402(s), whereby every possible compensation element and program throughout an organization is reviewed to ultimately (and hopefully) lead to the conclusion that no part of the program is reasonably likely to incentivize excessively risky behavior. Pearl Meyer's technical services team has developed analytical processes and tools that can help companies evaluate their HCM positions relative to the new rule. It is to every company's advantage to undertake this analysis comprehensively, not only to meet requirements, but also to begin incorporating deep and thorough discussions about human capital management at the board level, if you're not already doing so.

About the Authors

Deb advises on executive compensation from a legal and regulatory perspective, including securities disclosure, tax and governance matters, contract negotiation, and reasonableness opinion letters.

Mark is a consulting team leader who brings 20+ years advising on executive and board pay, including benchmarking, retirement plan design, and tax/accounting and governance considerations.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.

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