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Encouraging Employers to use Human Capital Reporting: A Literature Review of Implementation Options

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Encouraging Employers to Use Human Capital Reporting: A Literature Review of Implementation Options

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List of acronyms

Acronym	Full title
ACCA	Association of Chartered Certified Accountants
ANSI	American National Standards Institute
ASB	Accounting Standards Board
A-GAAP	Australian Generally Agreed Accountancy Principles
BIS	Department for Business, Innovation and Skills
CDSB	Climate Disclosure Standards Board
CIPD	Chartered Institute for Personnel and Development
CSR	Corporate social responsibility
Defra	Department for Environment, Food and Rural Affairs
EU	European Union
GAAP	Generally Agreed Accountancy Principles
GRI	Global Reporting Initiative
HCM	Human Capital Management
HCR	Human Capital Reporting
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IC	Intellectual capital
ICR	Intellectual capital reporting
IfG	Institute for Government
ISO	International Organization for Standardization
KPI	Key performance indicators
MD&A	Management's Discussion and Analysis (Canada)
MINDSPACE	Messenger, Incentives, Norms, Defaults, Salience, Priming, Affect, Commitments, Ego
NHS	National Health Service
OECD	Organisation for Economic Cooperation and Development
OFR	Operating and Financial Review
PWC	PriceWaterhouseCoopers

R&D	Research and Development
SHRM	Society for Human Resources Management
UNDP	United Nations Development Programme

1 Introduction

The ambition of the UK Commission for Employment and Skills is to transform the UK's approach to investing in the skills of its people. The world economy is once again creating difficult conditions for growth and employment in the UK, with a challenging business climate and rising youth unemployment.

For growth to be sustainable the UK Commission argues it must be driven by the skills and entrepreneurship of people throughout supply chains, in different sectors of the economy (UKCES, 2011). It sees the development of skills as a fundamental part of securing growth and prosperity for the UK. This work contributes to the UK Commission's vision, for a dynamically led approach to skills as a source of competitive advantage to the UK economy. In particular, it does this by helping to develop the evidence base on those policy levers which can potentially encourage employers to invest in the skills of their workforces.

It builds upon the UK Commission's wide ranging series of papers, Review of Employer Collective Measures, which reviewed the various policy levers available (such as training levies, occupational regulation and high-performance working tools) to collectively stimulate investment by employers in the training of their staff.[1] It concluded that the current level of investment in skills in the UK is sub-optimal due to various dimensions of market failure.

There are a number of possible reasons for low provision of skills development and training, with patterns based on size of organisation and sectoral specialisation. Barriers to training include: imperfect information; staff willingness to train; access to suitable training provision; fear of poaching and short-termism in investment decisions. The reporting of human capital is seen as one of the ways in which aspects of information failure and short-termism could be countered as the value of human capital could be more clearly evidenced. This literature review is intended to contribute additional knowledge and understanding towards our understanding of the policy lever of human capital reporting (HCR).

[1] The Review of Employer Collective Measures consisted of five reports: a conceptual review examined the theoretical literature on optimal investment in training; an empirical review explored the nature and extent of investment in skills by employers; a policy review examined the available international evidence on the effectiveness of existing policy interventions; a policy prioritisation *exercise* undertaken at events across the UK in summer 2008, sought views on from stakeholders on the feasibility of policies; and a final report synthesized all the evidence and set down conclusions and advice. See: http://www.ukces.org.uk/ourwork/employer-collective-measures

1.1 Aims of the literature review

The aim of this review is to explore the existing academic and industry literature, in the context of exploring possible options for the future of HCR, in both public and private sector organisations in the UK. For the purposes of this review, these options have been conceptualised to three broad areas across the mandatory/voluntary spectrum of employer engagement in reporting on human capital. They are:

- **Regulation** – mandatory changes to the financial reporting standards which would oblige organisations to provide data on their investments and activities in this area.

- **Code of practice / best practice guidance** – semi-voluntary change as a result of which organisations would be encouraged to provide details of what they have done relative to the best practice code.

- **Cultural shift** – voluntary change towards the development of a common view that HCR is the ‘right thing to do’.

Such option types could enable the introduction of various forms of reporting on a continuum, from representing employees on a balance sheet using a valuation technique (at one end of the scale), through to the provision of organisations’ views, or staff members’ views, of the contribution of staff to the development and growth of their business (at the other end of the scale). Within this continuum, many different options could be included, such as reporting on the results of recent staff surveys, indicators of employee motivation, commitment and engagement, labour turnover and employment relations.

The focus of this research is to consider, within the contextual space of these options, the nature of existing regulation or practice and how this came about, what current practice looks like and potential challenges in introducing the respective option in question to encourage employers to report on human capital. It draws on UK and international evidence to identify best practice and assess the options.

1.2 Report structure

Chapter two starts with a brief summary of the policy developments in this area over the last decade. The current reporting requirements and practice of HCR in the UK are then explained, as is the future of narrative reporting (contextual and other non-financial information required from certain types of organisations in their formal annual reporting submissions), following a recent policy change. **Chapters three** to **five** present information relating to each one of the three policy options (mandatory reporting, voluntary code of practice and cultural shifts) under consideration. In each case the background and context of each option is established, key academic contributions are identified and examples of international practice are provided where applicable. Technical and conceptual challenges are also discussed. Finally, **Chapter six** presents the overall conclusions of the study.

2 Human Capital Reporting in the UK

2.1 Introduction

The issue of how human capital should be reported through accountancy and reporting procedures is generally referred to as human capital reporting (HCR). Many of the activities that could potentially be reported upon through various HCR mechanisms are referred to as human capital management (HCM) practices. These activities include a range of employee-related strategies, policies, procedures and processes that focus on producing benefit for staff and ultimately for an organisation as a whole. Typical HCM activities include staff training and development and employee retention schemes. This chapter will set out the policy context for HCR in the UK. The current UK reporting requirements and the current UK narrative reporting practices are presented in detail.

2.2 Policy context

Successive UK governments over the last 20 years have paid considerable attention to reforming accounting standards. A recurring theme is the issue of how to report HCM activities through HCR, with a view to countering short-termism and dealing with poor people management. A related issue is the extent to which it may make a difference in terms of investment in HCM (including training and development of staff skills) if one approach is supported rather than another.

One of the significant markers of the growing interest in this field was the publication of the Kingsmill Review in 2001. This review reached the fundamental conclusion that good HCM is routinely under-reported, even though it is clearly a crucial element in organisations' performance and productivity (DTI, 2001). The review further recommended that the government should set up an inquiry to consider how private and public sector organisations' reporting of human capital issues might be improved.

During the same time period in 2001, the UK government indicated that a shift in emphasis was planned in relation to accountancy regulations. In June 2001, the then Chancellor of the Exchequer, Gordon Brown indicated, during a speech on the productivity gap in the UK, that he intended to reform company law in order to make the country increasingly enterprise focused (Ferran, 2001). A White Paper was subsequently produced in July 2002, entitled 'Modernising Company Law'. This contributed to the Accounting Standards Board's (ASB) guidance on the Operating and Financial Review (OFR) (ASB, 2006; which is discussed in the next section). The OFR is a narrative report on a company's business, performance and future plans which is optimally placed to carry information on human resource management and human capital (DTI, 2003). Reforming the OFR has been on the coalition government's agenda since it arrived in office, as will be seen further on.

Returning to the Kingsmill Review, its recommendation to undertake an inquiry into HCR was carried out by the Accounting for People Task Force in 2003. In its final report a small number of key recommendations were made. These are set out briefly below:

- HCR should have a strategic focus and be communicated clearly, fairly and unambiguously.
- HCR should include information about the size and composition of the workforce; the retention and motivation of employees; the skills and competences necessary for success, and training to achieve these; remuneration and fair employment practices; and leadership and succession planning.
- Reporting of HCM should be balanced and objective and enable comparisons over time by building on commonly accepted definitions.
- All companies producing OFRs should include HCM-related information in those.
- The ASB should develop guidelines on key indicators and definitions in consultation with stakeholders.
- The government should consult stakeholders on the dissemination of HCM reporting best practice.
- The ASB should monitor the HCM reporting developments and prepare a report in two years' time (i.e. 2005) (DTI, 2003).

The report reached the overall conclusion that a strongly prescriptive regulatory framework was not desirable. It was believed that consensus on good HCM practice was lacking. UK companies appeared to be diverse in their recognition of the importance of HCM and in the strength of their views on the impact of HCM on company performance (DTI, 2003). Therefore, the Accounting for People Task Force recommendations aimed at beginning an evolutionary process towards a widespread, diverse but consistent HCR, relating to HCM practices across the UK.

In spite of the positive initial reception of the Accounting for People report, its recommendations, by and large, were not implemented. In 2005, draft legislation went before Parliament stating that the OFR must include information about the company's employees. However, this requirement never entered into force (Roslender and

Stevenson, 2009). The reasons for this remain unclear. Possible ones, resulting from the fundamental challenges this area poses, include the underlying difficulty of identifying best practice and imposing consistency in HCR, and the potential for strong institutional inertia in response to the move (Roslender *et al*., 2004). Despite this lack of progress, interest in HCR remained. In August 2010, the Accounting for People Task Force was relaunched, seeking to advance the case for HCR. Its relaunch may have been due, in no small part, to the renewed policy vigour introduced by the coalition government. Its intention to reform narrative reporting is explained in section 2.5.

2.3 Current UK reporting requirements

Organisations in the UK must provide financial reports and annual financial statements. In addition to mandatory financial reporting, some organisations must provide additional information, referred to as 'narrative disclosure'. This relates to non-financial data (such as environmental, social and community-related information) to be presented in the organisation's enhanced business review. Companies are required to provide an enhanced business review that discloses information that is material to understanding their development, performance and position, and the principal risks and uncertainties facing them (this information is published in the directors' report). The organisations that must provide this information are listed companies, as specified in Section 385, Companies Act 2006.[2] Beyond the mandatory requirements, companies may make additional voluntary disclosures (Beattie and Smith, 2010).

- Guidance is provided by the ASB on what should be included in the narrative disclosures. It suggests that the following aspects relating to employees should be part of a company's OFR:

- Employee health and safety – days lost to injury, levels of occupation-related disease in the workforce, compliance levels with working hours directive.

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

- Training and development – hours spent in training, numbers of courses taken, leadership/career development.

[2] A quoted company is one that is listed on the London Stock Exchange, New York Stock Exchange or NASDAQ, or is in the European Economic Area.

- Morale/motivation – employee feedback results, absence rates, levels of employee engagement.

- Workforce performance and profile – employee productivity, revenue/profit per employee, diversity, number of professionally qualified employees (ASB, 2006, pp. 46–47).

2.4 Current UK narrative reporting practice

The growing importance of HCR in the UK was emphasised by the CIPD (2003). Its study focused on an in-depth review of how 10 major UK companies are measuring and evaluating the contribution of their employees' human capital. It found that organisations undertake very little external reporting on human capital issues, although some hoped to do so in the future. All companies reported internally (not externally via narrative reporting processes), with most using competency as a key criterion. A variety of measures, mostly company specific, were used and some companies had adopted a balanced-scoreboard approach to measurement.

In practice, company directors have significant flexibility in what they report in narrative disclosures, and as a result "many organisations disclose the bare minimum or simply state that it is not considered sufficiently important" (ACCA, 2009b, p. 3). The ASB's 2009 report on narrative reporting by UK listed companies suggests that too few companies provide a full disclosure of their business model (ASB, 2009a). The study shows that, while many companies continue to devote significant time and effort to improving their narrative reporting, there are always opportunities for further enhancement as experience and best practice develop.

The variable quality of the data generated through narrative reporting requirements was also commented upon through the major review of narrative reporting launched in August 2010 by the UK Department for Business, Innovation and Skills (2011). In the summary of the first of two consultation findings, published in December 2010, it was observed that while some UK companies produce high quality reports, "there remained room for improvement particularly at the tail end where compliance with the letter rather than the spirit of the legislation was limiting the value of disclosures" (Department for Business, Innovation and Skills, 2010b).

2.5 The future of UK narrative reporting

Narrative reporting has attracted the attention of the coalition government since its election in May 2010. The reform of narrative reporting (i.e. information currently contained in the OFR or business review) was part of a wider reform agenda from the outset of the coalition's programme for government (HM government, 2010). As part of this a new consultation process, on the future of corporate narrative reporting, was launched in August 2010. This was followed by another consultation in September 2011, which sought to make reporting of this nature "simpler, clearer and more focused" (Department of Business, Innovation and Skills, 2011).

Following analysis of the consultations, the government has recently (October 2012) published its revised structure for narrative reporting in the form of draft regulations (Department for Business, Innovation and Skills, 2012). In summary, companies will now be required to produce a strategic report, similar to the existing business review. Furthermore, quoted companies will be required to report "to the extent necessary for an understanding of the business, on their strategy, their business model, and any human rights issues" (*ibid*). They will also have to report on the numbers of staff, by gender, in their organisation as a whole, and those sitting on their board and on executive committees.

Within the revised draft regulations, there does not seem to be any mention of additional/amended requirements to report on HCM related activities, around skills and training. Subject to any amendments, these regulations are due to come into force from October 2013 and companies with reporting years ending after this date will be expected to prepare their annual submission according to the aforesaid revision.

2.6 Conclusion

Financial reporting in the UK is mandatory for all business organisations. Narrative disclosures are also mandatory for listed companies and are voluntary for all others. In general, the nature and form of what is reported through narrative disclosures is left to directors' discretion, and as a result it is not done by many organisations. It is evident that "many organisations disclose the bare minimum or simply state that it is not considered sufficiently important" (ACCA, 2009b, p. 3). The recently published draft regulations, which revise the narrative reporting requirements, do not appear to place an emphasis on reporting skills or training. The lack of reporting on skills and training, according to the evidence collected in the UK Commission's Collective Measures study, may act as a barrier to optimal investment as employers are not recognising the value of their people and of their skills.

3 Option 1: Mandatory reporting

3.1 Introduction

This chapter sets out the core aspects of mandatory reporting as a possible direction for HCR. In order to do this, the background and context of the concept of mandatory reporting are considered. The key academic contributors to the field are briefly reviewed. International practice in mandatory reporting is considered as well as the role of mandatory reporting in various policy contexts. Some of the technical and conceptual challenges to this approach are discussed and, finally, possible directions for this option in HCR are summarised.

Mandatory reporting, through the establishment of an accountancy standard for training, was an option considered under the UK Commission's Collective Measures study. However, the issues involved in investing/increasing training through modifying accountancy standards pose a number of challenges, such as reappraising the nature of training as an intangible asset, the difficulties around the portability of skills, if staff leave/move employment, and the complexities of adapting International Accounting Standards (IAS) to meet these requirements. As a result, the policy lens refocused on the reporting of human capital. This section aims to help to develop a deeper understanding of current practices, challenges and opportunities in introducing mandatory HCR.

3.2 Defining mandatory reporting

Corporate reporting in general combines two main types of information (as detailed in the UK context). The first of these is **financial reporting**, which consists of financial data and includes financial statements compliant with Generally Agreed Accountancy Principles (GAAP). Financial reports frequently have accompanying notes to explain aspects of the statements that may be unclear. The second type of information is **narrative reporting**, which consists of additional relevant information about the business (including contextual and other non-financial information). The latter may be presented in a format such as a business review document. The provision of narrative reports, in conjunction with financial reports, enables an organisation to communicate aspects of its business that it would not be able to convey through the provision of financial reporting alone. Such aspects may include, for example, information about market position, strategy, performance and future plans (PWC, 2011).

'Mandatory reporting' is defined here as the potential to introduce regulatory changes to require organisations to report on the human assets within their business. A requirement of disclosure may potentially be brought about through changes to financial reporting standards and/or through changes to the primary legislation.

3.3 Background

The issue of how best to represent the value of employees within an organisation was first recognised in the 1920s and initiated by the work of Paton (1922). The topic began to attract increasing interest in the 1960s with the emergence of social accounting,[3] which was the practice of informing interested parties about the effects and impacts of the actions taken by a business.

In the 1970s, the specialist field – which was increasingly referred to as ‘accounting for people’ – became an area of considerable interest within accountancy. However, over the next 20 years the topic fell from favour. This was mainly due to some of the fundamental challenges facing mandatory reporting (discussed below). In particular, the problem of producing credible financial valuations for accounting practitioners was considered to be a very significant one.

Interest in the area began to re-emerge in the mid-1990s with developments in the intellectual capital (IC) and knowledge management fields. These areas began to be seen as fertile ground for research. Since then, the topic has been of ongoing interest to academic researchers and accounting practitioners, and this has resulted in a range of further studies (Roslender, 2010a; Roslender, 2010b).

3.4 Key academic contributions to this field

As mentioned above, Paton (1922) was one of the earliest proponents in this field. He recognised ‘labour’ as an important element to include on the balance sheet, together with ‘land’ and ‘capital’, the other two key factors of production. Paton’s work also affirmed the growing importance of accounting within the enterprise (Roslender, 2010a; Roslender, 2010b). Hermanson’s work in the 1960s is also important here. The term ‘human asset accounting’ was coined by him. He identified employees as operational assets by comparison with actual owned assets, and considered them to be just as significant from a business perspective in terms of wealth creation. To support this, he argued for a robust valuation methodology to calculate the value of human assets so that they could effectively be presented as a clear value of the business (Roslender 2010a).

Hekimian and Jones (1967) presented an alternative approach to the valuation of employees within a business, based on opportunity costs (as opposed to replacement

[3] Typical social accounting types of reporting included environmental accounting and CSR reporting.

costs). This value would be estimated by how much managers would be willing to bid to retain a specific employee. A further contributor to the debate at this stage was Likert (1967). Likert mapped patterns of management and argued that productivity improvements could be linked to strong management systems. This ultimately affected the valuation of the business. Likert aimed to highlight how this could be changed and what aspects organisations should be particularly concerned about.

Flamholtz, quoted by Roslender, argued in 1974 that valuation of labour was not only about putting people on the balance sheet (human asset accounting) and stressed the importance of employees within accounting processes. He proposed a broader understanding of this concept and argued that “human resource accounting should focus on providing management with accounting information on employees to assist them in their decision-making, planning and control tasks” and that “accountants should embrace the challenge of providing relevant human resource cost information beyond that associated with labour costs in the income statement” (Roslender, 2010a). In this way, managerial accounting would be designed to make businesses more effective and efficient by providing methods of measuring human resource cost and value. Most importantly, it would potentially offer a way of thinking about the role of people in the organisation (Roslender, 2010b; Roslender, 2010a). This work was associated with the development of the term ‘human resource accounting’.

Peters and Waterman (1982) were significant in popularising the notion of putting employees at the centre of a business. They are attributed with the development of the declaration “Our people are our greatest asset”. While their work is embedded more in popular management literature than in academic literature, their thinking served to highlight the fundamental problem of how to value employees. They were not concerned with accounting and reporting matters, but did mobilise much interest in the role and value of employees in a successful business.

The latest contributors, since 2000, to the accounting for human resources (HR) debate are an academic group at the Personnel Economics Institute (PEI), Stockholm Business School. The focus of this group is on human resource costing and accounting (HRCA), which specifically aims to develop new methodologies for determining valuation and which proposes alternative counting (valuation) processes. This was informed by previous work in the field of utility analysis and emerged through the psychology literature rather than accountancy (Roslender, 2010a, p. 5). This is directly relevant for mandatory accountancy practices because measures of valuation of employees must be universally agreed amongst those who would be obliged to provide reporting data.

3.5 International practices in mandatory reporting

Looking across a range of other countries where compulsory reporting or aspects of this have been introduced, we can see efforts being made to capture some financial and narrative information on a mandatory basis. In particular, there is Denmark where a mandatory framework with a voluntary content has been established.

In **Denmark** it is mandatory for organisations to include an account of the formation of intellectual capital (IC) in the annual report. And whilst this is a mandatory requirement there is also a strong voluntary component in the reporting procedure. First issued in 2000 and further developed 2003, “an intellectual capital statement is an integrated part of company knowledge management” (Danish Ministry of Science, Technology and Innovation, 2003b, p. 7). An IC is based on four types of knowledge resources: (as commonly applied in the IC field): employees, customers, processes and technologies). These are evidenced through four elements, which constitute the IC statement itself – representing an organisation’s knowledge management work. These are: (1) the knowledge narrative; (2) the set of managerial challenges; (3) the number of initiatives; and (4) the relevant indicators.

The IC statement has both **internal** and **external** objectives. Internally, it is seen as a management tool used to generate value in a company. IC statements are seen as a part of private and public sector organisations’ knowledge management strategies to build and systemise knowledge management. Externally, IC statements are used to communicate knowledge management objectives, initiatives and results to a number of target groups (including potential employees, customers, partners, investors and citizens). Therefore, communication of IC statements could help to attract new employees, customers and even investors. It provides an opportunity for companies to show that they are innovative and flexible, and that knowledge and HR are important assets (Danish Ministry of Science, Technology and Innovation, 2003b).

Guidelines

Danish IC statement guidelines, the first of their type in the world, have been based on the actual experience of 17 companies. They participated in the Danish Agency for Trade and Industry project on IC statements, each company preparing two sets of IC statements. These provided a foundation for the guideline to help other organisations start preparing IC statements (Danish Agency for Trade and Industry, 2000). The guidelines demonstrate that the reporting approach is built on the same principles as financial statements, asking questions relating to the same issues. The difference is in how these questions are asked. The table below presents a comparison of financial statement questions and IC statement questions.

Comparison between financial statements and IC statements

Financial statement	Intellectual capital statement
What are the organisation's assets and liabilities?	How is the organisation's knowledge resource comprised?
What has the organisation invested?	What has the organisation done to strengthen its knowledge resources?
What is the organisation's return on investment	What are the effects of the organisation's knowledge work?

Source: Danish Ministry of Science, Technology and Innovation (2003a).

The Danish Ministry of Science, Technology and Innovation report (2003b) gives guidance on how to prepare IC statements. This is done by providing:

- An overview of how IC statements might look like to companies from different sectors.
- Information about the key aspects to be covered in each of the sections of the IC statement, and what is the most useful structure.
- Guidance on particular sections of the IC statement.
- Understanding of the main challenges that companies might experience when producing the IC statement.
- Practical examples of how this has been done in particular companies in the past.
- Guidance on how to provide external IC statements (their content, structure, presentation and an ideal model).
- Support for how to embed the development of IC statements in the organisation (e.g. how to drive the process forward, who should have the responsibility for producing it, and how to ensure the quality assurance of the process).
- Benefits.

The following figure shows the proportion of 100 Danish companies (across a wide range of sectors) with IC statement objectives.

Proportion of companies with the following intellectual capital statement objectives

Source: Danish Ministry of Science, Technology and Innovation (2003b).

An IC statement is both a "management tool" to generate value in a company and a "communication tool" to inform stakeholders (employees, customers, investors etc) how an organisation is generating value for them (Danish Ministry of Science, Technology and Innovation, 2003b, p. 7). Looking specifically at some of the perceived benefits of this approach in Denmark, a Danish Agency for Trade and Industry report (2000, p. 8) summarised the key benefits for companies providing IC statements. A statement was considered useful for the following reasons:

- It is a tool for managing knowledge resources and thus creating added value in organisations.
- It can help to structure and assign priorities to knowledge-management efforts within the organisations.
- The process of preparing an IC statement may help to create a culture of knowledge sharing.
- It creates a common identity by telling the organisation what it must know and what it must excel at.
- Publication of IC statements may lead to better communication (with internal and external stakeholders).

- It may help to attract new employees.
- It may improve communication between company and customers.

In a number of other countries there are further examples of elements of reporting processes that are mandatory. Some of these are presented below.

- In **Canada** – Since 2002, the Canadian Performance Reporting Board (CPRB) has been aiming to improve the quality of business reporting of listed companies. In this context, it developed the Management's Discussion and Analysis (MD&A) tool, which is used for communicating information about the financial performance of an organisation alongside financial statements. This move was undertaken in recognition of the fact that financial detail alone will not provide enough information externally to be able to assess the performance and prospects of an organisation. Ongoing improvements to the MD&A tool have been made to ensure that, for example, the information provided is linked to organisational strategy. The Canadian Securities Administration regulates the preparation of the MD&A (Canadian Performance Reporting Board, 2009).

- In the **United States** – In 2002, the Sarbanes–Oxley Act was passed to set new standards for all US public company boards, management boards and public accounting firms. The Act was passed in the context of problematic accountancy processes that contributed to considerable losses by investors (such as the well-known case of Enron[4]), although the standards do not apply to privately held companies. The Act has a number of elements. Most notably, it resulted in the creation of the Public Company Accounting Oversight Board to oversee and regulate accounting firms providing auditing services. Other notable aspects include the requirement that auditors are entirely independent of those for whom they provide services, that individual senior executives take responsibility for the accuracy and completion of corporate and financial accounts, and that enhanced financial disclosures – including off-balance sheet transactions – must be provided (Kuschnik, 2008).

- In the **European Union** (EU) – In 2003, the European Parliament approved an amendment to the EU accounting directives. This was done to complement the IAS changes in 2002, which require all listed companies in the EU to use IAS from 2005 onwards. The 2003 change enables this to be extended to all companies

[4] Enron went bankrupt in 2001; it was one of the largest and most complex bankruptcies in US history.

and is intended to encourage a large-scale shift towards high quality financial reporting (EC, 2003).

- In **Belgium**, private and public sector organisations (with some exceptions) are obliged to provide employee data on a 'Social Balance Sheet' to the National Bank of Belgium, together with their annual accounts.[5] The information required covers formal and informal training conducted at the employer's expense (e.g. number of workers in receipt of formal/informal training; number of hours of training undertaken, net cost to business) plus a full breakdown of workforce characteristics (education level, occupation etc.).

- In **Austria** – The valuation of intangible assets and intellectual capital reporting (ICR) has been an issue for discussion in Austria over the past decade. In 2001, the Austrian Ministry for Education, Science and Culture undertook a review focusing on the higher education sector. In universities, although annual reports are not required in the same way as in the private sector, there are nevertheless assets that need to be accounted for and considered. In 2002, the Austrian Parliament agreed that it would become mandatory for universities to publish IC reports. In the context of a reorganisation of the entire Austrian university sector, performance contracts between funders and universities were to be set up and reviewed every three years. These contracts and progress made towards the goals therein would be reported annually through a performance report. The IC report was designed to be published in parallel with the performance contract and the performance report. The concept of the IC report is to provide universities with the opportunity to report on all of their work (and not to be limited to the aspects of their work previously mentioned in the performance contract and report). In addition to facilitating the communication of what has been done and achieved, the IC report provides a tool to assist with management and strategic decision-making within the university (Heinz Leitner, 2002).

3.6 Mandatory reporting in R&D environments[6]

Reporting processes within a research and development (R&D) context were considered in order to provide insight into any potential lessons that may be of relevance for the HCR debate.

[5] For further details see the National Bank of Belgium's guidance: http://www.nbb.be/pub/03_00_00_00_00/03_04_00_00_00/03_04_01_00_00/03_04_01_08_00.htm#1

[6] Some of the core elements of this analysis are presented here and the full detail is presented in Appendix A.

The R&D reporting practices for listed companies in the UK and Australia are identical. Both countries follow the International Financial Reporting Standards (IFRS) IAS 38 when accounting and reporting R&D expenses. Once established and measured[7] under IAS 38, R&D expenses are reclassified as research phase costs and development phase costs. Research phase costs are always shown as expenses, while development phase costs are capitalised under certain conditions.

If it is not possible to distinguish the development phase of a project from the research phase, all of the expenditure should be treated as if it had been incurred in the research phase. Patents, like the other types of intangibles, are not reported explicitly in financial statements. However, in combinations or other types of transactions involving intangibles these are assessed at a fair value and reflected in the financial statement of the buyer (and that of the seller).

In the UK tax credits are used as instruments for R&D incentivisation. This is also the case with the use of tax credits in Australia. However, in addition, the previous transition from A-GAAP to A-IFRS has resulted in a restriction in the ability of Australian companies to capitalise intangible assets (Ekberg and Lindgren, 2007). This may result in reduced investment in R&D.

In the USA there is an ongoing transition from US-GAAP to IFRS and this is expected to be completed by around 2014. The IFRS is more liberal in that it allows capitalisation of particular R&D expenses. Therefore, it offers incentives for companies to pursue R&D and as a result, if successful, to increase their value. It has been suggested in the media (USA Today, 2008) that adoption of IFRS in Europe has boosted income, investment returns and other financial measures of European-based companies.

Therefore, there are existing accountancy practices for the reporting of development phase costs in R&D in certain situations. These may inform the HCR alternatives to some extent.

3.7 Mandatory reporting in environmental and sustainability contexts

The world's most widely used sustainability reporting framework is the Global Reporting Initiative (GRI). The GRI aims at continuous improvement of the framework and the expansion of its application worldwide. This is a voluntary reporting framework. However, in Finland there is an example of the use of mandatory reporting in relation to some aspects of environmental reporting. The most significant governmental activity regarding

[7] Unlike in the US, measurement in the UK and Australia is based on the cost model or the revaluation model, but only if the intangible asset trades in an active market.

sustainability reporting is the new Accounting Act introduced in 2005, which requires organisations to report on environmental aspects, together with financial information, in the annual report of the board.

In terms of the impact of this in Finland, evidence is relatively sparse so far on the difference this has made in real terms. However, Schadewitz and Niskala (2010) have analysed the market valuation of listed Finnish firms. Combining a conventional valuation model with responsibility reporting, they concluded that communication via GRI responsibility reporting is an important explanatory factor for a firm's market value. They found that this approach improved communication between companies and investors as it enabled a clear mechanism to provide relevant information and an understanding of how organisations were different from one another in this regard.

3.8 Challenges of mandatory approaches

Two main challenges may be identified to the development and use of mandatory reporting. These challenges involve (i) conceptual and (ii) technical aspects of reporting that may make the process difficult. Each of these is considered in turn below.

3.9 Issues around conceptual aspects of mandatory reporting

- This set of challenges relates to fundamental questions of why and how to put people on the balance sheet. A core issue here is the principal objective of accounting for employees within the valuations of organisations: is it just about "putting people on the balance sheet" or a broader issue of providing HR information for better management, decision-making and planning? Perceptions of the relative importance of particular approaches are not uniform in the academic community and between accounting practitioners, which makes this a contentious matter.

- Building upon the above point, a further challenge relates to how to account for health and well-being in IC and how to compare it to other human capital attributes (such as education and training, experience and expertise, team working, and ability to innovate and accommodate change and uncertainty). Also relevant here is how to account for sickness absence (and prolonged sickness absence in particular) and the emergence of new forms of presenteeism.[8] Detailed information about the duration and cause of absence may be a useful

[8] Presenteeism refers to the increasing number of people continuing to attend work while medically unfit.

activity for management accounts and might provide more value than seeking to quantify the cost of such absences, as it is the common practice now.

- An increasingly common view is that the solution is a new financial reporting instrument – in a form of narrative reporting, an updated operating and financial review, or a new business review. At the same time, on profit and loss statements people are put under the 'costs' category although people are really perceived as assets. The current conditions preclude an option of treating people as investments rather than costs (Reddy, 2010).

3.10 Issues around technical aspects of mandatory reporting

These challenges relate to the technical difficulty associated with devising a robust valuation methodology. This is problematic because there are fundamental differences in the way that organisations may approach aspects of this. Differences may relate to, for example, how to determine the value of human capital assets and how to identify the appropriate amortisation models to capture human capital.

In the 1960s and 1970s, numerous potential valuation methodologies were developed, but a consensus was lacking about whether they were suitable and how well they would fit in the framework for financial accounting and reporting (Roslender, 2010a; Roslender, 2010b). The main issues focused on two key problem areas:

- **Subjectivity** – what to include in order to provide a reliable basis on which to base accounting calculations.

- **Comparability** – between one enterprise's balance sheet and another, even when using the same valuation methodology (Roslender, 2010a, p. 3).

3.11 Possible directions for mandatory reporting

In general, the direction of thinking on mandatory reporting may be broadly described as moving from "representing people on the balance sheet using a hard number financial valuation" to "encouraging people to produce their own accounts of contributions to the value creation and delivery process" (Roslender, 2010a, p. 2). Within this broad shift there are numerous strands of thinking about the direction in which this issue should go. Some possibilities are as follows:

- Broadening the scope of the managerial accounting discipline from the traditional exclusive jurisdiction to being increasingly inclusive (Roslender, 2010a; Roslender, 2010b).

- Moving from narrow accounting to cross-functional collaboration with other management disciplines (Roslender, 2010a).

- Combining the financial (numerical) aspect with more narrative elements to provide a more insightful story, from business reporting to corporate reporting.

- Using new management accounting and the developments in scorecard reporting frameworks as a means of reporting non-financial information to managers. The strength of the balanced scorecard remains in its reporting capabilities, which complement the strategy map. Scorecards are aimed at providing management accounts information from a number of complementary perspectives. Scorecards retain their reliance on numbers, although they have been mainly used to give non-financial information.

- Combining scorecards and strategy map concepts as complementary developments to provide a highly valuable synergy. Strategy mapping is seen as a way of providing pure financial information along with more intangible information that may be broadly categorised in three groups: organisation, information and human capital (Roslender, 2010a).

- Broadening the scope of scorecards – from being based predominantly on quantitative information to being concerned with more qualitative information (in the form of narrative-based reporting frameworks).

- Introducing self-accounting as a possible alternative narrative approach (Roslender and Fincham, 2001). These researchers believe that “accounting for intellectual capital still continues the practice of imprisoning people (human capital) within other people’s accounts” (Roslender, 2010a, p. 14). They suggest that people should be able to provide their own narratives about their status and activities through the provision of self-accounts. The authors identify the internet – particularly advanced social networking technologies – as a possible tool for continuing dialogue. They believe that people will see such opportunities as a way of promoting better understanding and cooperation across organisations. Incorporation of elements of self-reporting on health and well-being issues is presented as a way of promoting a better understanding of absenteeism as well (Roslender, 2010a, pp.15–17).

3.12 Conclusion

There are examples of mandatory narrative reporting processes in other countries, such as Denmark, where this approach has become accepted practice. It is also evident in specific sectors, an example being environmental reporting in Finland (where environmental reporting has clearly increased).

We can see from the evidence presented above that the issues involved in agreeing on the conceptual and technical aspects of mandatory reporting are considerable. However, these challenges are not insurmountable.

There are a number of possible directions in which mandatory reporting could go. For this approach to be successful, gaining agreement on the fundamental conceptual elements would be required to provide a foundation for future development.

4 Option 2: Voluntary code of practice

4.1 Introduction

This chapter sets out the core aspects of voluntary reporting as a possible direction for HCR. In order to do this, the background and context of the concept of voluntary reporting are examined. Secondly, the key academic contributors to the field are briefly reviewed. International practice in the area and the role of voluntary reporting in various policy contexts are considered. Some of the challenges of this approach are discussed and, finally, possible directions for this option of HCR are summarised. This again builds upon the previous work on HCR carried out by the UK Commission and the potential to modify accountancy standards.

The concept of voluntary reporting is defined here in terms of the introduction of a code of practice that would initially be adopted by a large proportion of organisations in the public and private sectors. As a consequence of growing participation in a code of practice, the adoption of best practices would occur on a large scale.

4.2 Background

There are three main theories put forward by Guthrie *et al*. (2007) that relate to voluntary reporting and annual reports:

- The first is a **legitimacy theory** that organisations should and will report voluntarily, owing to their obligations to the larger society. The rationale for this is described as follows:

  > a company would voluntarily report on its activities if management perceived that these particular activities were expected to be undertaken by the communities in which it operated. Legitimacy theory relies on the notion that there is a ‘social contract’ between the company and the society in which it operates. (Guthrie *et al*., 2007, p. 36)

  Furthermore, companies must continually appear to be operating in a manner that is consistent with societal values. This is often achieved through informal and formal methods of communication, such as company reports in the latter instance.

- Secondly, there is the **institutional theory** that firms may anticipate the direction of developments in mandatory reporting and may respond ahead of time to gain access to capital and continued support from the financial markets. Larger firms have more resources to take the initiative and therefore may be the forerunners.

- Thirdly, there is a **theory based on the rights of stakeholders**. According to this, all stakeholders, particularly investors, have a right to be provided with information about how organisational activities impact upon them. This will generate demand for the information to be provided (Guthrie *et al*., 2007).

4.3 International practices in voluntary reporting

Aside from Denmark, with its strong voluntary component in a mandatory reporting framework. some voluntary reporting guidelines also exist in other European countries, Australia and Japan (Guthrie *et al,* 2007), as detailed below.

- In **Europe** - the European Commission introduced some initiatives for measuring, managing and reporting on IC. For example, the RICARDIS project (2006) adopted the Meritum classification of IC. The aim of the project was to stimulate ICR in research intensive small and medium-sized enterprises.

- In **Australia** - the government has set up the Australian Government Consultative Committee on Knowledge Capital (AGCCKC) to 'produce a set of comprehensive knowledge capital standards whose application across the public and private sectors will contribute to the development of Australia as a competitive knowledge economy' (AGCCKC, 2004, p. 2, reported in Guthrie *et al.*, 2007). The Australian Guiding Principles on Extended Performance Management (EPM) were produced by the Australian Society of Knowledge Economics.

- In **Japan** - Guidelines for Disclosure of Intellectual Assets Based Management were released by the Ministry of Economy, Trade and Industry in October 2005. These guidelines are to help managers produce an intellectual-assets-based management report to provide a deeper understanding of how the combination and utilisation of intellectual assets creates value.

- Furthermore, in the **United States** – a proposed standard for what kind of information public companies should disclose, regarding human capital, was published in draft in 2012.[9] Drafted by the Society for Human Resources Management (SHRM), it is awaiting approval by the American National Standards Institute (ANSI). Although voluntary, "it could create pressures on companies to develop some uniformity in what they report", according to Laurie Bassi, McBassi & Co., who chaired the workgroup which drew up the standard (McCann, 2012).

[9] The second Public Review Draft Version was published on 5th October 2012 and is available here: http://hrstandardsworkspace.shrm.org/apps/group_public/document.php?document_id=6684

4.4 Voluntary reporting in environmental and sustainability contexts

As discussed in the previous chapter, a widely used sustainability reporting framework is the GRI. Within the GRI, there are G3 guidelines, which are the cornerstone of GRI's Sustainability Reporting Framework. This is used on a voluntary basis. However, in Finland there is mandatory reporting in relation to some aspects of environmental issues. By comparison, both the UK and Australia have voluntary approaches to environmental reporting.

There is an increasing trend towards getting third-party assurance for the sustainability report and to integrate the sustainability report into the company's annual report. The assurance providers generally use AccountAbility AA1000 or ISAE 3000 assurance standards.

Other relevant guidelines include the United Nations Global Compact (UNGC), the Organisation for Economic Cooperation and Development (OECD) Guidelines on Multinational Enterprises, and the International Organization for Standardization (ISO) – ISO 14000 series and ISO 26000. Each of these covers aspects of environmental and/or social responsibility. A recent initiative, The Prince's Accounting for Sustainability Project (A4S), launched by HRH the Prince of Wales, provides guidance on sustainability reporting. Also, the Carbon Disclosure Project (CDP) under the Climate Disclosure Standards Board (CDSB) assists companies in measuring the carbon emissions across the globe, data from which is made available to wider audience.

A summary of the approach to environmental reporting in the UK, Finland and Australia is presented in Table 1.1.

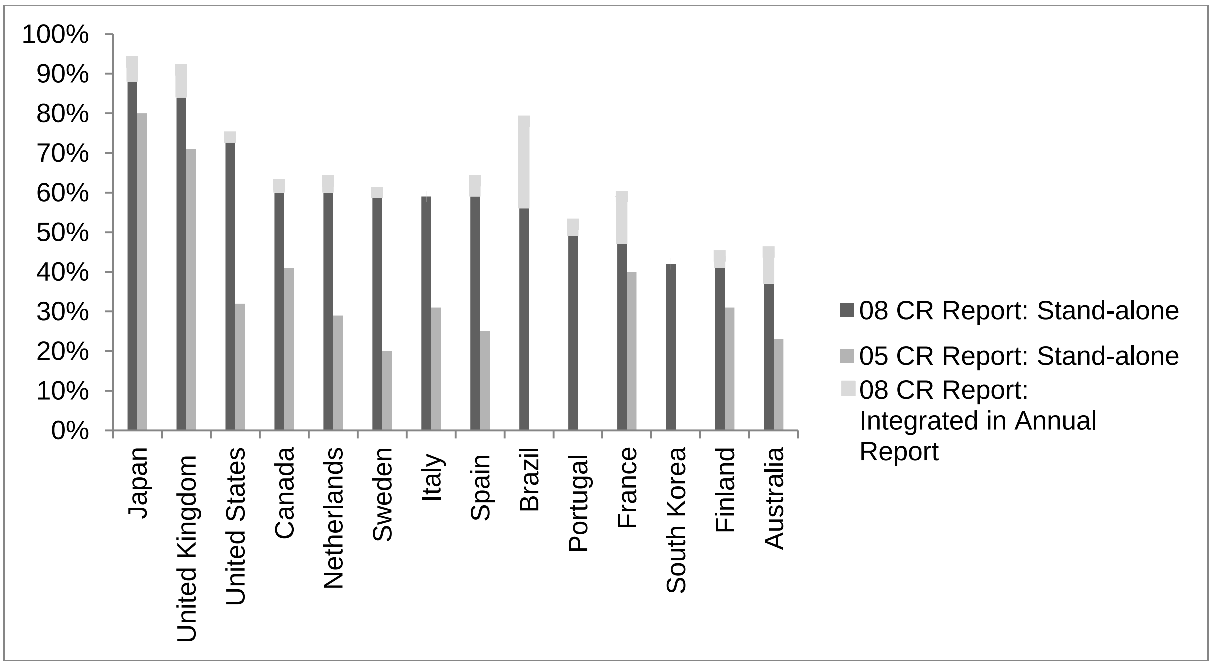
Table 1.1 Comparison of environmental reporting practices

	UK	Finland	Australia
Current situation	***Voluntary***: One of the countries with the highest percentage of reporting on carbon emissions. This becomes a mandatory requirement from 2012.	***Mandatory*****:** Some of the earliest environmental reporting. It is mandatory to report on environmental and HR issues in the report of the board. 72% of companies use G3 guidelines and 30% get external assurance.	***Voluntary*****:** Level of reporting lags behind that observed in other developed countries. However, it has doubled since 2005.

Related legislation and guidelines	Government regulations[10]; Climate Change Act 2008; Guidance from Defra[11], AccountAbility; GRI G3 guidelines.	Accounting Act 2005; Guidelines by National Accountancy Board; GRI G3 guidelines.	National Greenhouse and Energy Reporting System (NGER); Carbon Pollution Reduction Scheme (CPRS); Australian Securities Exchange (ASX); Principle 7: GRI g£ guidelines.
Trends	Integrated reporting, carbon reporting and assurance.	Increasing trend of broader corporate responsibility reporting with assurance and third party comments.	Increasing sustainability reporting.

Interestingly, although the UK does not have mandatory environmental reporting, a study in 2008 by KPMG showed that the UK produces more stand-alone and integrated carbon reports than Finland. This is shown in Figure 1.1. While it may be argued that this may simply reflect differences in accountancy practices in the different countries, it is nevertheless an important observation in this context.

Figure 1.1 Comparison of international carbon reporting data



Source: KPMG (2008).

10 Connected Reporting- A practical guide with worked examples, 2007. The Prince's Accounting for Sustainability Project, Available from [http://www.accountingforsustainability.org/files/pdf/Connected%20Reporting.pdf], Accessed on 06/10/2011.

11 Environmental Key Performance Indicators- Reporting Guidelines for UK Business, Department for Environment, Food and Rural Affairs, 2006, Available from: [http://archive.defra.gov.uk/environment/business/reporting/pdf/envkpi-guidelines.pdf], Accessed on 06/10/2011.

4.5 Challenges of voluntary approaches

There are a number of potential challenges that may arise in the context of introducing and maintaining voluntary reporting processes. These are set out in the sections below.

The ACCA has highlighted some challenges in voluntary reporting. First, the issue of how organisations need to ensure that their disclosures on HCM are balanced and credible has been raised. Organisations generally tend to focus on the positive elements of performance and steer away from including any less positive aspects. To ensure balanced and credible reporting, ACCA suggests an independent assurance of reporting on specific areas (ACCA, 2009).

Secondly, the issue of how an organisation communicates in what way it is adding value to the business by investing in human capital data was presented by ACCA. Most organisations tend to provide the raw data with little commentary or explanation about why this has been collected and what value it brings. Analysts, on the other hand, are not interested in the raw data but want an explanation of how any performance improvements or strategic developments are being used to leverage opportunities in new markets or keep up with competitors.

An ASB report (2009b) also discussed some of the challenges to voluntary reporting. In particular, it focused on preparing a good quality annual report that communicates all the important information effectively. The report mentioned the following challenges:

- **Content** – not including all the important and required information. Sometimes companies are struggling to report due to a lack of clarity regarding the requirements.

- **Communication** – ineffective communication of that content.

- **Clutter** – an excess of immaterial detail may detract from potentially important information.

A study by Stiles and Kulvisaechana (2003) on voluntary reporting presented the possible challenges experienced by firms implementing more systematic and standardised HCR. These concerns are particularly relevant to knowledge-intensive industries such as biotechnology. Their concerns are as follows:

- A fear of sensitive knowledge being made available to competitors.
- A fear of criticism from employee unions, creating restrictions on labour force flexibility.

- Concern about the practical difficulties in data collection and whether investors will understand the information once it is presented to them.

A recent study by Beattie and Smith (2010) discussed the mandatory requirements relating to human capital and noted that companies may make additional voluntary disclosures. Disclosing sensitive information is seen as a serious burden to companies in terms of the cost of information provision and the risk of disclosing information to competitors. The authors analysed the relevant literature on the documented level of disclosure and found that this had been evaluated as ‘low’. The reasons for this were related to the lack of an established reporting framework, the general lack of a proactive stance by companies in attempting to measure and report information externally, and the fear of competitors using such information.

The authors also looked at the issue of a potential for differences in the disclosure decision between the accounting and HR functions within the companies. They suggest that HR professionals attach significantly more importance than accounting professionals do to the views on the human capital contribution to value creation and its external disclosure. The authors also found that internal human capital information collation and external reporting are not aligned, and the possible reasons for it are the relative difficulties of measurement, the lack of a reporting framework, regulatory requirements and concerns about competitive advantage.

A study by Toms (2002) showed that the disclosure of IC information (which may include human capital information) could be self-perpetuating in terms of maintaining and enhancing IC value. This was based upon the view that “intangible asset creation occurs through enhanced reputation and disclosures influence the external perception of reputation” (Toms, 2002, p. 258). It was argued that this was particularly pertinent in relation to attracting, retaining and promoting the reputation of high calibre human capital.

4.6 Conclusion

Evidence from the use of voluntary codes of practice in different countries and sectors shows that this can work to effect change and to mobilise support, resulting in behaviour adjustments. It is possible to overcome the core challenges of this approach, such as the lack of uniformity in practice and the fear of competitive advantage due to disclosures. Indeed, many of the problematic aspects of the approach may also be used to the benefit of those participating (e.g. in demonstrating to investors organisational performance in HCM).

5 Option 3: Cultural shifts

5.1 Introduction

This chapter presents data relating to a cultural shift as a possible route to achieving HCR. In order to do this, the background and context of the concept of culture change is discussed. The key academic contributors to the field are briefly reviewed. Ways of facilitating cultural change are subsequently considered. Some of the challenges of this approach are discussed and possible directions for this option in HCR are summarised.

The concept of a cultural shift is used in the context of the potential to influence (rather than require) a change in behaviour in organisations, and in the wider context within which organisations themselves operate. It is considered in order to encourage reporting on human assets within a business. This shift may be brought about in numerous ways, possibly resulting in the creation of a groundswell of public opinion that affirms this approach as the correct one to take. The exact nature and form of the cultural shift that might take place under this option could be on a continuum from a minor shift (slowly increasing reporting of this type) to a major shift (producing a more widespread change in organisational behaviour).

Although there are a number of definitions of organisational culture in the literature, most authors agree that it may be defined as “the climate and practices that organisations develop around their handling of people, or [to] the promoted values and statement of beliefs of an organisation” (O'Donnell and Boyle, 2008, p. 4).

Organisational culture comprises a range of components, including organisations’ rituals, beliefs, values, norms, language and behaviours. These practices are often tacit and most exhibited by those who have been working in an organisation for a long time. Typically, the practices build on organisations’ past successes and contribute to building the organisation’s ‘norms’, which also form part of its culture. Those norms are defined as the organisation’s “established (normal) expected behaviour patterns” (O'Donnell and Boyle, 2008, p. 5). Franco *et al.* (2002), and Wallace *et al.* (1999) set out their views on how cultures and subcultures are formed, which is helpful in informing how best to influence cultural change.

5.2 Key academic contributions to this field

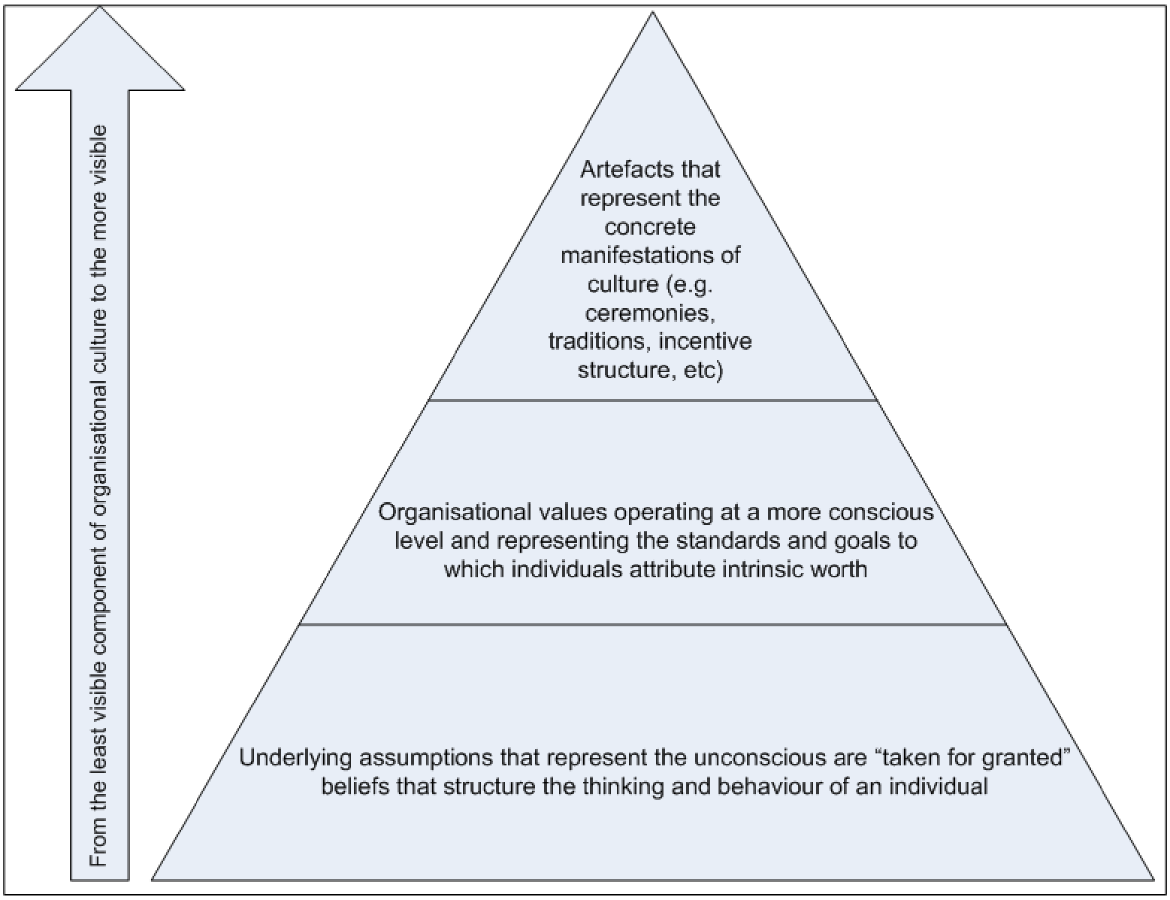
Understanding organisational culture requires scrutiny of the behaviours manifested within the organisation and consideration of what is driving those behaviours. Schein stresses that culture “points us to phenomena that are below the surface, that are powerful in their impact but invisible and to a considerable degree unconscious". Furthermore, he states that:

> we can see the behaviour that results, but often we cannot see the forces underneath that cause certain kinds of behaviour. Yet, just as our personality and character guide and constrain our behaviour, so does culture guide and constrain the behaviour of members of a group through the shared norms that are held in that group. (Schein, 2010, p. 8).

In addition, Schein refers to the four dimensions of culture. According to him, these are made up of structural stability (i.e. the perceived stability of the culture by the group), depth (unconscious part of the organisational identity), breadth (the extent of influence of the culture across all aspects of an organisation's activities) and patterning or integration (the ordering of patterns that connect all the behavioural elements together) (Schein, 2010).

In the context of effecting change, Davies *et al.* (2000) argue that organisational culture is made up of different levels (from the least to the most visible), as illustrated in Figure 1.2. In their description, they stress that the elements at the base of the pyramid are those that are most tacit (and therefore harder to identify and change), and those at the top are the most visible and easily addressed. It is important to note that each cultural level in the pyramid is connected from the base to the top. Therefore, underlying assumptions give rise to organisational values, which in turn give rise to more visible manifestations of culture. Hence, if only the top level of the pyramid is addressed by an organisational or culture change effort, the other two, which form the base, will not necessarily change and the change effort is likely to be unsuccessful. As O'Donnell and Boyle point out, "culture is particularly important when an organisation is undergoing significant transformation or when introducing major reforms which require different or new cultural value traits from those exhibited in the past" (2008, p. ix).

Figure 1.2 Levels of organisational culture



Source: Adapted from Davies et al. (2000).

5.3 Facilitating cultural change

This section highlights some of the ways of implementing organisational and culture change identified in the literature.

The Audit Commission, in its report on managing change to improve local services, presents a view of the different types of change that can be implemented at an organisational level (Audit Commission, 2001, pp.13–16). The two-axis "scale of change" (from incremental to step-change) and "style of change" (from directive to organic) respectively represent how radical the change is and how centrally controlled it is. The type of change required by an organisation will depend on both its current performance and the predictability (or otherwise) of its environment (Audit Commission, 2001, p.13). The type of change presented as most relevant to the public sector is "transformation".

Schein (2010) outlines a range of change mechanisms available at different stages of an organisation's development. Although many of these change mechanisms are mostly relevant for the private sector, some of them will undoubtedly also apply to public sector institutions. It is suggested that the change mechanisms most relevant for start-up and early growth organisations include those that produce incremental change through general and specific evolution and insight-based changes and promotion of staff to different roles within a culture. By contrast, for organisations mid-way through their growth, Schein suggests a number of possible change mechanisms, including systematic promotion from selected subcultures, technological seduction and infusion of outsiders. For mature organisations, Schein points to scandals and explosion of myths, turnarounds, mergers and acquisitions and a process of destruction and rebirth (Schein, 2010). These change mechanisms would form part of an organisational strategy to shift behaviour patterns.

Davies *et al.* (2000) highlighted other facilitators of 'best practice' in order to produce successful change in the context of attempting a cultural and organisational shift in the NHS. All of these areas are also applicable to other parts of the public and private sector. These key facilitators are implementing change incrementally rather than attempting a:

> wholesale and simultaneous change on all the many different aspects of organisational culture; a clear vision of where the organisation is going; taking into account the needs, fears and motivations of staff at all levels; and taking into account the interests and influence of other stakeholders (Davies *et al.*, 2000).

Turning to the behavioural economics literature, the Institute for Government's (IfG) report *Mindspace* outlines some tools for 'soft' behavioural change. It focuses on a cluster of activities that have been repeatedly found to have strong impacts on behaviour. These activities are presented in Table 1.2 and are listed by the acronym MINDSPACE (Messenger, Incentives, Norms, Defaults, Salience, Priming, Affect, Commitments, Ego) (IfG, 2010).

Table 1.2 IfG MINDSPACE approach to behavioural change

Messenger	we are heavily influenced by who communicates information
Incentives	our responses to incentives are shaped by predictable mental shortcuts such as strongly avoiding losses
Norms	we are strongly influenced by what others do
Defaults	we 'go with the flow' of pre-set options
Salience	our attention is drawn to what is novel and seems relevant to us
Priming	our acts are often influenced by sub-conscious cues
Affect	our emotional associations can powerfully shape our actions
Commitments	we seek to be consistent with our public promises, and reciprocate acts
Ego	we act in ways that make us feel better about ourselves

Source: IfG (2010).

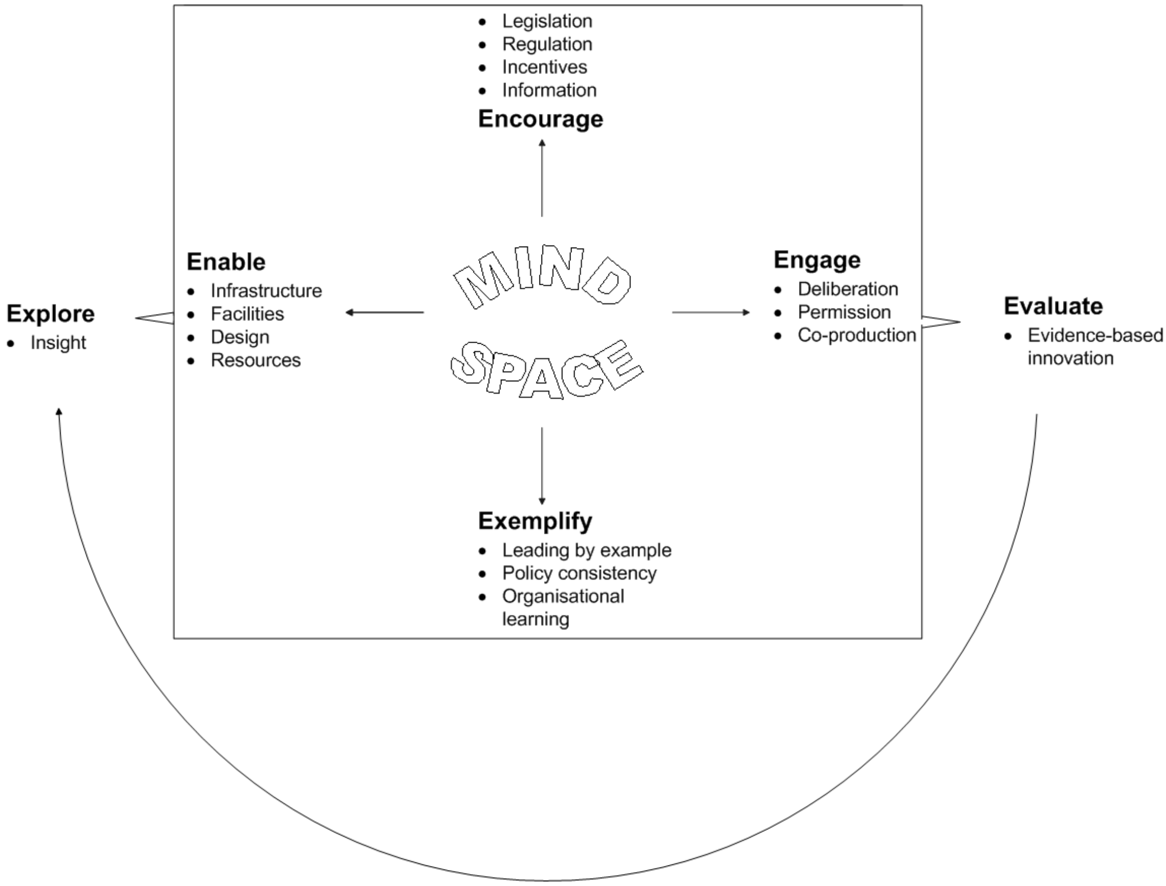
The IfG report also illustrates how MINDSPACE can be applied in practice in policy-making. In this, the report draws on the "4E" policy framework originally developed by the Department for the Environment, Food and Rural Affairs (Defra), which has been applied previously in various behaviour change strategies. The 4E framework describes the four actions that should underpin the government's attempts to change behaviour: Enable, Encourage, Engage and Exemplify. The IfG report adds two more supporting actions: Explore, which takes place before policies are implemented; and Evaluate, which judges the success of the policy. All six are briefly described below:

- **Explore** – understanding whose behaviour you are changing (how attitudes and motivations vary between the different groups of people).
- **Enable** – starting from 'where people are' by recognising the practical and structural barriers people face and the availability of choices they have.
- **Encourage** – applying MINDSPACE to change behaviour by understanding better the behavioural dimensions of policies.
- **Engage** – facilitating public debate and gaining approval and acceptance.

- **Exemplify** – changing government's behaviour (the actions of government representatives send messages about the behaviour it condones).
- **Evaluate** – working out what works. Although it may be unclear how various effects will interact in specific cases, policy-makers should aim for evidence-based innovation.

Figure 1.3 shows how these particular actions relate to and are linked with each other.

Figure 1.3 IfG MINDSPACE approach to behavioural change



Source: IfG (2010).

Thaler and Sunstein's (2008) work on the concept of 'nudge' also is an important strand of thinking in current behavioural economics. This approach focuses on establishing contexts for choices to be made – choice architecture – and then creating mechanisms through which people may make the best decisions for them

Bradley and Parker highlight some other facilitators of change, some of which overlap with those of Davies *et al.* (2000). These include keeping changes small and rewarding people for their successes, ensuring that all employees are aware of the organisation's strategic objectives, ensuring that employees know how they can individually contribute to the achievement of these strategic objectives, and supporting and rewarding experimentation (Bradley and Parker, 2004).

5.4 Challenges in undertaking organisational and cultural change

An Audit Commission report on improving performance in public sector organisations has highlighted six underlying reasons that cause public sector managers to feel frustrated with performance management (Audit Commission, 2002). These reasons were derived from the Audit Commission's in-depth work with 12 public sector organisations drawn from local government, the health service and the emergency services over a period of four months. They comprise the following useful list of issues that often impede cultural and organisational change (Audit Commission, 2002, p. 4):

- Leaders aren't interested.
- There's no time to learn.
- There are too many priorities.
- People don't understand that what we do has to change.
- The system doesn't help.
- Some people don't perform.

In addition, a United Nations Development Programme (UNDP) working paper on institutional reform and change management in the public sector highlighted a number of pitfalls that should be avoided in order to implement change in organisations successfully. These include not understanding the context of change, failing to make a compelling case for change and not creating a vision to direct change efforts, failing to acknowledge obstacles to change, and, finally, failing to persevere and maintain focus on change (UNDP, 2006).

5.5 Practice in undertaking cultural shifts

One example of cultural shift resulting in a change in public opinion comes from the field of corporate and social responsibility (CSR). Here there has been a significant shift in thinking in recent years. It was noted by O'Donnell *et al.* (2009) that there has been a global increase in CSR reporting. In 2005, 53 per cent of the top 250 companies of the Global Fortune 250 and 33 per cent of N100 companies issued separate corporate responsibility reports.

The scope and type of information included in CSR reports has also changed over the last few years. Prior to 1999, purely environmental reporting was dominant. In 2005 there was a move towards social, environmental and economic reporting. This was parallel to a rise in the number of industries including CSR in their annual reports. Growth in CSR reporting is seen by O'Donnell *et al.* (2009, p. 361) as a way to help "investors identify companies that will outperform others because applied CSR is correlated with strong financial returns and provides a measure of management quality and risk management systems".

5.6 Conclusion

The option of bringing about wide-scale change through a cultural shift in thinking about HCR is a complex one. The field of CSR shows that investors will value data on organisational performance (and potentially on the value placed by organisations on HCM). Literature on organisational change and behavioural economics highlights some of the difficulties of building a strategy around a cultural shift. The concept of cultural change is difficult to define and reach agreement on. A strategy to change culture involves grasping challenging issues and potentially will require a number of mechanisms to achieve the intended outcome.

6 Conclusions

The overall aim of this study has been to illustrate and consider mandatory and voluntary options to encourage the introduction of increased HCR in public and private sector organisations.

6.1 HCR in the UK

In the UK, at present organisations can undertake HCR through narrative disclosures (alongside their financial reporting), if they chose to do so. However, we know that this is not done by many organisations and that those that do often simply provide minimal data and information. The recent revision of narrative reporting requirements does not appear that it will considerably improve this.

The extent to which this contributes to ongoing underinvestment in skills development is outside the scope of this research. However, we can conclude that it results in missed opportunities for the organisations that do invest in the skill development of their employees to showcase this to various interested groups. Most notable among these are current employees, investors, customers and potential future employees. We may further conclude that this missed opportunity has a possible knock-on effect for other employees within similar sectors and industries, as their organisations do not need to compete in relation to the investments that they make in their staff (because this information is not available in general in the public domain).

6.2 Observations on the range of HCR reporting options

The form and strength of regulation in relation to the management of HCR is the central issue in this context. **Mandatory reporting** which incorporates HCR data (such as in Denmark) shows that it is possible to implement this approach. This has had an effect in relation to aspects of the reporting that have flexible content, which have been widely taken up. Other mandatory reporting may be seen in the environmental context in Finland and in a range of other countries in specific contexts. We also know that **voluntary approaches** can be implemented successfully, as seen in Australia and Japan. However, ongoing challenges such as the lack of uniformity and the fear of competitive disadvantage as a result of disclosure remain. Finally, a **cultural shift** to bring about a change of thinking in relation to HCR, as in the case of CSR, is possible but complex.

In reality, any enhancement in the reporting of HCM will not occur because of one of these factors alone. As in Denmark, it will rather likely be the combination of some element of mandation, which will raise the profile amongst business and non-HR professionals and voluntary approaches; those which encourage use of 'best practice' amongst groups or networks of businesses, alongside a groundswell of businesses seeking to present the best HCR to their investors, stakeholders, customers and competitors, encouraged by rewards and recognition.

6.3 Considerations for the design of human capital reporting requirements

This literature review poses a number of issues to consider in the design of HCR conditions, which would be useful to explore in further research, such as:

- The most appropriate form and strength of potential regulation (e.g. code of practice, mandatory reporting formats).
- How to build consensus for change and common understanding of underlying definitions and concepts.
- How to establish the right mix of quantitative and qualitative reporting.
- How to implement consistent practices while acknowledging the diversity of UK business practices.

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Appendix A: Comparable policy contexts - lessons from Research and Development

The reporting practices for Research and Development (R&D) in the UK and Australia are identical for publicly accountable companies. Both countries follow the International Financial Reporting Standards (IFRS), International Accounting Standards (IAS 38) when accounting and reporting R&D expenses. Once established and measured under IAS 38 (through the cost model or the revaluation model, which – unlike in the US – is applicable in the UK but only if the intangible asset trades in an active market) R&D expenses are reclassified as research phase costs and development phase costs. Research phase costs are always treated as expenses, while development phase costs are capitalised if six criteria are met:

- Intention to complete the intangible.
- Technical feasibility of completing the intangible.
- Availability of sufficient resources to complete the development.
- Ability to measure reliably any expenses incurred in the development of the intangible.
- Ability to sell or use the asset.
- Generate future economic benefit.

If it is not possible to distinguish the development phase of a project from the research phase, all of the expenditure should be treated as if it had been incurred in the research phase. Patents, as the other types of intangibles, are not reported explicitly in financial statements. However, in combinations or other types of transactions involving intangibles, these are valued (at a fair value) and reflected in the financial statement of the buyer (and that of the seller).

Before 2005, publicly accountable companies in the UK and Australia used the UK Generally Agreed Accountancy Principles (GAAP and Australian GAAP (A-GAAP)) respectively in reporting R&D expenditures. Within A-GAAP, there was not a standard way of dealing with all intangible assets. R&D costs had to be capitalised if “recoverable beyond reasonable doubt”. Intangible assets, other than goodwill, were subject to revaluation even if no active market existed (which is a very different and substantially more liberal regime than the one under IFRS). The transition to IAS does not seem to have been widely debated or, if so, the debate has had no impact. This appears to have been caused by the imminence of the need to conform to international standards of financial reporting. In the case of the UK these have been mandated by EU legislation, which sets forth the following statement:

> [by] 2005 all listed EU companies (including banks and insurance companies) must prepare their consolidated financial statements in strict accordance with IAS. Member States may also permit or require companies to apply the system to their annual accounts. Member States may also require application of the new rules in non-publicly traded companies (EC, 2010).

In the case of Australia, this change seems to have been necessitated by the need to stay in line with the rest of the world. The predominant accounting standard for financial reporting in the US (and the one required by the US Securities and Exchange Commission for publicly traded and other regulated companies) is the US GAAP. Although not all companies are required to follow it, there are certain situations, such as obtaining credit or seeking investors, in which those companies are required, by contract, also to follow GAAP when preparing their financial statements. Under the US GAAP, SFAS 142, once recognised and measured (using the cost model, not the revaluation model), R&D expenses are not treated as investments but as expenses. R&D costs (irrespective of whether they concern in-process R&D or not) are normally treated as expenses, unless they have alternative future use. Costs of software developed for external use are capitalised if the software is established as being technologically feasible. The costs of software for internal use are capitalised only when such costs are incurred during the software development stage. Patents, as the other types of intangibles, are not reported explicitly in financial statements. However, in combinations or other types of transactions involving intangibles, these are valued (at a fair value) and reflected in the financial statement of the buyer (and that of the seller). In certain circumstances and only for the purpose of comparability – for example, when a company that has operations outside the US plans to expand or report in format comparable to its competitors/partners – the IFRS may be used. Financial statements of foreign companies traded in the US are permitted to be submitted in IFRS format.

A transition to IFRS (and therefore IAS 38) for medium and small-sized entities in the UK has been proposed by the Accounting Standards Board (ASB) to take place from 2012. This sheds light on the process of implementing change to the prevailing standards. In particular, as part of this change, consultation is initiated with the aim of collecting feedback on proposed changes and particularly on their economic and financial impact. Various entities then express opinions which are reviewed and reflected in the implementation of the standards (not in the standards themselves).

A similar transition, restricted to publicly accountable companies, is currently underway in the US. There, a transition from US GAAP to IFRS has been agreed upon and is expected to be completed by 2014. The proponents of the change indicate that it is necessitated in response to globalisation and the need for comparability in reporting. Further, they indicate that, while the transition from US GAAP to IFRS is likely to result in billions of immediate costs, savings will outweigh these costs in the long run. The IFRS is regarded as more liberal in the sense that it allows capitalisation of particular R&D expenses; therefore it is considered to offer incentives for companies to pursue R&D and, as a result if successful, to increase company capital value. Another argument in support of this transition is that the adoption of IFRS in Europe has boosted income, investment returns and other financial measures of European-based companies. The opponents of this change claim, however, that it would be difficult to accomplish because it is complex and costly, and requires fundamental changes in education and accounting practice. The sides in this debate have largely been US Securities and Exchange Committee, US business, the Financial Accounting Standard Board, academia, International Accounting Standards Board (IASB), Public Company Accounting Oversight Board (PCAOB), International Federation of Accountants (IFAC) and other professional organisations (USA Today, 2008).

In the UK and Australia, which have transited to IFRS, tax credits for R&D are used as instruments for incentivising R&D. These instruments also have the aim of mitigating any adverse effects of transition on R&D activity.

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