



Human Capital Handbook 2011

Accounting for People 2.0 Edition

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Introduction

Dr Michael Reddy

Founder, Human
Potential Accounting



The Human Capital Handbook 2011

Accounting for People 2.0 Edition

In parallel with the launch of [Accounting for People 2.0](#) (AFP 2.0) and the creation of a focused library of supporting materials, [Human Potential Accounting](#) is launching its own publication.

The *Human Capital Handbook 2011* will be published in January 2011 as a multi-authored online book (ebook) of a dozen or more short chapters. It will include a range of perspectives on human capital issues, from across the world and from a wide variety of business areas and professions.

The following four pieces, of particular relevance to AFP 2.0, are in this special edition:

1. *Accounting for People: Inconvenient Truths* ([Dr Michael Reddy](#))
2. *RICARDIS: A Summary* (approved by Tim Hoad, Chairman of the [RICARDIS](#) High Level Expert Group)
3. *Accounting for People: a Short History* ([Professor Robin Roslender](#), Heriot-Watt University and Editor, [Journal of Human Resource Costing and Accounting](#))
4. *Real Improvements in Corporate Governance Require More Than Regulation* (Chris Hodge, Head of Corporate Governance, [Financial Reporting Council](#))

Another resource at the service of the new AFP 2.0 working group, at no cost, will be a password protected zone (bookshelf) of the [HubCap Digital](#) platform, a not-for-profit library, publishing facility and discussion forum whose wider functionality remains open to all. HubCap's library contains human capital accounting materials from internationally recognised bodies and centres of research; from traditional and open access journals; and from academics and business professionals in the UK and worldwide.

I hope you enjoy the Handbook and find HubCap Digital useful.

-- Michael Reddy, PhD, FRSA and Director, Human Potential Accounting

RICARDIS: A Summary

Tim Hoad

"RICARDIS: Reporting Intellectual Capital to Augment Research, Development and Innovation in SMEs", a report on the role of intellectual capital reporting in the research field, was published by the European Commission's Research Directorate-General in June 2006.

The paper has much wider applicability and can be seen as relevant to many other aspects of business besides research, development and innovation.

The purpose of RICARDIS is threefold:

- ◆ To highlight the business case for R&D investments by reporting on the contribution of intellectual capital
- ◆ To make recommendations to investors and private stakeholders on how to interpret and value intellectual capital statements, and how to encourage companies to report on their intellectual capital
- ◆ To make recommendations for public policy makers on how to stimulate companies to report on their intellectual capital

In our view this offers a comprehensive blueprint for investment in and selling the benefits of human capital investment, leading in turn to more accurate valuations of an organisation's intellectual capital and its contribution to the future profitability of any organisation. (In reviewing the original RICARDIS text we submit that the use of "intellectual capital" is coterminous in all respects with common usage of "human capital" and that the two terms can be used interchangeably in this document.)

Intellectual Capital as the Hidden Driver

The traditional accounting model is based on the principle of historic cost and, for this reason, only a narrow range of intangibles is included within financial statements. In providing a record of what has happened in the past, historic cost accounts provide a useful starting point in assessing the performance of the business; however without forward-looking information, the picture that they provide is incomplete. Conventional accounting standards, which define an asset in such a way as to exclude assets that cannot be directly linked to a revenue stream, will lead to most internally generated intangible assets being immediately expensed.

Intellectual Capital Statements take a different and complementary stance by taking into account (using “account” as in conventional accounting terminology) those things which are useful in evaluating the future (rather than only the past) and this means that a much wider range of intangibles would need to be included.

The methodology of considering historical financial statements and forward-looking Intellectual Capital statements side by side is aimed at improving the transparency of an organisation’s purpose in seeking to create value, thus enhancing the completeness of its Business Model reporting.

At the centre of the Business Model reporting process is the quality of decisions being made by management that relate to the future prospects of the business. It may be noted that, first and foremost, IC Statements are about internal reporting, management and control of the business. The process of creating an IC statement in this way not only helps management to better understand its own business but equally helps improve their dialogue with investors. This indirect contribution of an IC Statement is just as valuable as the direct contribution to its external dialogue when the organisation needs to seek finance from banks, or equity from investors.

A good IC Report therefore will improve an organisation’s internal processes for managing its overall resources, both tangible and intangible. Even more importantly, it will provide a sound basis for improving the quality of the dialogue with financiers when explaining why the organisation does what it is doing, and how it is building the resources and capabilities necessary to succeed in the future. IC Statements help to clarify the way in which competitive advantage is being built by composing a narrative which explains both the value chain positioning and the business model for value creation.

Intellectual Capital has been defined as the combination of an organisation’s human, organisational and relational resources and activities. It includes the knowledge, skills, experience and abilities of the employees (we would add their creative mindset and commitment), its R&D activities, organisational routines, procedures, systems, databases and its Intellectual Property rights, as well as all of the resource links to its external relationships such as with its customers and suppliers, R&D partners etc. It can be both a product of R&D activities and the enabler for creating greater value from R&D.

Intellectual Capital is a key element in an organisation's future earning potential. It is the unique combination of the different elements of Intellectual Capital alongside tangible investments that determines an enterprise’s competitive advantage. Empirical studies provide evidence for the tight link and contingency between investments in R&D, innovation, human resources and relational capital.

Investments in R&D and innovation are intangible investments per se, which entail greater risk and uncertainty than other investments. The problem of protecting the intellectual capital, the frequently long-term character of the investment and a lack of understanding of the nature of research and innovation, make it harder for investors to assess such investments. Hence the perceived risk is appraised as being high, often higher than necessary.

IC Reporting is the process of creating a story that shows how an enterprise creates value for its customers and investors by developing and using its Intellectual Capital. This involves identifying, measuring, and reporting its Intellectual Capital, as well as constructing a coherent presentation of how the enterprise uses these knowledge resources. It responds closely to the EU’s Business Review provisions as enhanced in 2006.

The main idea behind IC Reporting is that financial information alone informs about the past performance of the enterprise but tells nothing about its future potential. The future potential of an enterprise lies not only within its financial capital but equally in the output from its Intellectual Capital. Creating transparency about the enterprise's intellectual capital will enable it to manage its intangible resources better, increase staff confidence and motivation as well as imparting greater certainty to investors and other stakeholders about its future earnings potential.

In Summary

An IC Statement is complementary to a financial statement in that it provides insight into important resources that are not found on the balance sheet, including knowledge, access to networks, and human resources. An IC Statement is complementary to a conventional business plan in showing how value will be created through R&D and through integrating various components of Intellectual Capital. Unlike the traditional business plan it therefore adds a degree of transparency to the hidden value drivers of human capital investments and pinpoints the availability (or absence) of the key complementary assets that are crucial to bringing the benefits of investment in human capital to the market.

About the Author

Tim Hoad was the Chairman of the High Level Expert Group on RICARDIS. He is the Owner Director at [IntangAbility Ltd](#), Director of Catalyst Executive Search Ltd, Trustee at the [Strategic Planning Society](#), and a founder member of the [New Club of Paris](#).

The full RICARDIS report may be downloaded [here](#).

Accounting for People: A Short History

Robin Roslender

Overview

The necessity of accounting for people was first recognised in the 1920s when Paton, one of the first generation of accounting theorists, questioned the credibility of a balance sheet from which “a well-organized and loyal personnel” was absent. However, it was only with the emergence of social accounting forty years later that the challenge of accounting for people was fully engaged. As a result it became one of the hottest research topics in accounting in the mid 1970s. In the absence of any significant breakthrough, the topic fell from favour by the end of that decade, becoming only a minority interest for almost two decades. Following the emergence of the complementary intellectual capital and knowledge management fields in the mid 1990s, a growing number of accounting researchers have concluded that the prospects for accounting for people have been greatly enhanced.

Technically Insurmountable Problem

It is ironic that the aphorism ‘our people are our greatest asset’, widely attributed to Peters and Waterman (“In Search of Excellence: Lessons from America’s Best-Run Companies”), became popular a couple of years after accounting researchers had exited the field. By this time the latter group had recognised that while ‘putting people on the balance sheet’ would find favour with employees and employers alike, as well as the broader society, it remained a technically insurmountable problem. It was possible to overcome the objection that unlike other assets employees were not owned, except in slave economies. It was possible to envision a balance sheet that would be in balance following the addition of a stock of high value human assets. The issue, though, was how to determine these values in the first place, coupled with the identification of appropriate amortisation models. Two decades of intense research activity had produced many valuation methodologies but very little consensus on which was truly fit for purpose, not to mention consistent with the prevailing framework for financial accounting and reporting.

Strategic Human Resource Accounting

Accounting for people’s most renowned exponent, Eric Flamholtz (Professor of Human Resource Management and Organizational Behavior at The Anderson Graduate School of Management, UCLA), quickly recognised that putting people on the balance sheet should not be the principal objective. As a graduate student in the late 1960s he came to understand that what he termed *human resource accounting* should focus on providing management with accounting information on employees (human resources) to assist them in their decision-making, planning and control tasks. Instead of seeking to provide human resource value

information, with the aim of populating a balance sheet, accountants should embrace the challenge of providing relevant human resource cost information beyond that associated with labour costs in the income statement. Although an accountant, Flamholtz held the view that human resource accounting should perform the crucial function of encouraging managers to 'think people'. In this way he too wanted enterprises to recognise that their people are their greatest assets, to be employed appropriately for universal benefit. This was radical thinking for a managerial accounting discipline regarded by many as largely subordinate to financial accounting and reporting by the early 1980s.

Managerial Accounting, Financial Accounting and Business Reporting

The passage of time has provided those of us who wish to advance accounting for people with many new insights and innovations to draw on for this task. Some have emanated from the managerial accounting discipline, which has been transformed in the past quarter of a century. No longer is managerial accounting information restricted to costs, nor indeed to only financial information. There is no requirement for managerial accounting information to be commensurate with the balance sheet or income statement. Its utility is determined by its relevance for management and the strategic management process. Managerial accounting's strength lies in it being an increasingly inclusive rather than the traditionally exclusive jurisdiction it was in the past. Or in the contemporary management speak, it is no longer a silo. And more recently, financial accounting and reporting has begun to explore its own architecture. In the years prior to Enron there was considerable interest in business reporting as the 21st-century successor to corporate reporting. A key aspect of business reporting is an enhanced role for narrative within accounting, weaving numbers and narrative into a more insightful story.

Intellectual Capital: Scoreboards

The emergence of the intellectual capital and knowledge management fields provided a wealth of new insights into what we might include in any accounting for people initiative. The scope for human capital indicators is only constrained by the ingenuity of those whose task it is to translate people's attributes into relevant management information. As a consequence it is not possible (if it was ever indeed desirable) to search for *the* set of human capital indicators since relevance varies from enterprise to enterprise. Once an enterprise identifies a specific set of key human capital indicators, they are combined with the other sets of intellectual capital indicators in some form of scoreboard reporting framework used to communicate this information internally and externally. The Skandia Navigator provided an influential exemplar of such a scoreboard in the late 1990s, alongside the Intangible Assets Monitor, the Ericsson Cockpit Communicator and the more generic Balanced Scorecard.

Evolving Portfolio

As the term implies, scoreboards are largely populated by quantitative information. Alternatives in the form of narrative-based reporting frameworks for reporting on intellectual capital soon followed. The most influential has been the Intellectual Capital Statement developed as a result of a Danish government initiative begun in 1998. A number of iconic Intellectual Capital Statements have been produced by Danish enterprises, including Coloplast, Carl Bro, and Systematic. In addition to narrative and numbers, these Intellectual Capital statements incorporate a variety of visualisations enhancing their accessibility. For my own part I have

commended taking the narrative approach one step further, identifying human capital self-accounts as another element of the evolving portfolio of intellectual capital reporting approaches.

Conclusion

Encouraging people to produce their own accounts of contributions to the value creation and delivery process is at the opposite end of the continuum from representing people on the balance sheet using hard number financial valuations. The existence of such a continuum should not really come as a surprise to readers given the rich history of interest in accounting for people within accountancy. Hopefully these few words will encourage anyone interested in accounting for people to begin to explore this history. They will not be disappointed.

About the Author

Robin Roslender is a specialist in interdisciplinary accounting research focusing on the management accounting field. He is particularly interested in what both social and sociological theory has to offer accounting researchers. He continues to research and write about developments at the interface between management accounting and marketing management. In recent years he has also become interested in intellectual capital and knowledge management issues as they relate to accounting, and is currently involved in an exploratory study of employee wellness viewed as an organisational asset.

Selected Articles

Roslender, R., Stevenson, J. and Kahn, H., 2006. Employee wellness as intellectual capital: an accounting perspective. *Journal of Human Resource Costing and Accounting*, 10(1), pp. 48-64. [[HubCap link](#)]

Roslender, R., 2009. The prospects for satisfactorily measuring and reporting intangibles: time to embrace a new model of (ac)counting? *Journal of Human Resource Costing and Accounting*, 13(4), pp. 338-359. [[HubCap link](#)]

Mouritsen, J. and Roslender, R., eds., 2009. Critical Perspectives on Intellectual Capital. *Critical Perspectives on Accounting*, 20(7), pp. 801-874. [[HubCap link](#)]

Roslender, R. and Stevenson, J., 2009. Accounting for People: a real step forward or more a case of wishing and hoping? *Critical Perspectives on Accounting*, 20(7), pp.855-869. [[HubCap link](#)]

Real Improvements in Corporate Governance Require More than Regulation

Chris Hodge

The economic crisis has sent a powerful message about the need for a sustained improvement in governance and Board behaviours. The Financial Reporting Council (FRC) has taken steps to strengthen the framework by updating the [UK Corporate Governance Code](#) for listed companies (formerly known as the Combined Code), and the Financial Services Authority (FSA) has introduced additional requirements for the financial services sector. But the quality of corporate governance ultimately relies on behaviour not process, and on proper communication and engagement between the company and its owners.

Business models have had to change because of the effects of the recession so Boards are now facing a more challenging task of managing their risks and altering their business models accordingly. Such changes often call into question whether accounting policies remain appropriate and whether internal control systems reliably capture all the relevant data. The [FRC's 2009 review of narrative reporting](#) also suggests that too few companies provide a full disclosure of their business model.

For this reason the UK Corporate Governance Code now clarifies that the Board is responsible for agreeing the nature and extent of the risks it is willing to take in pursuit of its strategy, and requires companies to give a clear description of their business model in their annual report. The long-standing [Reporting Statement on the Operating and Financial Review](#) sets out how this can be done.

The new requirement to describe the business model is one part of a broader effort to ensure that the information given to investors and the market remains useful and relevant. There has been a particular focus on the Business Review and other information in the “front half” of the annual report, and in August 2010 the Department of Business, Innovation and Skills initiated a [major review of narrative reporting](#).

The need to ensure continuing usefulness applies equally to financial reporting. For example, experience shows that [insolvencies increase after the technical end of a recession](#) as companies run out of working capital. As companies emerge from the recession, the FRC also anticipates an increase in the level of mergers and acquisitions. The FRC has [reviewed financial reporting of significant business acquisitions](#) and concluded that the quality of information should be enhanced to improve understanding of the rationale for acquisitions.

Communication is not a one-way process from companies to their shareholders. In order to deliver real improvements in governance it is important that investors use the information they receive as the basis for a discussion with Boards about the way companies are being run. For that reason the FRC has published the first [UK Stewardship Code](#), setting out principles of good engagement which institutional investors are encouraged to apply. The FSA is expected shortly to introduce a requirement on asset managers to disclose whether or not they follow the Code.

About the Author

Christopher Hodge is Head of the Corporate Governance Unit at the UK's Financial Reporting Council

Further Reading

[Can Culture be Regulated?](#) Speech by Hector Sants, Chief Executive, FSA at the Mansion House Conference on Values and Trust, 4th October 2010

Accounting for People: Inconvenient Truths

Michael Reddy

There are a number of separate but connected elements on the financial reporting landscape. These are some of them.

1. People are our biggest asset yet it is seemingly impossible to find a place for them on the balance sheet in its present form. This is inconvenient.

There is an increasingly common expectation that a third financial reporting instrument is the solution, whether this be Narrative Reporting, an updated OFR, a new Business Review with sharper teeth, or something else.

2. On the P&L people are logged as “costs” which is an unusual rubric for an asset.

This is inevitable however in that as an accounting tool the P&L can only register historical data and expense what it finds there. Such limitations of conventional accounting methods are inconvenient in the sense that they preclude an option to treat people as investments rather than costs, which is particularly important with assets that also have the greatest potential for future as much as historical value.

3. People are our biggest liability.

It is useful to highlight this, given that the P&L normally fails to identify and quantify people liabilities, costs and risks in as complete, transparent and accurate a manner as it might. Conventionally people costs include the evident out of pocket items such as recruitment, training, salary and benefits, as well as concrete on-costs such as equipment and travel, while failing however to accurately itemise, allocate and incorporate the people costs buried under legal, insurance, pension obligations and other matters, to say nothing of the soft costs of management and HR wear and tear. This means that on a quarterly basis the FD can give only an incomplete and possibly misleading account of what it is really costing to employ its people, and consequently of their current value to the business.

4. The same lack of accurate information about the value of human capital, as distributed throughout the business, is a feature of M&A activity, but appears to be accepted as irrelevant or intractable.

Despite the fact that merger and acquisition is one of the most common financial growth strategies for large corporations, multiple studies over the last two decades show that most M&A deals don't achieve financial goals. For example, in the mid-1990s, Bain & Co. found that 85% of M&A deals failed to meet financial projections or delivered negative value to shareholders. A 2007 study by Hay Group and the Sorbonne found that more than 90 percent of mergers in Europe fail to reach financial goals.

All of these studies pinpoint people issues — poor communication of the benefits of the deal, lack of definitions of success for the organisation and individuals and culture clashes — as a cause of financial failures.

Or worse, M&As destroy corporate value. Our own experience suggests that many acquisitions ride on a tide of brand enhancement, and a touch of board level ego-boosting, rather than a sober assessment of the human capital that will make or break the new organisation. The development of more refined pre and post-merger leadership and behavioural and cultural auditing tools would improve the odds of an acquired business reaching its potential in 3 to 5 years.

5. A fundamental characteristic of markets is their short-termism.

The quarterly report is a cornerstone of financial reporting but acts as an inhibiting factor in terms of growth, yet it is set in stone by the demands of shareholders with an eye to short term gains. Analysts too use the short time horizon to justify their existence while they focus on the breaking news delivered by the financial media.

The logic of the thread above suggests that a potential line of reform could be explored when significant shareholders, possibly institutional funds, put their weight behind a medium to long term human capital investment strategy.

6. The systemic nature of the current version of Anglo-American capitalism with its interlocking interdependencies can threaten systemic breakdown in certain circumstances.

All the components of this market-based phenomenon interlock into a mutually supportive or destructive system, with a range of business models, processes of capital raising, investment strategies and performance reporting as potential avenues or obstacles to reform.

7. The shift of economic power from West to East is likely to accelerate rather than slow down and has probably already passed its tipping point.

One possible effect lies in a dispersion of non-Western norms for valuing human capital, which in turn could accelerate pressures for reforming the current version of Western capitalism.

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