# Foreword

The UK Commission for Employment and Skills is pleased to present this submission on the Future of Narrative Reporting Consultation, as to how the reporting on non-financial information could bring valuable additional transparency to the public arena. We are responding, in particular, to emphasise the importance of the **human capital or "people" dimension** as a vital source of non-financial information and to offer our support in providing guidance on how its coverage in the narrative reporting framework can be strengthened in future.

Our recommendations are that Government:

1. Recognises the importance of skill development to business success and includes human capital reporting in its development of narrative reporting
2. Mandates businesses as a minimum to report on skill development within its Business Review. We hesitate to mandate that businesses should include certain information in their Business Review (because of the danger of undermining the Directors' responsibility to determine key factors), but this issue is of such vital importance to the competitive position of both individual firms and the economy as a whole that we think serious consideration should be given to making it a mandatory reporting item
3. Works with business to develop appropriate measures of skill development

We also recommend further development of existing tools that encourage private investment in skills development and the adoption of High Performance Working (HPW), such as the Investors in People (IiP) standard and integrate/align them to any changes in narrative reporting standards.

In this submission, we make the case for this change in the narrative reporting framework not only because human capital is essential to the success of individual businesses but, also, because it supports wider policy developments taking shape. These developments are aimed at creating the right conditions to stimulate businesses to invest in and utilise their human capital to its full potential. This in turn seeks to support the development of a more internationally competitive skills base for the UK as a whole. In particular, as Government articulates its aspirations for the development of a **modern workplace** it is recognising the important role human capital plays in improving business performance.

At its core this is about behavioural change. Based on the UK Commission's research evidence we see narrative reporting as one of the tools that can help to support this behavioural shift, achieving a far-reaching step change in how businesses perceive their people and their skills. This needs to be explicit, transparent and a core part of managing the business. Human capital reporting serves to do this: by facilitating the gathering and processing of more explicit information about human capital within business, helping businesses to make more optimal investment decisions which will impact on current and potential **staff**, **customers,** and **organisational performance** and by raising the profile of the value of human capital, and what they have to offer, as a more tangible asset, providing the means to more effectively turn "potential" business performance into "actual" performance with benefits not only for the business but also to the wider **investor** community.

**Jeremy Anderson**
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**UK Commission for Employment and Skills**

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# 1. Introduction

The UK Commission for Employment and Skills advises Government on the policies, strategies, and measures that we need as a country to achieve our World Class Ambition of being one of the top eight countries in the world for skills, jobs and productivity. Established in 2008, we strengthen the employer voice and provide greater employer influence over the UK's employment and skills systems by bringing employer leadership through our Commissioners. Fundamentally then, this is about developing policy to support economic growth through skills and jobs.

In monitoring UK progress to the skills, jobs and productivity ambition, we have published two annual reports, most recently Ambition 2020: 2010 edition. We have also published advice on ensuring the UK has the skills it needs and are currently working with officials in BIS on the development of the forthcoming Skills Strategy and Comprehensive Spending Review. This builds on earlier work. What has become apparent through our research in this area to date is that there are many aspects of public policy which impact on skills levels in the UK, not just the skills and employment systems. Consideration also needs to be given to the effects of economic development, spatial and industrial policy, for example, as well as business enterprise.

The policy framework we present in Ambition 2020 demonstrates the range of factors at play influencing current skill levels and affecting skills supply and demand and a basis to consider how such factors interrelate. Our work highlights therefore the need for a more holistic approach to skills development that includes supporting employers more broadly in the way they manage their businesses including influencing their decisions on wider business investment as well as workforce development. Narrative reporting has a key role here.

We set out our advice as follows:

2. The prize: Why improved human capital reporting matters to government
3. The prize: Why improved human capital reporting matters to business
4. Building on current narrative reporting practice
5. Conclusions, Recommendations and our offer

# 2. The prize to the economy: Why improved human capital reporting matters to government?

The Government seeks to enhance the international competitiveness and prosperity of the UK. The value of the economy is based on how many people are working (the employment rate), the jobs they do (a balanced economy), and the value of what they produce whilst they are at work (productivity). Skills are essential for all three and are a key determinate of a nation's economic competitive advantage, as articulated by Adam Smith (1776) when describing the balance between supply and demand:

> The balance between supply and demand is regulated *"first, by the skill, dexterity, and judgment with which its labour is generally applied; and, secondly, by the proportion between the number of those who are employed in useful labour, and that of those who are not so employed*.
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> [An Inquiry into the Nature and Causes of the Wealth of Nations 1776]

Our recent benchmarking research showed that the UK is currently the 6th largest economy in the world and the 4th largest in the OECD. However, this world class position is not reflected in employment and productivity rates. The UK only ranks 10th and 11th respectively. When it comes to skills, despite significant progress in recent years, the UK is ranked 19th for low skills, 21st for intermediate skills and 12th for high skills against OECD competitor nations with little anticipated improvement to 2020. Further action is required to ensure Performance can be truly world class.

The Government acknowledges the value of skills to businesses and the UK economy as a whole and the importance of the skills agenda has been reflected in a number of speeches and statements, for example: '(...) *Skills delivered in the workplace are essential for economic growth and personal progression'*.[1]

Given the importance of skills to economic growth, this highlights the importance of taking action at a micro level to support the effective development and use of human capital in the workplace – narrative reporting on human capital provides one tool to encourage such action.

## 3. The prize to business: Why improved human capital related narrative reporting matters to business

We have published a comprehensive assessment of the value of human capital and skills - we summarise here the value to business, which is the key focus for developments in narrative reporting:

- Businesses which do not train their staff are twice as likely to fail as those that do.
- Benefits associated with a higher skilled workforce include: increased employee satisfaction, exploitation of new opportunities, lower rates of absence and staff turnover, better returns, improved productivity, and higher added value product strategies.
- Higher skill levels increase a firm's confidence in their employees' ability to adapt, so encouraging greater investment and innovation.

Our research has identified **High Performance Working (HPW)** as a means for businesses to move into this modern workplace sphere and to realise these benefits. HPW is essentially a holistic approach to managing a business which encourages on-going business development to enable businesses to: continually seek competitive advantage move up the value chain, reorganise their working practices, raise skills demand and invest in their staff. By doing so, employers can improve the use of skills in their workplaces and thus overall organisational performance. [2] However, at the moment only a small number of UK businesses have moved to this modern workplace approach and adopted High Performance Working Practices (HPW). Narrative reporting is one tool that can help to extend take up and a realisation of wider benefits. [3]

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[1] John Hayes, speech to ALP (14 July): http://www.bis.gov.uk/news/speeches/john-hayes-assoc-learning-providers

[2] See High Performance Working: A Policy Review, Evidence Report 18, UKCES, May 2010 http://www.ukces.org.uk/upload/pdf/High%20Performance%20Working%20-%20Main%20Report_1.pdf and High Performance Working: A Synthesis of Key Literature, Evidence Report 4, August 2009 http://www.ukces.org.uk/upload/pdf/UKCES%20Evidence%20Report%204.pdf

[3] Our recent review identified that the IIP Standard mapped against many of the facets of a high performance working organisation and in particular, the new choices approach, launched in 2009, ensures a greater focus on

Our analysis builds on earlier work; for example, the Kingsmill Review of 2003 highlighted the benefits of human capital reporting issues for businesses at a number of levels: better management within the firm, greater investor confidence, improved ability to attract, motivate and retain staff, and so on. [4] Thus, improving narrative reporting might benefit a number of different groups, which impact on the success of the firm and ultimately, the economy more broadly:

- **consumers and customers** drive the value of businesses through their marketplace choices. As well as being attracted to the improved goods and services they could expect to receive from firms providing higher value goods and services facilitated through investment in their staff, they may also place a greater value on companies with reputations for investing in staff as they have for companies with good reputations in CSR.

- **investors** would benefit both from a deeper understanding of the ways in which businesses are investing in skills development of the workforce, and, with a raised understanding of the value of this training to businesses, would better be able to assess the relative value of different firms on a wider range of measures, including human capital. Evidence from the US suggests that, over a period of time, firms with higher levels of human capital investment are more likely to achieve higher levels of success

- **employees and potential employees** would benefit from having improved information about the potential investment opportunities provided by businesses to their staff, and therefore a clearer understanding of how they might be developed themselves within different firms;

Thus, benefits to businesses arise through:

- The process of gathering the information, by tackling information deficiencies within business, challenging senior management on current practice and fostering discussion about the value of skills to individual firms;

- If barriers to sub-optimal provision are tackled through the process then business could expect to benefit from improved staff motivation, greater survival rates, improved productivity and so on;

- In itself, this may be enough to attract more investors, customers and staff. However, the publication of this data could also support this through greater transparency and appealing to those clients whose behaviour would (and arguably should) be motivated by high skill businesses;

- Publication will also perhaps lead to greater benchmarking across business, which may also influence employer decision making.

Despite these benefits, our research has found significant variations in levels of investment in skills development and training and evidence of **sub-optimal employer investment** in skills. This points to market failure. The barriers to employer investment in skills resulting in market failure include: the inability to reliably measure the returns on investment in skills as well as imperfect information about the value of investing in skills. Other factors point to

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the needs of the business. As a policy tool and business framework, IIP provides a clear potential for encouraging take up of high performance working and a set of measures which could be taken up in narrative reporting.

[4] Accounting for People 2003, p. 8-9.

short-term behaviour in the capital markets, a lack of management skills in identifying skills deficiencies and the impact they can have on business performance, as well as the fact that current accounting practice treats spending on skills development as a cost and not as an investment. At this time of constraint on public expenditure, we need to consider responses to market failure which are not as costly to the public purse as subsidised provision. We need to lever in greater private investment in human capital to address sub-optimal provision which considering what potential levers and tools might signal to employers the need to change and begin to tackle the root causes of sub-optimal investment. This includes tackling information deficiencies and presents a role for human capital reporting.

Improving narrative reporting requirements with regard to human capital provides an important potential route, therefore, to tackling many of these barriers. We propose that explicitly recognising, reporting and celebrating human capital within the workplace is an important factor that can underpin business success by:

- raising the profile of the value of skill investment to managers, accountants and, employees within firms bound by the requirements, facilitating greater internal dialogue about human capital practices and their impacts and

- raising the profile beyond these firms to the wider business community of human capital reporting and practices and why they are important to business – at this general level, it could provide a useful 'nudge' to the training decisions of employers outside the scope of narrative reporting.

Additionally, the *publication* of the information through a company's Annual Report would demonstrate to investors, consumers and employees, the value of skills and human capital, providing a clearer description of the extent of skill development and the scale of human capital within these firms. Vitally too, we suggest that giving consideration how a wider set of HPW factors could be incorporated in narrative reporting would extend business performance further still.

As we stated above, much of this is not new and has, to some extent, been considered in the past, following the Kingsmill Review in particular. So what is different now? Government is calling for greater transparency in businesses in the wake of the banking crisis and clearly sees the narrative reporting as a route to achieving this. Additionally, there is less public money to spend on staying with the globally competitive skills race, but the race itself is no less important as we seek to emerge from the recession stronger and prosperous. Thus, it would appear to be an opportune time to use narrative reporting as one additional tool to influence employer decision making, tackle information barriers and encourage employers to share the responsibility for developing and maintaining a skilled workforce. The changes the Government introduces to narrative reporting will likely impact on the business community beyond those directly required to complete Business Reviews and we do need tools which will have a wider reach and achieve a greater step change in how business see and deploy their people. So what can we learn from past experience and apply differently and more successively now in this area.

## 4. Building on current narrative reporting practice

In this section we outline our understanding of current narrative reporting practice in human capital reporting and how this might be developed

**Human capital reporting** (HCR) has developed from a rudimentary definition in the 1960s to a stage now where employees are not solely seen as a cost but also "constitute an

intangible asset in terms of reputation, intellectual capital, expertise and knowledge and innovation".[5]

The growing importance of HCR to business was emphasised by the Chartered Institute of Personnel Development (CIPD). In a 2003 paper it stated it had "a wealth of evidence from its programme of research investigating the impact of people management practice on business performance to demonstrate that human capital is at least as important as financial capital in generating success."[6]

However, despite some positive developments in incorporating HCR in business reporting, it has not quite made sufficient progress to tackle market failures, perhaps because the timing of introducing further measures has not been quite right, as suggested in section 4.

Under the auspices of narrative reporting, those companies that are required to conduct an enhanced Business Review, as set out by the Companies Act 2006, use the best practice guidance, established by the Accounting Standards Board (ASB) for that purpose. Known as the Reporting Statement of the Operating Financial Review (OFR), it "is intended to have persuasive rather than mandatory force."[7]

The Reporting Statement acknowledges the importance of staff in that "employees may be a particularly key resource – and accordingly a key risk – for many entities"[8] and its Implementation Guidance provides direction in assessing employee performance and development to quoted companies, specifically obliged by the Companies Act to provide information on their employees and social and community issues.[9] The Reporting Statement's advice on these issues is reproduced here:

- *Recruitment and retention – employee turnover, retention rates, remuneration policies, number of applicants per post, offer/acceptance statistics, levels of skills shortages;*

- *Training and development – hours spent on training, number of courses taken, leadership/career development;*

- *Workforce performance and profile – employee productivity, revenue/profit per employee, diversity, number of professionally qualified employees.*[10]

The Reporting Statement acknowledges that employee matters, of concern to directors, will depend on the organisation in question (its sector, business model, strategy etc).[11] This means that directors are given significant leeway in what they actually report. As the Association of Chartered Certified Accountants (ACCA) comments:

*"... it is ultimately left to directors' discretion to decide whether this information is material to the business and therefore should be included in disclosures, and as a result many organisations disclose the bare minimum or simply state that it is not considered sufficiently important*."[12]

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[5] ACCA 2009, p. 1.
[6] CIPD 2003, p. 1.
[7] ASB, Reporting Statement, 2006, p.5
[8] ASB, Reporting Statement, 2006, IG24, p. 45, Ibid.
[9] As per Section 385, Companies Act 2006, a quoted company is one which is listed on the London Stock Exchange, New York Stock Exchange, Nasdaq or in the European Economic Area.
[10] ASB, Reporting Statement, 2006 IG26, p. 46, Ibid.
[11] ASB, Reporting Statement, 2006, IG26 p.46, ibid
[12] ACCA, p. 1.

The discretion of what to actually report about employee matters means that levels of skills shortages, hours spent on training, the number of courses taken, the number of professionally qualified employees, and so on and so forth, are typically not reported. As the ACCA also observes, "organisations undertake very little external reporting on human capital issues".[13]

When companies do report on human capital issues, many choose "peripheral disclosures ... over the more important key drivers of their business"[14], as identified in a review of narrative reporting by the ASB. It advises that non-financial measures should be clearly relevant to the business and information on employee matters should not include unimportant items, "such as the number of employees just to tick a box."[15] The ACCA similarly states that "there is still little credible information communicating this view of HCM [human capital management] in annual reports and sustainability reports along with other quantitative and narrative disclosures".[16] The ASB's review also states that, "where companies are struggling to report, it could be due to a lack of clarity of the requirements."[17]

This lack of clarity may explain the lack of human capital reporting found by ASB. It may also be the case that under-reporting is symptomatic of the relatively low profile of training and skills compared to other narrative reporting requirements, such as corporate and social responsibility (CSR). If the profile of training and skills can be raised to a similar level as that enjoyed by CSR then this may 'nudge' employers into investing in more training and skills for employees.

We cannot be clear on the reasons, and for many firms covered by the requirements, it is not because they do not already train or have high skilled workforces, but we suggest that the current inconsistencies and shortfalls in narrative reporting could be addressed reporting enhanced through strengthening the current guidance. In doing so, we suggest this could form one element of a sustained approach to encouraging employer investment in skills.

## 5. Conclusions: Improving narrative reporting to reflect the value of human capital

We see improved **narrative reporting** as one vital tool that can help to support the transition towards a modern workplace culture that Government seeks. Such a step puts a stronger onus on skills development and skills utilisation at the firm level to support more businesses in the UK to achieve high performance working and greater business success. For business, an engaged and productive workforce is their biggest asset, key to profitability and growth. Improved narrative reporting could impact in a number of different ways:

- On the **firm** itself in the gathering and processing of information for the narrative report, in tackling sub-optimal training behaviour rooted in information deficiencies and in reaping the benefits associated with a skilled and productive workforce;

- Enabling **investors** to make better informed investment choices and thus, again, rewarding employers that invest in skills development.

[13] Ibid.
[14] ASB, Rising to the Challenge
[15] ASB, Rising to the Challenge P.20
[16] ACCA, Ibid.
[17] ASB, Rising to the Challenge P.3

- Helping **consumers and customers** to see whether they share the company's values before they choose to do business with them, therefore also indirectly raising the importance of a modern workplace culture to business success.

- Allow potential **employees** to make an informed choice of whether this company is a great place to work, also helping employers to attract and retain the best talent.

Our **recommendations** are that Government:

1. Recognises the importance of skill development to business success and includes human capital reporting in its development of narrative reporting
2. Mandates businesses as a minimum to report on skill development reporting within its Business Review
3. Works with business to develop appropriate measures of skill development

We also recommend further development of existing tools that encourage private investment in skills development and the adoption of High Performance Working (HPW), such as the Investors in People (IiP) standard and integrate/align them to any changes in narrative reporting standards.

**Our offer**
We recognise the challenge of this agenda and that previous attempts have not taken the agenda far enough. We would be happy to support Government to:

- Make the case to business for including skills in narrative reporting

- Make the case to business for investing in skills per se;

- Identify the appropriate form of Guidance which might most effectively tackle the barriers to optimal provision we have identified;

- Work with Government on forthcoming research into appraising the options to improve human capital reporting in the workplace and our general research into influencing behaviour.

- Identify broader measures to enhance private investment in skills so that the revisions to narrative reporting guidance are delivered as an effective package of measures to increase UK skill levels and enable us to improve our position on the world stage.