The Operating and Financial Review and Human Capital Reporting

Is the OFR the place for Human Capital Reporting?

This briefing document is based on a roundtable on the OFR and Human Capital Reporting at Chartered Accountants' Hall, Wednesday 16 July 2003
‘In making their good faith, honest judgements about what information is material and should be included in their OFR, directors should be governed by the high level objective of the OFR, which is to enable users to assess the strategies adopted by the business and the potential for successfully achieving them. Information will be material to the OFR if failure to disclose it clearly, fairly and unambiguously might reasonably be expected to influence members’ assessments of the company and hence the decisions they may take, either directly, or indirectly as a result of the significance that the information has for other stakeholders and thus the company. Information that is material to the OFR may be quantitative or qualitative; and may relate to facts or probabilities, and to past, present or future events and decisions.’

Operating and Financial Review Working Group on Materiality:
Introduction

Over the years many organisations have declared that people are their greatest asset. Unlike financial reporting there has been no generally accepted procedure for measuring the quality and effectiveness of this human capital, although people – their skills and their knowledge – are seen as crucial factors in a business’s competitive advantage and profitability.

The last few years have seen a growing recognition of the need to develop a reporting framework for human capital, culminating in the establishment by the Department of Trade and Industry (DTI) of the Accounting for People Task Force which in the spring of 2003 published a consultation paper Accounting for People looking at the ways in which organisations can measure human capital management (HCM). A final report will be published in the autumn.

At the same time that thinking in HCM has been developing rapidly, the Company Law Review has driven the concept of a mandatory Operating and Financial Review (OFR) for larger companies. The OFR is perceived as a key channel through which directors can communicate the progress and the potential of their company. Unlike many other areas of company reporting, one overriding OFR principle is that the directors should not be given a prescriptive checklist telling them what should be in an OFR, rather there should be broad guidelines covering the general content and the process for the production of the Review. Using that guidance, over time, directors will have to shape the process and the product to suit their company.

Given that, could the OFR provide the way in which companies develop and refine their HCM reporting?
Human Capital Management in the OFR

An OFR in the annual report of a publicly quoted company (and other public interest organisations) is generally regarded as an important tool in providing transparency. An OFR requires the board to explain the overall business strategy and context in which the financial statements appear. The widespread belief is that it would be harder for directors to produce misleading figures in the main financial statements (the profit and loss account, the balance sheet and the cashflow statement) if those numbers are subject to a narrative produced by the directors within the same report.

While the OFR may provide an ideal place to discuss financial information, it does not necessarily follow that companies will find commenting on human capital equally easy. There is a depth of thinking on the CLR and the OFR in particular that is probably not yet present in the human capital argument. Much of the thinking around human capital up to now has been compliance-driven. For instance, Accounting for People originated from a study by the chairman, Denise Kingsmill, on ways to reduce the constant and consistent gap between women’s pay and men’s pay. A suggestion to reduce that gap – where women’s pay stays at around 80 per cent of men’s – was to report on ‘human capital’. This, in essence, would have been statutory reporting on gender equality in pay.

Out of that proposal came an idea which equates with both the spirit of the OFR to explain and discuss the business performance and the desire of certain users of company information to know more about companies’ human capital strategy. Human capital is now being seen as a productive and valuable area to capture in order to indicate the performance and prospects of a company. The OFR is seen to be the most logical place for such high level strategic reporting.

The OFR is discursive which suits the nature of reporting of HCM. In the view of many, such reporting is likely to remain a descriptive and judgmental narrative, rather than one that can be subject to a standard numerical formula. There are those who are working on standard formulae to quantify the value of people and the value of the strategy and practices for people in organisations generally, although many doubt how much progress will be made and how acceptable they will become in the foreseeable future. Perhaps more success is being achieved on developing metrics for individual companies or business units.

Framework for the OFR and HCM-orientated content

Since the Accounting Standards Board (ASB) first introduced the OFR into UK financial reporting in 1993, it has generally been acknowledged that the OFR should not be prescriptive. This idea of not wanting to place constraints on directors in the production of the OFR has been maintained by the Company Law Review and by the Department of Trade and Industry (DTI) OFR Materiality Working Group.

The directors should be responsible for deciding what information is material to their business, rather than the Government or any other external standard setter.

The OFR is produced to help investors and other users of financial statements to make decisions. Therefore the contents must be both relevant and material. One of the key questions facing those who prepare guidelines for the production of the OFR, and for those actually producing OFRs, is to establish what the concept of materiality means. Does it mean the same as for the financial statements, or does it mean something more subtle and more inclusive? In terms of HCM, which cannot be driven numerically, it seems likely to mean the latter. But the basic point remains that information in the OFR should be seen as capable of informing decision making.
The scope of the information to be included in the OFR is wide, covering both qualitative and quantitative information. It covers not only past events and statements of facts, but it also looks to probable events, risks and opportunities. The idea of materiality in terms of HCM should be seen as demonstrating that there is a link between the ways in which people in an organisation are managed and developed, and the underlying, ongoing business performance. In particular, HCM could be linked to business drivers such as innovation, efficiency and effectiveness. The OFR could be perceived as the bridge between ‘hard’ numbers and ‘soft’ people issues.

Those in favour of HCM reporting argue that there would be positive value in the OFR for companies, as well as public sector organisation and charities, to include a tailored statement on HCM. It would be important to avoid both standard wording and a prescribed standard set of comparable numbers that are not meaningful.

In the context of HCM reporting, there is some pressure for the OFR to include detailed prescriptive measures on criteria such as accidents, fatalities at work, the incidence of stress, or absence through sickness. Such an idea is against the non-prescriptive spirit of the OFR. It also runs contrary to the idea of relevance and materiality, as such information may not enable stakeholders and society in general to judge the performance of companies. This is particularly true in the context of HCM. It is argued that the most important information a board can give people who are trying to understand the company is what they, the board, believe the value drivers are.

The OFR could be the place where an organisation sets out its human capital strategy and values. The statement could be reinforced through the use of key indicators both in numerical and qualitative terms. Such a statement would have to be customised by each company preparing an OFR.

Such a use of the OFR would be an opportunity for organisations to contribute to an understanding of their performance and prospects, which is trackable over time by different stakeholders. Using the OFR in such a way could be a powerful rebuttal to the compliance-driven ‘capitalism is a savage beast’ line of argument if organisations are able to make explicit what they are doing in people terms. Over time the OFR could make a positive contribution to improving the process by which organisations’ ‘licences to operate’ are granted by society, rather than boilerplate clichés as seen in the past.

Research from inter alia the Chartered Institute of Personnel and Development among companies around the world suggests that there is a correlation between their performance and their long-term viability and the ways in which they develop and manage people.

The CIPD and others continue to identify the relevant practices. Statistically evidence shows that organisations with an explicit statement of people strategy and an explicit statement of the values and purpose of the organisation, and a clear understanding of how those two strategies relate are more successful than those that do not. Similarly, there is compelling evidence that shows that those organisations that take a positive approach to managing and developing people are more sustainably successful than those that do not.

The practices that make for effective people management and development include treating employees with respect, listening to them and investing in their skills and development. It is to do with treating them as contributors of value rather than as
cogs in a wheel. It is to regard them as assets with a contribution to make, not just as disposable resources to be shoved out of the door at the earliest opportunity. The problem has been demonstrating the linkage between people strategies and business performance. Some within the HR profession say there is reluctance to make explicit this linkage. Introducing HCM reporting into the OFR would give greater urgency to this issue.

There are signs of progress. For instance research at Bath University has produced a model called ‘Unlocking the Black Box’. The research tried to identify whether people management practices relate to business outcomes. It came to three conclusions: there is a series of people management actions to do with ability; a series to do with motivation; and a series to do with opportunity.

On ability, it is to do with recruitment practices. Bringing in people who have the right attitudes and the right potential for development and the right capability to be trained, rather than just hiring people expecting them to be really skilled now. It is then to do with training and developing them continuously so that they are enabled to contribute at a higher level. It is to do with the performance management of those people and the clarity of the objectives and the feedback they get. All this contributes to the building of the human capital inside the organisation.

The second series of actions relates to motivation, including objectives, performance management, reward systems and recognition systems. Many of these areas need to be in the hands of line managers. They do not work if they are just personnel department procedures but rather need to be devolved down through the organisation.

The third area of opportunity is the one that is probably the most often overlooked: whether people have the space to make change happen for the better. Are people enabled to have the autonomy, working on their own or with their work teams, to make a difference? Do they have the chance to put into practice the sorts of words that we all use, about seeking the willing contribution of people from all levels in the organisation? It is those types of areas that could be articulated in the OFR. But one model will not suit all organisations.

It remains vital that organisations determine for themselves the key measures. For some it will be the number of people with PhDs they recruit, or the number of patents they register. But without context – explaining the direction of the organisation and what it is trying to do through people – it is meaningless. Some of the key measurements produced will be quantifiable, while some will be qualitative judgements, but such a mixture should not be seen as a problem.

While there may be enthusiasm among the preparer community for greater inclusion of issues such as HCM, there is probably a widespread nervousness that is translated into statistics which take time and money to produce but do not achieve the purpose about achieving greater insight into the prospects for the business.

**The audience for the OFR**
The Company Law Review concluded that the responsibility of the directors was to the company and the members of the company as a group. The audience for the OFR and for a commentary on HCM has to be seen in that context.

However an issue can be directly and indirectly material to members. It seems inevitable that any stakeholders in the company (employees, customers, suppliers, government and society in general) will see themselves as potential or actual users of the OFR.
So while the criteria for relevance and materiality have strictly to be seen as what matters to members, in practice it may be difficult to see what difference this would make.

The effects of the company’s operations on the interests of employees, customers, suppliers, government and society in general affect the interests of members. All of those stakeholders are involved in either giving a ‘licence’ (either legal or consensual) to the company to operate in its existing markets or to move into new, untapped markets.

One common theme that emerges from all of the literature produced by accounting and auditing standard setters around the world is that materiality is consistently seen in terms of the effect it has on the decisions that might be made by the users of financial reports.

It is important to avoid a plethora of impenetrable statistics, especially in unfamiliar areas such as HCM. It is also important that organisations achieve consistency over time within the OFR. There should also be consistency between the OFR and other reports produced by the company. If something is reported in one year as an open-ended question then the DTI Working Group says that it should be answered in the following year, or if it is still open-ended, it should be noted and carried forward. The OFR should allow the reader to follow the story of a company from year to year.

One of the ways in which a handful of companies mislead shareholders is by being consistently inconsistent in terms of the measures they use from year to year. On the other hand, the OFR has to reflect the changing strategy of a business. So it is entirely consistent to change the measures to reflect that changing strategy. Ideally there would be an explanation of what has gone, explaining why it has gone so that measures once deemed important are not allowed to quietly disappear.

It has been suggested that the OFR should not be issued with the annual report. If the OFR is intended to carry new information, it is argued that there is no point in issuing it with the annual report as that does not move markets. Instead, if the OFR is to have the biggest impact and to be seen as useful, it should be issued with the company’s preliminary announcement. It seems unlikely that such a switch will happen in the short term.

The City’s view of the OFR is seen as crucial to its success. Preparers of financial information still believe that City analysts shy away from dealing with human capital issues in financial reporting. It seems that there is a Catch 22 where preparers don’t provide such information because analysts don’t ask for it, and they don’t ask about it because directors don’t provide much detail in this area. There needs to be a common language whereby companies and analysts can talk to each other about human capital issues to enable market participants to have a better understanding of companies and to be in a position to make better judgements.

It seems that there is a need for training for both users and preparers on human capital issues to allow for an increased understanding and greater general awareness.
Developing the framework and the measurements

Having identified what should be included in the OFR, the directors have to ensure that they can obtain that information. There has been a debate about whether directors are in a position to prepare the OFR. It is acknowledged that there are boards where all members are in touch with factors that affect the business, while other boards may not be completely in touch. Boards have to be aware of their own knowledge, skills and competencies and of those elsewhere within the company who possess such assets.

Whatever their depth of knowledge of the business, directors have two options. Directors can respond to requests as the new framework for the OFR emerges. Such an approach will add cost but it is doubtful whether it will add value.

The other option is for directors to control how the business is measuring and managing intangibles such as HCM metrics. A proper set of measures is required, and a reliable framework for measuring.

Under measurement theory a reliable framework needs to have completeness, independence, distinctness and a common unit. Developing a framework for intangibles can be difficult because of problems of completeness, independence and the common unit. Once a framework has been developed and approved by the board it is necessary to provide measures that are a representation of the assets and their use (it is their use that adds value not their existence). A range of issues can be looked at in this way from sales or market share through to more complex items such as customer satisfaction and staff attitude.

Producing these measures can be an effort and it needs willingness on the part of staff to engage in the process. Where these measures are devised for one particular business, or even one particular section of the business, it is highly unlikely that they will transfer to another business.

Organisations should be starting the measurement process now so that when it is needed for the OFR it is already available. But measuring what? That depends on the individual business. For instance, a business may need to manage how well people work in teams, or how well retail customers project its products to consumers. To manage such issues they need to be measured. Creating such a framework makes it easier for the business to do what it should be doing and to report externally on its activities.

Although it is good practice to base OFR information on the same information used by directors through the year, care needs to be taken in ensuring that statistics that are meaningful to management are not just placed in the public arena without fuller explanation to make them meaningful to shareholders.

The challenges posed by the OFR

While it is clear that the mandatory OFR will proceed, there is a strain of scepticism. Some commentators note that the process seems to be coming over burdensome as reflected in the work of the DTI Working Group and the ICAEW’s guidance on preparing an OFR, while others argue that the move to a statutory OFR should be seen as a failure of the voluntary system. Preparers of financial information are facing a period of unprecedented change (such as the revised Combined Code on Corporate Governance and the introduction of International Accounting Standards) so encouraging, even on a voluntary basis, disclosures of human capital management measures, must be treated with some caution. However, there is also a risk that if companies do not move in this direction some sort of reporting framework will be imposed by legislation.
**Looking at the future**
A constant tension between users and preparers of financial information is the users' desire for forward-looking information and the preparers' reluctance to provide it. The OFR provides an opportunity to put historical financial information into a proper context, at the same time as it provides a channel for the directors to provide a focus on the future. It is acknowledged that most users of financial information are interested in future outturns. However, many directors maintain it is not their role to predict the future, rather to provide information about the business so users of the financial information can reach their own decisions regarding future prospects.

**Even handedness**
The Company Law Review referred to ‘honest good-faith judgement’. In an age when there is widespread cynicism about the way organisations distort or select information to present the most favourable impression, rather than the truthful or correct impression, the OFR must avoid being seen by directors and by users as anything other than an even-handed document. It must describe the bad news as well as the good news, enabling users to make a fair assessment. This applies in the context of HCM, as elsewhere.

**Confidential information**
A great deal of discussion has taken place on the issue of ‘commercial confidentiality’ and whether companies may wish to hold back on certain information. Should there be an overriding exemption for excluding information which if issued publicly would harm the company? The DTI Working Party on the OFR concluded that general exemptions on the grounds of commercial sensitivity are inappropriate as there are already requirements to provide information to the market about significant issues. It is highly unlikely that the OFR would be the first time in which material and sensitive information would be disclosed to shareholders.

**OFR process guidance - making it happen**
For directors to produce the relevant information for the OFR, an appropriate, practical process that needs to be put into place. Companies need to start developing those processes now.

Recent research Through the eyes of management: a study of narrative disclosures (funded by PD Leake, a trust associated with the ICAEW) indicated that the quantity and quality of narrative disclosure is variable and that reporting of quantified forward-looking information is rare. It seems therefore that companies will need help on this issue. Quantification is needed to ensure the OFR does not descend into vague hype or boilerplate legalese.

The research did not show a strong willingness to disclose information voluntarily. It indicated that the best disclosers are those companies that have the widest consumer base such as privatised utilities and companies where the general public is buying their products. These companies need to signal a high level of respectability.

There is a paradox here. Companies still seem reluctant to disclose information for fear of giving away competitive information to a competitor. On the other hand, there is evidence to suggest that greater transparency would reduce the cost of capital. A related dilemma is that while the OFR may be aiming to advance competitiveness, it is actually adding to the burden of all companies – but especially smaller quoted companies – and thus directly reducing competitiveness.
Whatever the arguments, preparing and producing an OFR are a reality. Earlier this year the ICAEW published Preparing an Operating and Financial Review: interim process guidance for UK directors. It makes the point that forward-looking information requires most attention because many companies are clearly inexperienced in this area. However directors may still argue that it is not their place to talk too much about what is going to happen in the future. If the key risks are set out, and the way the company is being moved forward is explained, then it could be argued that investors not directors have to decide what the future may hold. It seems there is a strong feeling that it is not up to directors to ‘predict the future’. Organisations may make forecasts – for instance – about the sort of growth they expect to make in the year but they usually accompany that with careful caveats explaining the assumptions behind those forecasts.

The process guidance indicates that the OFR should comprise only items of information of such a size or nature that means their statement or omission might reasonably influence economic decisions. With annual reports having grown in size in recent years succinctness is important, otherwise there is a danger of overload for users. The board has to make a collective judgement on what to exclude and what to include.

The guidance sets out six principles on the process to follow when gathering information for an OFR and explains the reasoning behind these principles. The principles are:

• The OFR is the responsibility of the full Board of Directors.

• There should be a formal process for preparing the OFR.

• The OFR should be relevant and meet the recommendations of existing pronouncements on content.

• The OFR should be an integral part of the corporate reporting process.

• The process should involve explicit consideration of whether the OFR content is reliable, balanced and understandable.

• There should be continual evaluation and improvement.

The formal process for preparing the OFR will include examining the HCM measures that a company includes. The directors will need to form a judgement as to which information is relevant to disclose in the OFR. In any organisation there is a large amount of information potentially available to include and directors will need to assess HCM information in order to decide which of it meets the definition of materiality.

What goes in to an OFR should be based on the type of information that is presented to the board on a routine basis. There should not be an artificial process invented for year-end reporting which is out of kilter with perhaps a narrower process that existed in the board during the year.
The future for HCM reporting

At the roundtable, participants were asked: ‘In your organisation could the measurement and reporting of human capital ever have the same standing as financial reporting?’

The answer was ‘yes’ but for this to happen a number of enabling factors need to fall into place.

• A causal link needs to be evidenced from people metrics to both long and short-term measures of business performance in general and in particular to the sustainability of financial return on investment (ROI). This is likely to be both a generally accepted causal link and also the establishment of this link for the specific organisation.

• There needs to be a good understanding of the needs and expectations of your stakeholders so that there is a clear link between business performance, the non-financial metrics and to stakeholder wishes.

• The measures (a) need to provide more insight than the existing financial measures; and (b) need to be designed to be as objective as possible. From these two points then it needs to be possible to establish a link between the measures and a net present value (NPV) for the business. The measures need to be sufficiently robust so that they can be used for decision-making purposes. Would you base a decision on it?

• The organisation must have a corporate environment and culture where there is a commitment to change operations in response to the non-financial information.

• The use of human capital and other non-financial measures will be of greater relevance in more people-based/service organisations or where non-financial aspects are more important.

• For the system to be effective there needs to be a culture in the organisation that is willing to accept bad news from lower down in the organisation and by corollary does not suppress the news or punish the messenger.
Conclusions

The OFR will soon be mandatory. The pressure on organisations to produce HCM information will continue to grow. Directors should be proactive in their response to these two separate, but inter-related developments.

All the statements in the OFR, including those that relate to HCM, should be the words of the company and meaningful to it. They should be customised, dealing with data and explanations that are set exclusively in the context of the business. HCM measures must be capable of being tracked over time.

Organisations need to stop being shy about human capital issues if they are to give a full and fair view of performance and prospects in the OFR.
Further reading

Consultation paper, Accounting for People Task Force (2003)

Human capital - external reporting framework, Chartered Institute of Personnel and Development (2003)

Operating and financial review, Accounting Standards Board (revised 2003)

Preparing an operating and financial review: interim process guidance for UK directors, ICAEW Audit and Assurance Faculty (2003)

Measuring human capital - good practice guideline, ICAEW Faculty of Finance & Management (2003)

Through the eyes of management: a study of narrative disclosures, Vivien Beattie, Bill McInnes and Stella Fearnley, ICAEW Centre for Business Performance (interim report 2002)
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