

Accountingfor**people**



**Consultation**Paper

## Accounting<sup>for</sup>people

The Task Force on Human Capital Management was established by the Secretary of State for Trade and Industry in January 2003 to:

- look at the performance measures currently used to assess investment in human capital;
- consider best practice in human capital reporting, and the performance measures that are most valuable to stakeholders;
- establish and champion the business case for producing such reports; and
- produce a final advisory report by the autumn.

This consultation paper identifies some key questions the Task Force has set out to consider, outlines relevant research findings and evidence, makes some preliminary proposals and suggests some possible reporting mechanisms

We should welcome comments on any matter raised in the paper. Please send them, by 4 July, to:

Accounting for People  
Room 493  
1 Victoria Street  
London SW1H 0ET

or by email to:  
[accountingforpeople@dti.gsi.gov.uk](mailto:accountingforpeople@dti.gsi.gov.uk)

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# ACCOUNTING FOR PEOPLE

## A Consultation Paper issued by the Task Force on Human Capital Management

### Introduction and invitation to comment

1. It has become commonplace for business leaders to observe that 'our people are our greatest asset'. The skills and commitment of an organisation's people play a central role in delivering many of the factors most frequently identified as critical to continuing survival and success. But people are not passive 'assets', to be managed like any other asset. The performance of an organisation depends upon the motivation and commitment of its people as well as upon their knowledge and skills.
2. Some employers, in both the private and public sectors, have taken on board these points, and have well-thought-through and well-developed people practices. They accept that what is not measured is not properly valued and cannot be effectively managed. Yet relatively few employers make a systematic attempt to assess their human capital (the relevant knowledge, skills, experience and learning capacity of the people available to the organisation), to appraise how well the organisation uses this resource through its human capital management (HCM) practices, or to examine changes over time. Even fewer organisations report externally on their HCM practices. We recognise that fear of misinterpretation by the market has been an inhibiting factor here.
3. All employers need to ask themselves:
  - do we believe that our people and HCM practices have an impact on the performance of our organisation?
  - do we believe that our Board (or equivalent) should try to understand the links between these practices and performance, and to ensure that our HCM strategy complements and supports our business strategy?
  - how can we demonstrate, to our own satisfaction and that of our stakeholders, that this is so?
4. Investors interested in the long-term strength and sustainability of a company's performance need good information on human capital and HCM practices. Taxpayers need information on how their investment in public services is being managed to achieve high performance standards. And employees, both existing and potential, need it both to increase motivation and commitment and as an aid to managing their own careers.
5. This consultation paper identifies some questions that the Task Force is seeking to answer, outlines relevant research findings and evidence on the use of indicators of human capital management in the UK, makes some preliminary proposals for external reporting on HCM and suggests some possible reporting mechanisms. We now welcome comments on all the matters discussed in this consultation paper, and in particular on:
  - the value of organisations' reporting on what they identify to be their most important HCM issues, focusing particularly on those issues concerned with maintaining an appropriate skills base and with employee motivation (paragraphs 17-18);

- whether, in addition to organisation-specific reporting, all organisations should be encouraged to report on the size and profile of their workforce, employee motivation, training and development, and remuneration and fair employment (paragraphs 19-21);
- how far there should be central guidance on the most appropriate numerical measures (metrics) to be included in these reports, or whether this is something best left to individual organisations (paragraphs 22-24);
- how best to ensure that HCM is both widely reported and the information is trusted by investors and other stakeholders as relevant, reliable and consistent, and what obstacles there might be to such reporting. In particular whether this is something to which organisations should be encouraged to commit themselves, whether relevant provisions should be incorporated within the Combined Code on Corporate Governance and/or material on HCM should be included in company Operating and Financial Reviews (OFRs) (paragraphs 25-30);
- how best to encourage progressive improvement in reporting standards, and in particular whether:
  - a body should be established charged with monitoring and encouraging development of standards over time, including the role, composition and funding of any such body;
  - there should be some recognition for organisations that met certain standards;
  - there should be some award for exemplary or significantly improving organisations (paragraphs 31-32);
- whether there are any special considerations that would mark out the public from the private sector, whether the same recommendations should in principle apply across the board or whether distinctive reporting requirements should apply to each sector.

### Some key questions

6. We began by identifying some basic questions about the availability and use of indicators of effective HCM:
  - Questions about key indicators (PIs) of effective HCM; for example:
    - are there key indicators (PIs) of effective HCM; how do these relate to key business/management processes and what makes them key?
    - are there any benchmark measures associated with them?
    - how far are any such key PIs universally applicable or contingent upon the type of business or strategy being followed?
    - can any link be demonstrated between particular PIs and profitability, and does it matter whether causality can be established?
  - Questions about their currency and measurement within organisations:
    - how widely are key PIs already used in internal management, and does this vary by business sector?
    - how consistently and reliably are PIs measured; do they need, or would they be susceptible to, standardisation?
    - are there useful models from overseas?
  - Questions about their use in external reporting:
    - are there useful examples of the use of PIs in external reporting?
    - who are the main stakeholders and would different stakeholders attribute different priorities to different PIs?

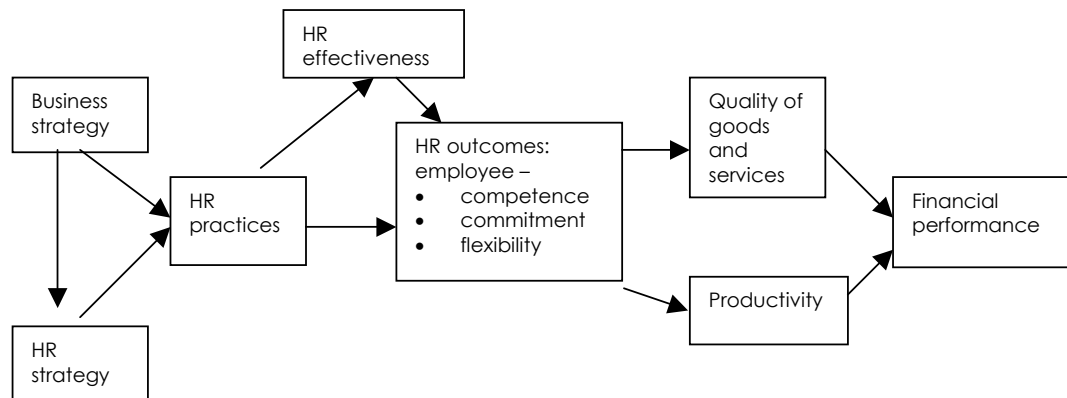
- what, if any, corporate behaviours should we be seeking to encourage (or discourage) through HCM reporting and what benefits should we expect from external reporting of PIs?
- what would represent best practice in external reporting (e.g. PI against benchmark supported by contextual narrative) and what, if any, common core of PIs might most usefully be included?
- what are the main obstacles to external reporting of HCM performance, and which particular PIs would present the most difficulties?

## Relevant research findings

7. We have reviewed relevant research findings with the assistance of the Judge Institute of Management at the University of Cambridge. Obviously, a number of factors influence the longer-term value of an organisation, including economic conditions, the markets in which it operates and the strength of its business strategy. When it comes to HCM, researchers have paid considerable attention to ways in which the skills, behaviour and knowledge which constitute human capital interact with social capital (structure, processes and culture) to form the broader intellectual capital of an organisation.
8. The link between human capital and organisational performance is based on two theoretical strands:
  - first, a resource-based view, in which the human capital of an organisation is a key invisible asset alongside its physical and financial capital. This theory suggests that human capital can make a particularly valuable contribution to sustainable competitive advantage since it depends upon policies and practices developed over time that are not easy for competitors to imitate;
  - secondly, a theory of motivation, which links performance to the rewards (not necessarily financial) available to individuals attaining a certain level of performance and their belief that they can achieve that level.
9. Recent studies have focused on two main ways in which HCM practice might enhance performance:
  - through raising the skills base of employees by, for example, appropriate recruitment and retention, comprehensive training and broad-based developmental activity; and
  - through enhancing employee motivation and ability to use their skills through measures such as design of reward systems, participative problem solving and teamwork.
10. Researchers have attempted to identify high performance practices in such areas as selection and recruitment; induction and training; staff appraisal; skill flexibility; job variety; job responsibility; team-working; communication; the use of quality improvement teams; harmonisation of terms and conditions; and comparative pay and incentive schemes. Within this broad framework there have been important differences of emphasis. Some writers place greater weight upon factors such as fair treatment, job security, scope for employee development, and design of jobs to promote autonomy and challenge. Others stress the role of worker flexibility, performance management and the use of incentive payment systems.
11. If the relative importance of different types of practice remains a matter of debate, there is nevertheless a growing body of evidence linking effective high performance HCM practices to the financial performance of the organisation. In particular there is a high degree of empirical support for the need for strong consistency among HCM practices to achieve good results; it is the combination of practices that matters rather than simply doing one or two well. There is less agreement on whether there are particular HCM practices common to all successful

organisations or whether appropriate practices vary with the nature of the organisation. Attempts to identify best practices in one organisation that can be successfully transferred to another have met with limited success. It is becoming clear that best practices have an 'architectural' nature in that the identification of factors contributing to high performance applies generally although the practices may differ. Two organisations with quite different HCM practices may have similar architectures in that, for example, both may structure their jobs and payment arrangements to link to particular desired behaviours and performance outcomes.

12. Some current research is of particular relevance. We are aware of a major current study by the Work Foundation exploring the link between high performance workplaces and productivity. And there have been some valuable recent attempts to model the ways in which such practices lead to superior organisational performance, notably by Professor David Guest of the City of London University, who has proposed the following model:



Professor Guest and others have found empirical support for this model through their work on The Future of Work Study.

13. Although it is not yet possible to demonstrate causality, there appears to be an emerging consensus amongst leading researchers that there is compelling evidence for linkage between strong people management and performance.

### Use of indicators of human capital management in the UK

14. Against this background, how do private and public sector organisations in the UK seek to assess their HCM strategies and how does this compare to practice in other countries? The Chartered Institute of Personnel and Development (CIPD) published its report 'Evaluating Human Capital' on the practices of major employers in 2002. Several organisations active in human resources consultancy conduct surveys or maintain databases on participating organisations to enable them both to assess trends or benchmark organisations against selected comparators. We are grateful to have been provided with reports on their work in this area by Deloitte & Touche, by EP-First and by PricewaterhouseCoopers. Taken together, these provide a valuable compendium of the types of measurements and indicators in current use and their perceived strengths and weaknesses.

15. As part of our inquiry we commissioned the London Business School to survey practice and opinion among the top 250 FTSE companies in relation to:

- their use of indicators of effective HCM;
- the association of such indicators with company profitability or competitiveness;

- the reliability and consistency of such indicators;
  - their use as an internal management tool;
  - the extent to which they are reported externally.
16. Results to date tend to confirm previous findings that although a range of indicators is used (with employee turnover and employee satisfaction amongst the most popular), many companies have few or no measurements for HCM. Those data that are collected are rarely reported externally. This may be for a range of reasons, including doubts as to their reliability, relevance and materiality, concerns over commercial confidentiality, the potential impact of disclosure on employees and employee organisations, and the practicalities of data collection.

### **Some preliminary proposals**

17. From the evidence and views we have gathered so far, it appears that no single set of HCM practices is widely accepted as 'best practice' applicable to all organisations. Nor is there any general agreement on a set of relevant indicators on which all organisations might be urged to report externally. There is a widely recognised tension between the need for flexibility to enable organisations to select from a wide menu of measures to reflect their own particular circumstances and the need for prescription to ensure rigour and comparability. Against this background we believe that there may be merit in an approach that seeks to combine:
- flexibility for organisations to report on these issues in ways that reflect their particular circumstances and the challenges they face; and
  - the introduction of a common core of minimum reporting to promote consistency and comparability, and hence aid identification of trends over time and informed comparisons between organisations.
18. To achieve this, organisations might be encouraged to identify those HCM issues which link most strongly to performance – whether of the whole organisation or of its different units – and to report on these using a mix of narrative and numerical data to provide a balanced and informative account to stakeholders of their practices and performance in relation to these. In general, this would mean focusing particularly on indicators of future capabilities and reporting on:
- maintenance and development of its skills base (through practices such as selective staffing, comprehensive training and broadly-based developmental activity); and
  - factors affecting employee motivation (through practices such as design of reward systems, participative problem solving and teamwork).
19. While the investment community and other stakeholders would welcome identification by managers of the most important HCM issues, we believe that some common reporting will be important. The Conference Board (a US not-for-profit body concerned with business and management issues) recently reported what a number of institutional investors who had requested greater reporting of HCM measures said they would most value. Widespread interest was expressed in information on:
- workforce profile (relevant to equal opportunities and diversity);
  - labour-management relations;
  - retention;
  - training/competencies;
  - remuneration; and
  - health and safety.

20. Information on these topics is clearly relevant to assessing how far organisations are maintaining and developing an appropriate skills base and employee motivation, and should be of interest to investors and other external stakeholders. It can provide a guide to an organisation's culture and may help identify risks to its reputation and future development. These topics bear on long-term value and are important to current and prospective employees. For all these reasons, they may be the most appropriate areas for possible inclusion in a common minimum reporting standard.
21. In particular, we wish to explore the case for encouraging organisations to report on:
- the size and composition of the workforce – this might include data on the numbers of people on which the organisation relies for its performance, including agency and contract staff in addition to those on the payroll, disaggregated by age, gender and ethnicity;
  - employee motivation – as well as data on staff turnover and absentee rates, set in context and disaggregated as necessary to show impact on the skills base, this might include information on arrangements for gathering employees' views and suggestions including results of staff satisfaction surveys where conducted;
  - staff training and development – including the match between the skills acquired and business objectives;
  - remuneration and fair employment – indicating the organisation's approach to pay and incentives and the means by which it satisfies itself that it does not discriminate unfairly in pay or employment; e.g. by the use of equal pay reviews.
22. Researchers, consultants and individual organisations have developed a wide range of metrics relevant to HCM. These may seek to measure:
- inputs, such as expenditure on training per full time employee equivalent;
  - outputs, such as the amount of training provided;
  - impacts, such as increases in the skills base within the organisation as a result of this training.
- Others attempt to measure the efficacy of linkages between these, such as training delivered per unit of expenditure or increase in the skills base in relation to training delivered.
23. There is little agreement about which metrics provide the greatest insight into HCM performance. Moreover, the interpretation of information on HCM requires an understanding of the context in which the organisation operates. For example, data may be strongly affected by cultural and other factors in different countries and a particular level of staff turnover may indicate poor HCM practices in one organisation but reflect an HCM strategy well aligned to business need in another. Particular care is needed in using HCM data to compare organisations operating in different countries or different industrial sectors. While many metrics are capable of being used as indicators of performance through appropriate benchmarking, financial valuation of human capital and indices of human capital, all of the currently used approaches appear to suffer from limitations and at the present stage of development the scope for specifying common metrics is unclear. We know that CIPD and others are currently working to develop frameworks for the assessment of human capital incorporating a number of elements.
24. We recognise the tension between setting any minimum reporting requirements high enough to allow reasonable comparison between organisations, including use of the same metrics, and avoiding an over-prescriptive approach that might stifle innovation, prejudice commercial confidentiality or be unduly burdensome. Our inclination is to favour an evolutionary approach; starting with a fairly general set of recommendations, with progressive improvement as measurement and reporting arrangements develop. However, we should welcome views on how far there should be central guidance on the most appropriate metrics for reporting on HCM practices, or whether this is something best left to individual organisations.

## Possible reporting mechanisms

25. Information on HCM will only be useful to shareholders and other stakeholders if it is trusted, both in terms of the reliability of data given and in providing a balanced and objective view of the organisation's practices and performance. The flexibility under the proposals outlined above for organisations to report primarily in terms of their own assessment of the HCM issues most closely linked to their performance means that it is particularly important that the reporting process is robust. In view of their role in relation to shareholders we believe that such reporting should be a matter for the company Board.
26. One possibility might be for organisations to be invited to commit themselves to including information on HCM in their report and accounts on the basis of minimum reporting standards. These might include arrangements under which companies confirm that the information gives a balanced and objective view. We should welcome views on how such standards might be developed.
27. In view of the centrality of HCM to most organisations, reporting on this might be seen as an issue of good governance and provisions might be added to the Combined Code on Corporate Governance alongside those covering the reporting of risks to the business. In relation to financial reporting, the code currently recommends that the Board should present a balanced and understandable assessment of the company's position and prospects. If provisions on HCM were to be introduced then all listed companies would be required under the Listing Rules to report on whether they had complied with the provisions. It would be possible to provide in the combined code for the Audit Committee or some other body responsible to the board to confirm that the report on HCM gave a balanced and objective view.
28. It has been suggested that information on HCM might be included in company OFRs. In its report on the fundamental review of company law in July 2001 the Company Law Review Steering Group included a recommendation that all companies of significant economic size should be required to provide an OFR as part of their annual report and accounts, and the Government accepted this recommendation in its July 2002 White Paper 'Modernising Company Law'. The Company Law Review report identified certain items that it recommended should always be included in the OFR and certain items that should be included wherever the directors in good faith identified them as material. The former items included the company's business and business objectives, strategy and principal drivers of performance, a fair review of the development of the business over the year and position at the end of it and the dynamics of the business. The latter included, amongst other points, corporate governance and an account of the relationship with employees, customers, suppliers and others.
29. An Operating and Financial Review Working Group was set up in December 2002 to develop broad principles and practical guidance on how directors can assess whether an item is material to their company and hence whether it must be included in an OFR. The Working Group is expected to publish a consultation document shortly. In January 2003 the Accounting Standards Board issued guidance on OFRs which emphasized the need to be balanced and objective.
30. We should welcome views on how HCM might best be reported in order to ensure that information on this is both widely reported and trusted by investors and other stakeholders. In particular we should welcome views on any or all of the possibilities identified above and what obstacles there might be to such reporting. How seriously, for example, should we take concerns in this context about commercial confidentiality?

## **Evolution of reporting standards**

31. The success of the proposed approach will depend upon a progressive improvement in standards of reporting on HCM as measurement and reporting arrangements develop. We would expect this to be demand led, as investors and other stakeholders seek more precise and comparable information, and to develop through competition to meet both internal and external demands for better measurements more directly indicative of performance. There may, however, be merit in assisting this process through the creation of a body charged with monitoring and encouraging development of standards over time. We should be interested in views on this and on the role, composition and funding of any such body.

32. We should further welcome views on:

- whether there should be some recognition for organisations that met certain standards;
- whether there should be some award for exemplary or significantly improving organisations.

## Accounting<sup>for</sup>people

The Chair of the Task Force is **Denise Kingsmill CBE**, Deputy Chair of the Competition Commission

The other members are:

**Helen Alexander** – Chief Executive, The Economist Group  
**Patti Bellinger** – Group Vice President, Global Diversity & Inclusion, BP  
**David Bishop** – Senior Advisor, KPMG  
**Professor Sandra Dawson** – University of Cambridge  
**Fred Goodwin** – Chief Executive, Royal Bank of Scotland  
**Ed Smith** – Partner, UK Board, PriceWaterhouseCoopers  
**John Sunderland** – Chief Executive Officer, Cadbury Schweppes plc  
**Ed Sweeney** – General Secretary, UNIFI

The Task Force is able to draw on the expertise and opinions of an Advisory Forum comprising more than twenty business people, stakeholders, HCM professionals, thought leaders and academics.

1 Victoria Street  
London SW1H 0ET  
tel 020 7215 5372  
fax 020 7215 0235  
email [accountingforpeople@dti.gsi.gov.uk](mailto:accountingforpeople@dti.gsi.gov.uk)  
web [www.accountingforpeople.gov.uk](http://www.accountingforpeople.gov.uk)