Reporting on Human Capital Management

V Hartley, D Robey

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Executive Summary

Background to this report

This report stems from the research conducted as an 'Organisation and Resourcing' project for the IES Research Networks. It follows from the IES Conference in November 2003 which focused on the subject of human capital.

During the year post-Kingsmill (2004), there were considerable developments in the area of human capital reporting. This report tracks these changes, and aims to provide HR professionals and others, with an overview of the developments in reporting requirements related to human capital, so that they will be better prepared to draft human capital reports within statutory reporting requirements.

Since the developments in reporting requirements are primarily intended for companies that report within a UK framework it is focused on the needs for these organisations. Inevitably, there will be parallels for public sector organisations and private sector organisations that report outside the UK, though the report does not specifically focus on the reporting needs of these sectors.

What is meant by 'human capital'?

The word 'capital' has many meanings but two are particularly relevant to a discussion of *human* capital:

1. the property and equipment and/or money used for carrying on a business
2. any advantage used as a means of gaining further advantages (both taken from *Chambers* dictionary)

The first of these definitions encapsulates the idea that the work–force is analogous to financial or working capital in that it is a key resource which must be managed effectively. The second implies that the workforce, or perhaps its specific attributes such as its skill or creativity, imparts a competitive advantage to the company enabling it to generate profits.

The Kingsmill report described human capital management (HCM) as 'a strategic approach to people management that focuses on the issues that are critical to an organisation's success' (Kingsmill, 2003, p7); these imply a causal link between people management and business success.

Intellectual capital

Human Capital is a component part of the 'intellectual capital' of a company, which has been described as follows:

> *'As it is applied today, the term, intellectual capital, has many complex connotations and is often used synonymously with intellectual property, intellectual assets and knowledge assets. Intellectual capital can be thought of as the total stock of capital or knowledge-based equity that the company possesses.'*
>
> (ICAEW, 1999, p. 4)

> *'The possession of knowledge, applied experience, organisational technology, customer relationships and professional skills that provides Skandia AFS with a competitive edge in the market.'*
>
> (Edvinsson, 1997, p. 368)

Intellectual capital is linked to the difference between market value and book value of a company. The move to the new know–ledge based economy makes the possession of intellectual capital more important than ever:

> *'Recent estimates suggest that 50 to 90 per cent of the value created by a firm comes, not from management of traditional physical assets, but from the management of intellectual capital.'*
>
> (ICAEW, 1999, p. 2)

Why is 'human capital' not recorded on company balance sheets?

Chairs and chief executives often state, in their annual report and accounts, that people are the greatest asset of their companies. But nothing is recorded in company reports under this heading. Balance sheets set out assets and liabilities but do not include human capital alongside working capital, or list human assets among fixed assets. The reason is that accounting standards do not permit such a treatment and the report explains the relevant accounting rules.

The Operating and Financial Review

The report explains what an operating and financial review (OFR) is is and the role that it plays in corporate reporting. It details the relevant framework for this disclosure and the implications that this has for human capital reporting.

The OFR sets out directors' analysis of the business which is, in effect, a retrospective commentary on the results in the financial statements but which also points forward to the future. A key concept is that the discussion is as seen 'through the eyes of management' (ASB, 2003, p. 3); that is, outsiders get the insiders' view. (All in italics following are from paragraph 6 of the Statement, unless otherwise stated.)

The OFR becomes a statutory requirement for listed companies for financial years beginning on or after 1 April 2005.

The ASB Statement makes the point:

> *'The OFR should include discussion of…the performance of the business in the period, and the main influences on performance including the expected effect of known trends and the potential effects of risks facing the business.'*

Human Capital issues may include effective leadership, recruit–ment of key individuals, major training programmes or introd–uction of performance-related pay. Significantly, risks must also be addressed. These could include losing key people, high staff turnover, difficulty in recruiting appropriate people, or potential industrial relations disputes:

'The OFR should discuss the performance of the period, identifying those trends and factors relevant to the user's assessment of the future performance of the business and the achievement of long-term business objectives… The OFR should also discuss predictive statements made in previous statements where these have not been borne out by events.'

The emphasis is on using the past to understand the future, providing the user with insight into the trends and factors affecting the company going forward.

Reliability and measurement

'Information contained in the OFR should be neutral, free from bias and complete, dealing even-handedly with both good and bad aspects.'

This means that it is not good enough to 'cherry-pick' a few good stories about human capital practices from around a group.

Information should be capable of year-on-year comparison, thus enabling a reader to identify trends:

'When disclosing measures in the OFR:

- *they should be defined and the method of calculation explained*
- *the source of underlying data should be disclosed and, where relevant, assumptions explained*
- *comparative amounts should be disclosed.*

'Wherever possible the OFR should identify and comment on the measures that are used by the directors as key performance indicators in managing the business.'

The Statement encourages reporting of key performance indicators (KPIs). This approach is known as 'inside out' (ICAEW, 1999) as it implies that the information which is used by the directors in running the company could also be relevant to stakeholders outside the company.

Usually, the Directors' analyses focus on the factors which have the greatest significance to the business as a whole. In future this will need to include human capital reporting.

Guidance notes

The ASB Statement's guidance notes on the OFR set out a number of points on human capital:

> *'The OFR should include a description of the business … this might cover areas such as … key dependencies, including … key employees.'* (paragraph 8)

> *'The OFR should discuss the objectives of the business and management's strategy for achieving those objectives.'* (paragraph 9)

> *'…a discussion identifying the principal risks facing the business, together with a commentary on the directors' approach to managing them …* eg *skill shortages and expertise of uncertain supply.'* (paragraph 20)

> *'The OFR should also give a commentary on the strengths and resources of the business … such items might include … intellectual capital.'* (paragraph 21)

> *'Directors should comment in the OFR on how they have sought to maintain and improve future performance … examples might include … human capital policies and practices, including employee training.'* (paragraph 23)

Proposed statutory requirements

The requirements are that the OFR shall be a balanced and comprehensive analysis of the business. The report examines the general requirements of the OFR which are compulsory and which will have to be embodied in the ASB's final standard.

Also of particular interest and relevance to human capital reporting is:

> *'The review shall include analysis using financial and other key performance indicators, including information relating to envir–onmental matters and employee matters.'*

Thus it is the company directors who will have to exercise judgement about what information to include and what to leave out. An important point, made in the guidance notes, is illustrated by this quote:

'The Regulations specifically mention the company's employees as a topic that directors will want to consider in the context of the OFR and it is difficult to envisage a situation where the directors of any business that employs people would take the view that this topic was irrelevant to an assessment of the company's potential to execute its business strategies successfully.'

The OFR practical guidance for directors

The principles behind the OFR were outlined by the OFR Working Group as guidance for directors. They include the following:

- *The Regulations require the OFR to include a statement of business objectives and strategies.*
- *The OFR reviews the past financial year but also provides forward looking information.*
- *Both quantitative and qualitative information are likely to be included in the OFR.*
- *Measures have to be relevant to the particular drivers of each business.*
- *An important aspect of human capital reporting is skills assessment both in relation to top management but also to any key people.*
- *In relation to the issues of variability and volatility the size of an item this year in comparison with last year, and its likely size in the future, will be indicative of whether or not it should be included.*
- *Invariably directors should comment on human capital man–agement in the OFR but exactly what they report will be driven by the business context.*
- *Recognition that directors may need to develop competences in new areas in order to effectively report in the OFR.*

'Because of the necessarily broad coverage of the OFR, some issues may require access to additional skills and competencies in areas not previously recognised as being needed.' (p. 11)

Human resource professionals are likely to find themselves best placed to advise on human capital issues in the preparation of an OFR.

Corporate governance framework

Good corporate governance is essentially about the duty of care which directors of a company owe to the shareholders who own the company.

The Combined Code for Corporate Governance explains:

> *'…The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance…'*

The key point is that the board must interest itself in HR matters in order to fulfil its corporate governance responsibilities.

Turnbull Guidance

Amongst the Guidance issued by Turnbull is this:

> *'Do the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control system?'*
>
> *'Does senior management demonstrate through its actions as well as its policies, the necessary commitment to competence, integrity and fostering a climate of trust within the company?'*
>
> *'Does the company communicate to its employees what is expected of them and the scope of their freedom to act?'*
>
> *'Do the people in the company (and in its providers of outsourced services) have the knowledge, skills and tools to support the achievement of the company's objectives and to manage effectively risks to their achievement?'*

Arguments against HCM reporting in an OFR

Critics of the recent developments in reporting on HCM in the OFR, cite:

- the lack of standard, consistent measures across all companies or at least, within sectors
- the need to avoid disclosure of commercially sensitive information

However, since the OFR is the directors' commentary and analysis of their business it follows that the choice of what is relevant should be that of the directors.

Rosemary Radcliffe dealt with the issues of confidentiality and commercial sensitivity, thus:

> *'The only criterion we came up with for not disclosing information is when you are preventing from so doing by another piece of legislation'.*

Further criticisms suggest:

- Regulation will induce mere compliance and 'boiler plate reporting.
- Companies will give the good news and hide the rest.

These concerns will be addressed when stakeholders challenge boiler-plate disclosures and when they suspect the OFR to be more a vehicle for PR than for financial reporting.

Summary

The OFR provides a framework for reporting on human capital. The company directors should include the information which they believe is significant to understanding past and future performance, and relating to the long-term prospects of the company. Human capital strategy and an explanation of how this is linked to business strategy should be included. Key performance indicators are likely to vary from company to company since they will be driven by context and the business specific issues that each faces (for further examples see Hartley and Robey, 2004). Further support for establishing the links between human capital and the business comes from recent changes in the corporate governance framework. More than ever before, directors of companies will be required to formally evaluate the contribution of their employees to the business.

1. Reporting on Human Capital Management

Human resources professionals, in private and public sectors, are more likely than ever before to be involved in recording and measuring a whole range of attributes related to that most valuable and expensive commodity, an organisation's people. In the past, total headcount and people costs encapsulated all the information needed but now there are over 1,000 indices which may be measured and compared to benchmarks, in order to assess the efficiency and effectiveness of human capital management (HCM). To some extent, however, this has been a silent revolution because, as far as many people outside the organisation are concerned, the key figures to appear in external information about the business are still 'head count' and 'costs' and little more is known. Often the analysts, investors and financial journalists closest to the company may be completely unaware that HR is utilising the most sophisticated and effective HCM techniques, which, in turn, are leading to consistently improving bottom line performance.

In late 2003, the Kingsmill Report sought to change this situation by calling for enhanced disclosures about HCM practices in public documents. In the past year, there have been further developments but no specific and definite guidance has yet emerged. Nevertheless, the framework for enhanced reporting on HCM already exists and HR management can use this to show how their strategy is differentiating their company from its competitors and achieving success.

This report sets out the current reporting framework and describes the developments during 2004. It advocates a particular view of reporting on HCM which is wholly consistent with existing reporting conventions. Nonetheless, this represents a radical departure from existing practices. Like any new venture there is no 'off the peg' solution but, for those willing to innovate, appropriate reporting on effective HCM practices will bring its own rewards.

2. What is Human Capital?

2.1 Definitions

The word 'capital' has many meanings but two are particularly relevant to a discussion of *human* capital:

- the property and equipment and/or money used for carrying on a business
- any advantage used as a means of gaining further advantages (both taken from *Chambers* dictionary).

The first of these definitions applied to the term *human capital* encapsulates the idea that the workforce is analogous to financial or working capital, in that it is a key resource which must be managed effectively. The second implies that the workforce, or perhaps its specific attributes such as its skill or creativity, imparts a competitive advantage to the company enabling it to generate profits.

The Kingsmill report described HCM as 'a strategic approach to people management that focuses on the issues that are critical to an organisation's success' (Kingsmill, 2003, p7). This implies a causal link between people management and business success.

2.1.1 Intellectual capital

Human capital is a component part of the 'intellectual capital' of a company. There are no standard and generally accepted definitions of these terms. A paper published in 1999 by the Institute of Chartered Accountants in England and Wales (ICAEW) states:

'As it is applied today, the term, intellectual capital, has many complex connotations and is often used synonymously with intellectual property, intellectual assets and knowledge assets. Intellectual capital can be thought of as the total stock of capital or knowledge-based equity that the company possesses.' (ICAEW, 1999, p. 4)

Alternatively, the Swedish company Skandia which has done considerable pioneering work in reporting on intellectual capital, defined it in these terms:

'The possession of knowledge, applied experience, organisational technology, customer relationships and professional skills that provides Skandia AFS with a competitive edge in the market.'
(Edvinsson *et al*, 1997, p. 368)

Thus intellectual capital includes the human capital ('professional skills' in the case of Skandia) of the organisation. The move away from traditional manufacturing industries to the new knowledge-based economy makes the possession of intellectual capital more important than ever:

'Employee know-how, innovative capabilities, skills or … the brain-power of the organisation play a predominant role in defining the productive power of the corporation and account for an increasing proportion of the capital in traditional industries … Recent estimates suggest that 50 to 90 per cent of the value created by a firm comes, not from management of traditional physical assets, but from the management of intellectual capital.'
(ICAEW, 1999, p. 2)

Intellectual capital comprises three components: one part is related to a company's customer base and factors such as market share and customer loyalty contribute to that value; a second part relates to the company's organisation for example to its IT infrastructure, strategic partnerships and alliances; the third part relates to human capital for example the creativity of the research team or the motivation of its customer sales staff.

2.1.2 Significance of market value

Intellectual capital is linked to the difference between market value and book value of a company; if a company's market value is £10 billion and its book value £6 billion, then the difference of £4 billion is attributable to intellectual capital. The idea is that the existence of intellectual capital enables companies to make profits above and beyond the profits expected from the assets recorded in the balance sheet and it is the expectation of these additional profits which leads to the company having a market value in excess of book value.

In practice, taking the difference between a company's market value and book value provides an indicative value of intellectual capital but is an over-simplified approach. There are many other factors which affect a company's share price and which contribute to a difference between market value and book value as press reports in 2004 over the value of Abbey National or Marks & Spencer exemplify.

Such factors include variations in general market conditions or sector specific news. Accounting conventions do not intend that the balance sheet should convey the market value of a company and, in fact, some variation in the extent to which companies record assets at market values is permitted; for example the accounting standard covering fixed assets permits properties to be included in a balance sheet at market valuation or at cost (ASB, FRS15). The challenge is to develop an accounting measurement for intellectual capital, but to date there has been no generally accepted objective measure. It follows that an objective measure for human capital will be even more difficult to design such that it gains universal acceptance.

3. Why is Human Capital not Recorded on Company Balance Sheets?

Chairmen and Chief Executives often state, in their annual report and accounts, that people are the greatest asset of their companies. If this is truly the case, then why aren't human 'assets' recorded in company reports under this heading? Balance sheets set out assets and liabilities but do not include human capital alongside working capital (such as stock, work-in-progress, debtors and investments) nor list human assets among fixed assets (such as land and buildings, plant and machinery, equipment and cars). The reason is that accounting standards do not permit such a treatment and this section explains the relevant accounting rules.

3.1 Conceptual framework

The Accounting Standards Board (ASB), the body responsible for setting accounting standards in the UK, has developed a broad conceptual framework which underpins specific accounting standards. This framework is published as a 'Statement of Principles for Financial Reporting' and Chapter 4 deals with the elements of financial statements. Assets are defined as:

> *'Rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.'* (paragraph 4.6)

The notion of control is integral to the definition. Control means that an entity has the ability to obtain the future economic benefits and to restrict the access of others to those benefits (paragraph 4.17). In deciding whether or not control exists, it is necessary to consider whether or not the entity has the ability to choose if and when to realise the economic benefits involved and whether the assets are separable from the business; this means considering whether the business could continue following a sale of the relevant asset or if the asset is an integral part of the business. The chapter explicitly states that certain factors such as 'superior management or good labour relations' are not assets because the economic benefits cannot be realised independently of the business as a whole (paragraph 4.21).

3.2 FRS 10

Financial Reporting Standard 10 (FRS 10) sets out specific rules for accounting for *Goodwill and Intangible Assets*. The definition of intangible assets draws on the general conceptual framework as the notion of control appears. The standard states explicitly that:

> *'An entity may have … a team of skilled staff [and] there may be an expectation that … the team of staff will continue to make their expert skills available to the entity. However in the absence of custody or legal rights to … retain staff the entity has insufficient control over the expected future benefits to recognise them as assets.'* (Accounting Standards Board, 1997, paragraph 2)

An intangible asset purchased separately from a business is recorded at its cost, for example, a licence. The standard, however, permits an internally developed intangible asset to be capitalised *only* if it has a readily ascertainable market value. This involves two tests. Firstly the assets being traded must be 'equivalent in all material respects' and, secondly, there must be an active market in those assets. Even if there were legal rights to retain trained employees, it would be difficult to argue that training costs should be capitalised since there is unlikely to be a readily ascertainable market value.

3.3 Football club reporting

One instance, in which employees are recognised as intangible assets, is in football club reporting. The annual report and accounts for year ended 31 July 2003 for Manchester United plc contains the following explanation of the relevant accounting policy:

> ***'Intangible fixed assets:***
>
> *The costs associated with the acquisitions of players' registrations are capitalised as intangible fixed assets. These costs are fully amortised, in equal annual instalments, over the football seasons covered by the player's initial contract.'*

At 31 July 2003, the book value of these intangible assets amounted to £55.3 million compared to a book value of tangible fixed assets of £125.5 million (www.manutd.com).

Here it is the transfer fees which are capitalised and these meet the requirements of the standard in that:

- The club has a legal right over the players both to obtain their services and to prevent them from playing for other teams.
- The players can be bought and sold separately from buying or selling the whole club.
- There is an active transfer market so that there is a readily ascertainable market price.

In general, however, companies do not capitalise (that is, recognise as a fixed asset) the value of their people because they have insufficient control and cannot stop people from leaving the company.

3.4 Goodwill

There is, however, one important exception to the general rule and that is in the case of goodwill. When one company purchases another and pays above book value then the difference between the purchase price and the fair value of the net assets acquired is called purchased goodwill and this does appear on the group balance sheet. Note that this is similar to the notion of intellectual capital discussed above. Goodwill subsumes all the elements of intellectual capital which do not meet the criteria for separate recognition in the balance sheet as intangible assets, for example, brands and publishing titles are included in goodwill. Clearly if an acquiring company pays a premium for a highly skilled workforce then the value of this human capital is also subsumed within the total value of goodwill.

Goodwill is only recognised when it is actually realised by the acquisition of one company by another. If an individual company creates value known as 'internally generated goodwill' then FRS 10 specifically prohibits capitalising such goodwill (paragraph 8).

3.5 International accounting standards

In 2005, the UK and other EC countries will move onto a common platform of accounting standards which have been developed by the International Accounting Standards Board (IASB). Listed companies will be required to report under International Accounting Standards (IASs) for accounting periods beginning on or after 1 January 2005. IAS 38 deals with accounting for intangible fixed assets and is broadly similar to FRS 10 in that its definition of intangible assets relies on control, separability and future economic benefits. It prohibits capitalising internally generated intangibles and also specifically states that staff training costs may not be capitalised.

In summary, UK and international 'generally accepted accounting principles' (GAAP) do not permit the value of staff to be carried as an asset on a business balance sheet. As more and more of a company's value becomes attributable to intangibles such as human capital, the accountancy profession as a whole will be forced to rethink its current position on accounting for intangibles. This is, however, a long term project. In the meantime, companies can report relevant information about HCM within the existing reporting framework albeit not on the balance sheet itself.

4. The Operating and Financial Review

4.1 Kingsmill recommendations

The Kingsmill Report concluded:

> *'We recommend that directors of companies producing [operating and financial reviews] OFRs, and all public and other bodies that produce OFRs or reports with similar aims, should include within them information on HCM within the organisation, or explain why it is not material.'*
>
> (Kingsmill, 2003, p. 24)

A number of possible vehicles for reporting HCM were considered but according to the report, the OFR was 'the strongest contender'.

This section explains what an OFR is and the role that it plays in corporate reporting. It details the relevant framework for this disclosure and the implications that this has for HCM reporting.

4.2 What is an OFR?

The OFR forms part of a company's annual report and accounts. It is supplementary to the audited financial statements (the profit and loss account, cash flow statement, balance sheet and all the relevant notes to the accounts). It sets out directors' analysis of the business, which is, in effect, a retrospective commentary on the results in the financial statements but which also points forward to the future. A key concept is that the discussion is as seen 'through the eyes of management' (ASB, 2003, p. 3); that is, outsiders get the insiders' view.

At present the OFR is not mandatory, although it is produced by many companies voluntarily. In draft regulations due to be laid before Parliament at the end of 2004 or in January 2005 (at the time of writing), the OFR becomes a statutory requirement for listed companies for financial years beginning on or after 1 April 2005. This development is covered in the section below. (For public sector entities the situation is different. As noted in the Kingsmill Report [paragraph 33], all government departments and agencies and most NHS entities are already required to produce an OFR).

4.3 The ASB statement on the OFR

The content of an OFR is not regulated, however, the ASB Statement ('statement' not 'standard') on the OFR has persuasive (rather than mandatory) force. It is a useful current guide and it is likely that the forthcoming Standard will show significant similarity. Moreover, it provides an accepted framework for companies wanting to report on HCM. This section outlines the current recommendations of the ASB's Statement on the OFR. These are key to understanding the context for reporting on HCM initiatives and measures and it sets out the principles which should be applied to such reporting.

The ASB's Statement on the OFR was revised (from the original 1993 Statement) and reissued in January 2003. The introduction to the revised Statement explains that the revision reflects 'later improvements in narrative reporting' (paragraph 1) and that 'for many companies, the OFR is already an important element of their communications with the capital markets, complementing as well as supplementing the financial statements' (paragraph 3). In its newsletter commenting on the responses to their consultative draft, the ASB noted that:

> *'Commentators welcomed … the increased prominence given to the strengths and resources of the business [and] the change in focus from 'results' to a wider notion of 'performance' assessed in the context of the business long-term objectives and using financial and non-financial measures.'*
>
> (ASB, 2003, p. 5)

This gives a good flavour of the purpose of the OFR. The ASB's Statement is intended to provide a framework rather than a rule-book for reporting. It begins with some broad 'principles' which should be applied and then sets out some more detailed 'guidance' on how to apply them. The guidance provide a list of the sorts of things which an OFR should cover but it is up to directors to decide whether or not particular points are relevant or significant to their business. The key principles and guidance notes relevant to reporting on human capital are set out below.

4.4 Key principles

All principles are from paragraph 6 of the Statement (these are quoted in italics):

> *'The OFR should include discussion of … the performance of the business in the period, and the main influences on performance including the expected effect of known trends and the potential effects of risks facing the business.'*

Human capital issues may include effective leadership, recruit–ment of key individuals, major training programmes or intro–duction of performance-related pay. Significantly, risks must also be addressed. These could include losing key people, high staff turnover, difficulty in recruiting appropriate people, or potential industrial relations disputes.

> *'The OFR should discuss the performance of the period, identifying those trends and factors relevant to the user's assessment of the future performance of the business and the achievement of long-term business objectives … the OFR should also discuss predictive statements made in previous statements where these have not been borne out by events.'*

The emphasis is on using the past to understand the future. One aspect is that costs incurred in human capital initiatives are usually expensed in the profit and loss account since they cannot be recognised as intangible assets under FRS 10. Where these costs are significant they can be explained in the OFR. The classic example is redundancy costs from which it is expected that future savings will be derived. For a pharmaceuticals company, the introduction of university sponsorship schemes to attract newly qualified doctorate researchers might be included; for a retail company, group-wide training of the sales force could be explained in the OFR. Importantly, if expected outcomes do not arise then the OFR should contain a discussion of such cases. In practice, this is a particularly difficult area because for listed companies there are a number of specific regulations concerning the inclusion of forward looking information in public documents and these would normally preclude forward looking information such as five year plans or budgets being included in an OFR. Yet the emphasis is on providing the user with insight into the trends and factors affecting the company going forward.

4.5 Reliability

> *'Information contained in the OFR should be neutral, free from bias and complete, dealing even-handedly with both good and bad aspects.'*

This means that it is not good enough to 'cherry-pick' a few good stories about human capital practices from around a group. The picture given should cover the whole group (a figure quoted for, say, staff turnover should be a group total not just from one particular part of the group). This does not preclude giving more detailed information where appropriate for an understanding of the business particularly in a diverse group. A discussion of the results from a staff satisfaction survey must cover all significant points not just the more favourable ones.

4.6 Comparability

> *'It will be appropriate for the approach adopted for the presentation of the OFR to evolve over time, or to differ from that adopted by other entities. However, disclosure should be sufficient for the user to be able to compare the information presented with similar information about the entity for previous periods and with information about other entities in the same industry or sector.'*

This principle has important implications for human capital reporting. Firstly, information should be capable of comparison year on year, thus enabling a user to identify trends. A company can disclose information that reflects the way its directors manage the business and this may be useful to readers of the OFR even if no other companies in a similar industry disclose the same information. In general, however, the usefulness of information will be enhanced if other companies in the same industry disclose similar information. Often the approach taken by an individual company will depend on whether it perceives itself as a leader in good disclosure and effective communication through its OFR and annual report or whether it is content to follow its peers.

4.7 Measures

> *'The OFR will typically include a range of financial (eg staff costs) and non-financial (eg headcount) measures. Comparability will be enhanced if the measures disclosed are accepted and widely used, either within the industry sector or more generally.*
>
> *'When disclosing measures in the OFR:*
>
> - *they should be defined and the method of calculation explained*
> - *the source of underlying data should be disclosed and, where relevant, assumptions explained*
> - *comparative amounts should be disclosed.*
>
> *'Wherever possible the OFR should identify and comment on the measures that are used by the directors as key performance indicators in managing the business.'*

Although the OFR is principally a narrative statement it will normally include measurements and to some extent such measurements shift the perception of information from 'soft' to 'hard' because the facts themselves are susceptible to the disciplines of measurement. As noted above, if there is no standard definition of a particular measurement, companies may develop their own. Different companies may measure a thing in different ways therefore it is good practice to disclose how the measurement is defined and calculated. The important point is that the definition should be unambiguous and precise and should be applied consistently across a group and from one year to the next.

The Statement encourages reporting of key performance indicators (KPIs). This approach is known as 'inside out' (ICAEW, 1999) as it implies that the information which is used by the directors in running the company could also be relevant to stakeholders outside the company. A measure such as employee turnover should not necessarily be collected and reported just because other companies are using it if the directors themselves do not find it useful. This approach does not necessarily mean that all the information used by the directors internally should be disclosed outside the company. In general, internal reports could contain details which could be reported externally at a more aggregated level. In practice, this is commonly the case with staff costs and numbers which are reported by business unit but disclosed publicly at a more aggregated level such as by business segment or grouping.

4.8 Practicalities

In practice, there is a long lead time for disclosure of data because comparative information for the previous year must also be disclosed. For example, if a figure for a monthly average of full-time equivalent staff is given in relation to year ended 31 December 2005, it is necessary to start collecting data from January 2004. In practice, data is sometimes collected retrospectively but this tends to be costly because it is often a 'manual' rather than IT-driven process and consequently more time consuming and potentially more susceptible to error. Reterospective data coll–ection is to be avoided whenever possible.

If company 'A' calculates a KPI in one way but other companies in the same sector use another method, company A can adopt the same method as its peers but would need to restate the compar–ative also, which would either introduce a year's lag (collecting data under both definitions for one year) or a retrospective trawl for data for the previous year.

4.9 Guidance notes

The guidance notes of the ASB's Statement on the OFR cover a wide range of topics. The points set out below, however, focus on human capital. As above, extracts from the statement are given in italics to distinguish them from explanatory text:

> *'The OFR should include a description of the business … this might cover areas such as … key dependencies, including … key employees.'* (paragraph 8)
>
> *'The OFR should discuss the objectives of the business and management's strategy for achieving those objectives.'* (paragraph 9)
>
> *'… a discussion identifying the principal risks facing the business, together with a commentary on the directors' approach to*

> *managing them …* eg *skill shortages and expertise of uncertain supply.'* (paragraph 20)
>
> *'The OFR should also give a commentary on the strengths and resources of the business … such items might include … intellectual capital.'* (paragraph 21)
>
> *'Directors should comment in the OFR on how they have sought to maintain and improve future performance … examples might include … human capital policies and practices, including employee training.'* (paragraph 23)

The Statement explicitly notes that the overall level of expenditure may be less relevant than the directors' analysis of the impact. Thus a particular training programme might not have been financially material but may have had a significant effect on the culture of the organisation.

In current practice, the directors' analyses focus on the factors which have the greatest significance to the business as a whole. This may mean that changes in market conditions, new products or services, acquisitions or disposals, changes in interest rates or exchange rates, research and development, technological changes, marketing, brand development and a plethora of other factors are considered to have had more impact than human capital issues have had, so the latter are not mentioned at all. However, this is expected to change in the future and the following section sets out the relevant recent developments.

4.9 Auditors' duties

The auditors have specific duties in relation to data disclosed in documents such as the OFR, which are published with the annual report and accounts even though such documents are not subject to a full audit. These duties are set out in Statement of Auditing Standard (SAS) 160 and basically require the auditors to assure themselves that 'the additional information is not in conflict with matters covered by their report (on the financial statements) and that they have no cause to believe it to be misleading'. Therefore the data disclosed must be robust and capable of a certain degree of independent verification.

5. The Way Forward on the OFR: Draft Legal Regulations and the Role of the ASB

5.1 Kingsmill recommendation

The Kingsmill Report was criticised by some for leaving the detail to be resolved by another committee.

5.1.1 Recommendation 4

> *'We recommend that the government consult with leading employees, investors, professional organisations and other relevant stakeholders on the introduction of a programme to aid the dissemination of best practice on HCM and HCM reporting.'*

Furthermore, the report stated that 'following a report from the Company Law Review the government announced its intention to require all listed companies over a certain size to produce OFRs' (paragraph 34) and that the government intends to 'devolve to a Standards Board powers in relation to accounting, reporting and disclosure' (paragraph 34).

5.2 Statutory OFR — requirement and timing

On 5 May 2004 the government published its intentions for the OFR in a consultation document called 'Draft Regulations on the Operating and Financial Review and Directors' Report'. This included the proposal that quoted companies will have to prepare a statutory OFR from financial years beginning on or after 1 January 2005. There was a significant amount of protest against introducing the statutory OFR at the same time as intern–ational accounting standards and, in a recent DTI press notice responding to the consultation, it was stated that the timetable has been relaxed. The final regulations have been set before parliament in early 2005 and will make the OFR a statutory requirement for quoted companies for financial periods beginning on or after 1 April 2005. The draft regulations also state that the ASB will be the board responsible for developing and issuing a statement for a mandatory OFR (this was implicitly confirmed by the press notice).

5.3 ASB approach

The ASB published a press notice (PN 243) in May 2004 stating that it intended to issue an exposure draft of the first OFR standard in the second half of 2004, to be finalised in 2005. The ASB established an Advisory Committee comprising eight people drawn from a range of backgrounds including industry, Cranfield and the TUC to assist in the project. The press notice commented that the Advisory Committee had been tasked with:

> *'considering current national and international guidance and reviewing the ASB's current statement of best practice on the OFR … in order to make recommendations for any changes to meet the requirements of the OFR Regulations, taking account of what is realistic and practicable to introduce for financial years beginning 1 January 2005.'*

This last point recognised that the standard would have been very late as it would be issued during the very year in which it becomes mandatory. As noted above, however, the effective date has been changed. The DTI press notice states that the deferral is 'to allow time for the business, assurance and enforcement communities to prepare for the OFR and to review the new reporting standard being developed by the ASB' (DTI, 2004, p2).

In summary, the ASB has the responsibility of developing a standard which complies with the Regulations but which will ultimately prescribe the way in which the Regulations will be applied. The possibilities open to the ASB are discussed in a later section.

5.4 Proposed statutory requirements

The Draft Regulations on the OFR issued by the government specify some general requirements for the OFR which are compulsory and which will have to be embodied in the ASB's final standard. These are not expected to change from the draft since the DTI press notice states 'no changes of substance will be made to the objectives and content of the OFR' (DTI, 2004, p1). The requirements are that the OFR shall be:

'A balanced and comprehensive analysis of:

- *the development and performance of the business of the company and its subsidiary undertakings during the financial year*
- *the position of the company and its subsidiary undertakings at the end of the year*
- *the main trends and factors underlying the development, performance and position of the business of the company and its subsidiary undertakings during the financial year*
- *the main trends and factors which are likely to affect their future development, performance and position.*

'Prepared so as to enable the members of the company to assess the strategies adopted by the company and its subsidiary undertakings and the potential for these strategies to succeed.'

Secondly, the Regulations specify four other general requirements of the OFR. These are that it shall include:

- *a statement of the business, objectives and strategy of the comp–any and its subsidiary undertakings*
- *a description of the resources available to the company and its subsidiary undertakings*
- *a description of the principal risks and uncertainties facing the company and its subsidiary undertakings*
- *a description of the capital structure, treasury policies and objectives and liquidity of the company and its subsidiary undertakings.*

Beyond these areas, the Draft Regulations allow for everything else to be discretionary although they mention other particular matters that may need to be considered including information about:

- the company's employees
- environmental matters
- social and community issues; business relationships
- receipts and returns to members (*eg* new share issues, repayment of capital or dividends).

> *'The review shall include analysis using financial and other key performance indicators, including information relating to envir–onmental matters and employee matters.'*

These provisions apply 'to the extent necessary' for the OFR to comply with the general requirements of the Regulations. Thus company directors will have to exercise judgement about what information to include and what to leave out. Since this is a challenging exercise, the draft regulations were accompanied by guidance for directors which indicates how to make the decisions about what to include in an OFR. This guidance is considered in more detail in the following section but an important point to note, in relation to HCM reporting, is this quote:

> *'The Regulations specifically mention the company's employees as a topic that directors will want to consider in the context of the OFR and it is difficult to envisage a situation where the directors of any business that employs people would take the view that this topic was irrelevant to an assessment of the company's potential to execute its business strategies successfully.'*

Thus, it is considered likely that most companies in the future will comment on HCM in their OFRs.

6. The Operating and Financial Review: Practical Guidance for Directors

6.1 OFR working group and its guidance

The Kingsmill Report also referred to the fact that the government was to set up an 'OFR working group to develop guidance on the key issue of materiality' (paragraph 34). This group published a document in May 2004 (at the same time as the DTI issued the Draft Regulations) entitled 'The Operating and Financial Review Practical Guidance for Directors'. This is intended to provide help for directors faced with complying with the Regulations and the prospective accounting standard from the ASB. The guidance will be updated once the Regulations are finalised and the following paragraphs are based on the current draft.

The guidance sets out six sets of general principles to be applied by directors in deciding what to include in the OFR. They also describe a due process for making the judgements about what to include. This is practical guidance and will sit alongside the accounting standard to be developed by the ASB. As the foreword states:

> *'Our guidance does not have legal status, and does not constitute reporting standards, although it has been developed in the light of the requirements of the draft regulations. (We will be producing an updated version of the guidance once the Regulations are finalised to reflect any changes that may be made following consultation).'* (p. 5)

Although the guidance is non-mandatory it has been issued by the DTI and will therefore be persuasive in terms of best practice. The general principles set out in the document include specific practical examples. There are sixteen of these in total, of which several deal explicitly and implicitly with human capital issues. It is relevant to consider these examples here as they are illustr–ative of the type of disclosure issues that companies face in practice.

6.2 Guiding principles

In its first set of principles, the guidance states:

> *'The Regulations require the OFR to include a statement of business objectives and strategies. These should be driven by the underlying purpose and values of the business, including its ethical stance. The company's purpose and values therefore also provide a good starting point for deciding what should be included in the OFR.'* (p. 10)

If trust is a core value, this will be reflected in the relationships between, say, the company and its employees and customers and this value will drive strategies for effective HR as much as for managing customer relationships.

Another set of principles deals with the scope of the information to be included. For example, the OFR reviews the past financial year but also provides forward looking information and different businesses may have different views about the appropriate time period for looking ahead. The example illustrating this principle suggests:

> *'A service business with few physical assets … and depending for its source of competitive advantage on the supply of particular human skills, will plan over a period consistent with its ability to recruit, train and develop its key resource.'* (p. 12)

This is contrasted with a business built around large long-term projects, for which the appropriate timescales would be much longer.

Another feature concerning the scope of information is that both quantitative and qualitative information are likely to be included in the OFR. The working group notes that during consultation, it was stressed that:

> *'The area of human capital reporting provides many good examples of the need to balance quantitative and qualitative information.'* (p. 12)

It goes on to mention that in the Kingsmill Report there is an emphasis on commonly accepted definitions but a recognition that measures have to be relevant to the particular drivers of each business. An example of qualitative reporting is cited for a company embarking on a new business venture:

> *'The depth, breadth and relevance of top management's experience in relation to the venture, and its plans for filling key gaps in this experience, proved vital to an assessment of its chances of success.'* (p. 12)

Thus an important aspect of human capital reporting is skills assessment both in relation to top management but also to any key people. This is particularly likely to be a significant factor when it comes to strategic change as such changes will lack credibility to outside observers unless the company can demonstrate that its people have the necessary competencies in the new area.

In determining the nature and size of items to be included in the OFR, the effect of that item on the business should be considered. The example quoted is:

> *'That of the resignation of an individual board member of a subsidiary company. This might not ordinarily warrant mention in the OFR but when a number of directors resign from the same board in quick succession it is a different matter and might well merit disclosure.'* (p. 14)

In relation to the issues of variability and volatility the size of an item this year in comparison with last year, and its likely size in the future, will be indicative of whether or not it should be included. The example suggests:

> *'In a professional services business, average figures relating to staff turnover may mask significant and important variations between different groups of staff. High turnover amongst senior and experienced fee-earners has, potentially, a much greater effect on turnover and profit in the short term than does comparable turnover amongst other grades of staff.'* (p. 15)

As with the examples above, decision making is always context dependent. Judgement must be exercised about the appropriateness of disclosure for a particular business.

The guidelines discuss the use of measurements in disclosures and suggest that these will depend upon the future standard from the ASB and what is currently done by the company itself or by other companies in the same industry:

> *'A good illustration of what is done internally is, again, given from the area of human capital reporting. The Regulations specifically mention the company's employees as a topic that directors will want to consider in the context of the OFR and it is difficult to envisage a situation where the directors of any business that employs people would take the view that this topic was irrelevant to an assessment of the company's potential to execute its business strategies successfully. But the details of employment policies and practices, and the associated metrics, will depend upon the nature of the business. For example, a company in the business of delivering large, long term technically complex projects will regard low staff turnover in any key area of the business as extremely important. Customer handling skills, by contrast, may be essential to a much more limited extent. But high volume, high throughput retailing may regard staff turnover as of less significance and customer handling skills as the key core competence for most of its staff.'* (p. 16)

This note is significant, as explained above, since it explicitly suggests that almost invariably directors should comment on HCM in the OFR but exactly what they report will be driven by the business context.

In discussing the future possibilities affecting the company, the effect of future legislation is discussed and the example given is to discuss the European Working Time Directive which also illustrates how the OFR covers the whole business environment not merely internal business issues.

6.3 Other matters

There are two other significant points in the guidelines which are not about human capital reporting but which an HR professional involved in preparing the OFR should be aware of.

Firstly, there is an issue about to whom the OFR is addressed. The Regulations make clear that the OFR is for the members (*ie* shareholders) of the company. The guidance, however, suggests that *employees*, customers, suppliers, or others may be influenced by the content of the OFR. This means that an employee may take a decision (*eg* to leave the company) because of the content of the OFR. Because such a decision could affect the company's future performance, the guidance recommends that the directors '*take a broad view*' (p9) in deciding what to include.

The second key point is that the guidelines explicitly discuss whether directors have the necessary skill-sets to prepare the OFR. In general, the knowledge and experience necessary to decide what to include in the OFR will be the same as that involved in running the company ('*the OFR should reflect the strategic issues that are in any case on the board's agenda'* [p. 11]). The guidelines note, however, that additional issues which were not included on the board's agenda may need to be included going forward (p. 11), HCM is a good example of this. In such a case, the guidance suggests that the OFR can be '*a catalyst for improved strategic decision making'* (p. 11). Furthermore, the guidance notes:

> *'The balance of skills and competences available to the board, both from amongst the directors themselves and from advisers and others, will also need to be adequate in relation to all the issues that, potentially, may need to be covered in the OFR. Because of the necessarily broad coverage of the OFR, some issues may require access to additional skills and competencies in areas not previously recognised as being needed.'* (p. 11)

HR professionals may find themselves best placed to advise on both of these issues arising in the preparation of an OFR in addition to having a key role to play in relation to human capital reporting. It is likely that the skills of facilitation of multi-discipline specialists, as well as those of resource planning and HR meas–urement will feature in the contribution of HR professionals.

7. The Future of the OFR

7.1 ASB proposals

The ASB released an exposure draft on the Operating and Financial Review in late 2004. The ASB's exposure drafts are open for public comment for a defined period after which the responses are considered and then a final standard is issued. Since the DTI has given the ASB very little time to develop its Standard and since the Statement on the OFR was only updated last year, it is generally thought that there will be relatively few changes between the Statement and the new Standard other than those necessary to make the Standard conform to the DTI Draft Regulations.

It is possible that the ASB will issue a standard as described above but will follow this up at a later date possibly by developing further standards to deal with specific areas. This approach would enable it to meet the DTI timetable but would also allow for more innovative work.

7.2 Measurement

The current Statement on the OFR recommends use of KPIs but does not provide a comprehensive list of measures to use for human capital or other areas. One member of the ASB Advisory Committee is Professor Andy Neely from Cranfield School of Management who has written extensively on measuring business performance (see bibliography). One of his concerns is that companies tend to measure what is easy rather than what is relevant. It seems he is unlikely to be in favour of a generic approach to measurement and more likely to prefer company directors devel–

oping the measures appropriate to their companies. This is in keeping with the ASB's view that the OFR is a report on the company as seen through the eyes of management.

IES has written specifically about performance measurement in the area of human capital. In one project, 'People to Profits', (Barber *et al.*, 1999) the research identified positive links between measures of employee satisfaction, customer satisfaction and business performance. The example in this research provides clear evidence of the contribution of employees on business performance, and by so doing, creates the rationale for what is measured.

7.3 Way forward

Whatever recommendations emerge from the ASB, it is clear, as the ICAEW Roundtable concluded in 2003:

> *'Organisations need to stop being shy about human capital issues if they are to give a full and fair view of performance and prospects in the OFR.'* (ICAEW, 2003, p. 11)

This means that finance directors and their counterparts in human resources will need to work together to develop appropriate management and recording systems to deliver relevant information which can ultimately be publicly reported.

8. Corporate Governance Framework

The Combined Code of Corporate Governance was issued by the Financial Reporting Council (FRC) in July 2003. This Code reflects a series of revisions to the UK's first Code, The Cadbury Report, issued in 1992. Broadly, the Combined Code contains a number of principles and provisions and the Stock Exchange Listing Rules require a listed company to make a two-part dis–closure covering:

1. how it applies the principles of the Code
2. confirmation that it complies with the Code provisions or, if it does not, an explanation of why not.

The 'comply or explain' approach has been applied since Cadbury and this allows for flexibility. For example, a newly quoted company which finds the provisions unduly onerous and not relevant to its circumstances can explain its reasons for non-compliance. This is what is meant by a 'self-regulatory' approach or 'voluntary' Code. This is in marked contrast to the US where, following the collapse of Enron, a legalistic approach has been adopted to enforce compliance on corporate governance issues.

The relevant legislation is the 'Sarbanes-Oxley' Act (2002) and a chief executive or finance director in breach of the Act could face a fine of US $50m and/or 20 years in prison. UK companies with a US listing are obliged to comply with many of the provisions of the Act. In the UK, however, it is generally preferred to avoid such a prescriptive approach because disclosure statements tend to become standard 'legalese' in order to minimise potential legal damage.

8.1 What is corporate governance?

Good corporate governance is essentially about the duty of care which directors of a company owe to the shareholders who own the company. This relationship should be one of trust and partnership and the Combined Code sets out the key principles of good governance. Section 1 deals with the company and has four parts, A to D, covering:

1. directors: roles of chairman and chief executive, board balance and independence, appointments, professional development, performance evaluation and re-election
2. remuneration: levels, policy, service contracts and compen–sation and procedures
3. accountability and audit: financial reporting, internal control, audit committee and auditors
4. relations with shareholders: dialogue with institutional share–holders, constructive use of the AGM

In their disclosures regarding compliance with the Code, com–panies refer to Section 1 only.

Section 2, to some extent, mirrors D above as it covers the resp–onsibilities of institutional shareholders in relation to their dialogue with the company, evaluation of governance disclosures and shareholding voting. The key issue here is that the institu–tional investors themselves are acting on behalf of others, that is, their clients whose pension fund or insurance premiums are being invested. Thus, they also have responsibilities towards these clients and the Code describes these.

8.2 Principles

The first 'Principle' of the Code states:

> *'Every company should be headed by an effective board, which is collectively responsible for the success of the company.'*

In the 'Supporting Principles', there is further explanation:

> *'… The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for*

the company to meet its objectives and review management performance …'

The key point is that the board must interest itself in HR matters in order to fulfil its corporate governance responsibilities.

A recent board effectiveness survey by Robson Rhodes, on the extent to which UK directors are taking up the draft of the Combined Code, found that many business leaders could become more actively involved in people issues: 'less than a quarter agree that their boards review key HR measures such as employee motivation and satisfaction. There is a real risk that if boards do not regularly track their key drivers of performance, and now–adays people will nearly always be one of them, vitally important intangibles may fall significantly in value before the board becomes properly aware of the problem' (Robson Rhodes, 2003). If transparent reporting begins with internally reported measures, it does not end there. Many businesses may need to extend or change the focus of their internal board reporting to derive a better understanding of the value drivers in their companies; they can then report these externally. Crucially, adequate corporate governance now highlights the need for directors to be better informed about all the key aspects of the business.

8.3 Internal controls

The principle on internal controls states that:

'The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets'.

The Code provision states that:

'The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems'.

8.3.1 Turnbull Guidance

The Combined Code refers directors to the Turnbull Guidance, issued in 1999, which assists listed companies to effect the requirements of the Code in relation to internal controls. This covers a number of issues such as responsibilities, procedures, the role of internal audit and disclosure. There is also an Appendix which sets out 'some questions which the board may wish to consider and discuss with management when regularly reviewing reports on internal control and carrying out its annual assessment'. Points relevant to HCM are set out below.

'Are the significant internal and external operational, financial, compliance and other risks identified and assessed on an ongoing basis? (Significant risks may include those related to market, credit, liquidity, technological, legal, health, safety and environmental, reputation and business probity issues).' 'Do the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control system?' 'Does senior management demonstrate through its actions as well as its policies, the necessary commitment to competence, integrity and fostering a climate of trust within the company?' 'Are authority, responsibility and accountability defined clearly such that decisions are made and actions taken by the appropriate people? Are the decisions and actions of different parts of the company appropriately co-ordinated?' 'Does the company communicate to its employees what is expected of them and the scope of their freedom to act? This may apply to areas such as customer relations; service levels for both internal and outsourced activities; health, safety and environmental protection, security of tangible and intangible assets; business continuity issues; expenditure matters; accounting, and financial and other reporting.' 'Do the people in the company (and in its providers of outsourced services) have the knowledge, skills and tools to support the achievement of the company's objectives and to manage effectively risks to their achievement?' 'Do management and the board receive timely, relevant and reliable reports on progress against business objectives and the related risks that provide them with the information, from inside and outside the company, needed for decision making and management review purposes? This could include performance reports and indicators of change, together with qualitative information such as on customer satisfaction, employee attitudes *etc.*'

There may appear to be some overlap between the Turnbull Guidance and the OFR in that both suggest areas of enquiry for the board which deal with aspects of human capital. The Turnbull Guidance, however, is enabling directors to make a statement that there is an ongoing process for identifying, evaluating and managing significant risks and should summarise the process applied in reviewing the effectiveness of internal controls. The OFR is about disclosure of specific business risks and explanation of how they are managed. Nevertheless, both show that boards of directors should be actively involved in human capital issues.

9. Conclusions: Post-Kingsmill — the Way Forward on HCM Reporting

9.1 Reporting on HCM in the OFR

Existing reporting requirements, particularly the ASB's Statement on the OFR, provide a framework for external reporting on HCM. This is, however, a very different form of reporting to that identified in the Kingsmill Report which identified a range of recommendations covering fairly standard 'text-book' human resource management practices.

Kingsmill included a recommendation that company reports should include information on:

- size and composition of the workforce
- retention and motivation of employees
- skills and competencies necessary for business success, and training to achieve these
- remuneration and fair employment practices
- leadership and succession planning (Kingsmill, 2003, p. 22).

Furthermore, it concluded that the appropriate place to include such data is in the OFR published with the annual report and accounts. This is not, however, consistent with the objectives of an OFR, which are all about providing information that will enable the users to be better informed about the business. This will often mean disclosing information which is actually being used by the company's management in order to enable it to fulfil its individual strategies. To be effective, such reporting is not about meeting a standard list of text-book measures. The latter approach is diametrically opposed to the principles that underpin an OFR. Moreover, published OFRs have been criticised for adding additional pages to already voluminous annual reports and accounts but failing, in some cases, to provide real information of use to analysts and investors. If the OFR is to avoid such criticism, it must avoid lengthy and formulaic disclosures and focus on setting out information which is relevant to users' needs.

9.2 Corporate Social Responsibility (CSR) reporting

CSR reporting has developed enormously over recent years and many major companies now publish glossy CSR reports alongside their annual reports and accounts and both are available in hard copies or from their websites. A CSR Report has a completely different objective to an OFR. Whilst the latter is concerned with communicating the directors' analysis of their business' performance, the CSR report is focusing on specific factors to do with the company's social and environmental policies. In practice it is believed that companies with a strong ethos of corporate social responsibility also perform well. Consequently, more and more investors, both institutional and private, are considering CSR practices alongside more traditional performance measures when making their investment decisions.

There are many different codes suggesting generic headings and specific measurements to be included in CSR reports. A CSR report lends itself better to reporting on a standard range of measures than an OFR because the focus of attention is more precise. An ethical investor with, say, a particular interest in equal opportunities would hope to find relevant measures, policies and commentary in the CSR and they can then make their decisions accordingly. An OFR is both less specific and more encompassing in its aims. Thus while a CSR report has an important role to play in providing information on employment practices in general, the OFR has a different role to play in providing information on HCM and in relating it to business performance.

9.3 Future changes

The forthcoming mandatory nature of the OFR and the requirement for adherence to relevant accounting standards will change the way human capital is reported. At present, according to Company Reporting magazine, less than one in ten companies report their employee policies in the OFR; around three out of ten report in the directors' report (with such reporting being described by Corporate Reporting as being 'of little consequence'); a similar number report in the Corporate and Social Report (CSR) and a similar number do not report employee policies at all (Company Reporting, 2004, p. 3). This means that in the future more than nine out of ten companies will have to change their practice and prepare OFRs that contain information about human capital.

9.4 Arguments against including HCM reporting in an OFR

Critics of the recent developments in reporting on HCM in the OFR, cite:

- the lack of standard, consistent measures across all companies or at least, within sectors
- the need to avoid disclosure of commercially sensitive information.

In her interview, August/September 2004, in Research Recomm–endation Electronic Voting (RREV), Rosemary Radcliffe, the Chair of the OFR Working Group which produced the 'Guidance for Directors' covered above, answered the above points.

Firstly, the OFR is the directors' commentary and analysis of their business and therefore it follows that the choice of what is relevant in communicating to their shareholders should be that of the directors. Standard measures would not be relevant to all companies, and would not help the shareholders who are interested in a particular company. Moreover, the information is intended for the shareholders and they should engage with the directors and ask for information that they want to see included.

Rosemary Radcliffe dealt with the issues of confidentiality and commercial sensitivity, thus:

'The Working Group that I chaired considered this area very carefully and we formed the view that there shouldn't be an opt-out. The only criterion we came up with for not disclosing information is when you are preventing from so doing by another piece of legislation. For example, if you are constrained by the Official Secrets Act, as you might be if you were a defence supplier or something of that kind.'

Further criticisms suggest that:

- regulation will induce mere compliance and 'boiler plate reporting'
- companies will give the good news and hide the rest, choosing to exclude details if performance has deteriorated over the year.

Once again, these concerns will be addressed if investors use the OFR to engage with the company directors by challenging boiler-plate disclosures and being sceptical when the OFR appears to be more a vehicle for PR that for financial reporting.

9.5 Summary

In summary, the current ASB Statement on the OFR provides a framework for reporting on human capital. As with other areas reported in the OFR, company directors should include information which they believe is significant to understanding past and future performance, and to relating to the long-term prospects of the company. In the future the OFR should, almost certainly, include information about the business's employees. human capital strategy and an explanation of how this is linked to business strategy would be a good starting point. KPIs could be used to reinforce the messages about HCM, and such measures are likely to vary from company to company since they will be driven by context, and the business-specific issues that each faces (for further examples see Hartley and Robey, 2004).

The DTI has provided directors with some breathing space to consider the implications of the statutory requirements and the standard for their financial reporting. But they need to begin critically evaluating the role of HCM and determining the metrics which will provide comparative data for their first statutory OFR. There are business benefits of this process and it can lead to improved communication inside and outside the company.

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