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The Long Road to Reporting on Human Capital

BY DAVID CREELMAN AND GREGORY WURZBURG (2011)

Most of the value of an organization does not appear on the balance sheet. This insight is not a new one. Over the years many people and institutions have raised the possibility of more extensive reporting on value-creating assets that do not appear on the balance sheet. In particular, there has been recurrent interest in reporting on the most valuable asset of all: human capital.

Today, reporting on human capital is still very much on the agenda for a number of international organizations, but no one expects formal reporting requirements any time soon. To understand what is likely to happen in the years ahead, it's helpful to look back and understand the journey down the long road to reporting on human capital.

The story of reporting on intangibles (or 'intellectual capital,' the terms are often used interchangeably) goes back at least to the late 1960s when James Tobin, noting that book and market value often diverged, introduced the notion of 'Tobin's q,' the ratio of a company's market value to the replacement value of the assets in its balance sheet. But the current chapter of the story goes back to the late 1980s when in even the most traditional manufacturing and primary industries (such as oil and gas), value creation was seen to hinge more and more on intangibles.

In the early 1990s it was evident that Volvo, for example, was no longer just a car company; it was a company that created value because it had built a particular network of suppliers and had a unique way of thinking about, and organizing, its work. Similarly, the value of British Petroleum was not just a function of the oil reserves where it had drilling rights, but on its ability to keep track of, and fully exploit, its engineering and scientific assets. In 1992 at the OECD, the committees interested in the roles of human capital and technology in the economy started exploring the importance of intangibles in creating economic value. When OECD's human capital and technology committee staff broached the idea of changing the accounting treatment of human capital and certain other intangibles, with OECD's Working Group on Accounting Standards, most members firmly rejected *even considering* the subject. However, the chairman of the Group did encourage the secretariat to research the pros and cons of excluding information on intangibles from financial statements, the prevailing practice at the time, and to report back to the Working Group.

The accountants were not just being intransigent. Accounting is a delicate field that struggles to deliver consistency without overly sacrificing relevance. The accountants weren't disputing that intangibles had relevance; but their sense was that creating consistency around these softer issues would be a nightmare and the inherent subjectivity could undermine the rest of financial reporting.

The OECD secretariat hired a consultant who researched earlier attempts to change the accounting treatment of human resources and other intangibles. He concluded that the obstacles to changing the accounting treatment of intangibles were insuperable. There were difficulties with measurement and valuation, and in the case of human capital, the fact that companies could not claim ownership of workers defeated the idea of treating them as assets on a balance sheet. Still anyone paying attention recognized that value creation was occurring in a different way than it was before. The information on financial statements was simply not giving external stakeholders a vision of how companies were creating value. While the accountants were not ready to act on this, others continued pushing and probing. In 1994, the Swedish insurance company Skandia went so far as to publish a report on intellectual capital as a supplement to its usual financial reporting.

OECD's first truly serious institutional interest in reporting on human capital took place in 1996. There was an expert meeting focused on whether human capital could be treated as an asset, particularly in companies, such as those in financial services and the exploding field of software development, that were short on traditional fixed assets. In these sectors value creation depended not on plant and equipment, but on software engineers, proprietary procedures, and customer loyalty. The meeting included Lief Edvinsson from Skandia, Jonathan Low of the U.S. Department of Labor and Ulf Johansson of Stockholm University Business School. The conclusion they reached then was that it would be difficult to figure out which human capital variables to report, it would be difficult to measure them, and impractical to force them into some kind of financial framework. Not an encouraging conclusion, but realistic.

That is not the end of the story. The experts broached the idea of structuring disclosure of *non-financial* information, reported parallel to the financial framework. Rather than try to cost out, for example, the value of software engineers or the value of long-tenured employees, perhaps there could be a way of reporting this information in a non-financial format that was more or less consistent between firms. For example, reporting on turnover in a standard way, or on total payroll, or on staff development as a share of total costs.

In the meantime, other OECD committees were wrestling with unresolved issues that arose from the growing importance of intangibles. The committees dealing with industry and technology policy were trying to supplement data on investment in fixed assets with better statistics on everything from innovation to patents to software. In the background was the underlying issue that much of the value in an organization— and ultimately the competitiveness of national economies—was not showing up in the usual industrial statistics and indicators.

Around the same time the committees responsible for financial and capital markets, as part of their efforts to improve the investment climate in an increasingly global economy, concluded that corporate governance in non-OECD countries required urgent attention. In the late 1990s the OECD published corporate governance principles which included guidance on reporting both financial and non-financial information.

In 1998, these separate streams of work began to converge. OECD staff trying to improve industrial statistics and indicators, and those interested in improving human-capital reporting in enterprises, teamed up with staff responsible for improving corporate governance. The confluence of interest led to the OECD proposing a conference on measuring and reporting intellectual capital.

Shortly after proposing the conference OECD officials discussed it with SEC officials in Washington. The SEC argued that intangibles did not matter for enterprise performance, and therefore there was no reason for an international conference on the subject. The SEC, working through the International Organization of Securities Commissions (IOSCO) and other international channels, began pressuring other countries to ask the OECD to cancel the meeting. [1]

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1 Underlying this odd position was the SEC's concern that the conference might interfere with ongoing negotiations about international accounting standards. At that time the SEC was pushing for adoption of U.S. GAAP as opposed to the International Accounting Standards (IAS) framework. At the time the IAS Commission was in the process of revising its accounting treatment of intangibles. On the other side, U.S. GAAP had nothing to say about intangibles. The SEC did not want anything they felt was going to elevate the importance of intangibles, because that would aid the IAS in becoming the international standard.

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Despite the objections of the SEC, in June 1999 the OECD and the Dutch ministries of economic affairs and education co-hosted in Amsterdam the International Conference on Measuring and Reporting Intellectual Capital. The conference was chaired by the Australian industrialist, Stuart Hornery. Participants included officials from ministries for finance, economy, industry, education and labour , as well as accounting and capital market regulators, and academics. The main messages coming out of the conference were that intellectual capital was playing an increasingly powerful role in the value creation process at the corporate as well as general economic level; and that financial accounting and reporting practices at that time provided inadequate information on stocks and flows of intellectual capital and their role in value creation. Participants did not favour changes in accounting and reporting practices; however, they argued in favour of exploring ways for improving the transparency of non-financial information on intellectual capital and its role in value creation.

Four months later Arthur Levitt, chairman of the SEC contradicted the earlier claims by SEC staff that “intangibles don't matter,” in a speech in which he underlined the need for financial market regulators to pay more attention to intangibles. Six months later Alan Greenspan, chairman of the Federal Reserve, in a speech about the new economy, said much the same thing: intangibles were important.

Anecdotal evidence also showed a growing conviction among businesses that intellectual capital was increasingly important. In 1999 the Brookings Institution started seeking financial support for a project looking at intangibles. The fundraisers found that it was not the software or Internet companies that were most interested in improving information on intellectual capital (it could be argued that the Internet boom profited enormously on the absence of good information on how intellectual assets created—or didn't create—value). Rather, the companies that were particularly interested in supporting the work included the likes of the oil companies and Boeing—companies in traditional industries which had completely reprogrammed the way they created value much like Volvo had done back in Sweden. They believed their capacity to create value depended on how they organized their work, not just what showed up as the book value of their fixed assets. These were the companies that were particularly interested in finding a way of telling a story about intangibles because financial statements did not allow them to do so.

Since the 1999 Amsterdam conference, the OECD has not played any active role in trying to advance the cause of greater and more systematic disclosure of non-financial information on intangibles. However, some governments did take steps in that direction. In recent years the Germans and Japanese have gone a considerable distance in creating intellectual capital statements which are very much individualized stories of how a particular organization uses intellectual capital to create value. Denmark has created guidelines similar to what we see in Japan and Germany. This approach generates useful insights, but it is hard to scale this to the point where most companies do it. It is hard to do well, and it is a lot of work for an analyst to read through these intellectual capital reports and interpret the implications for share value. Telling an organization's own 'intellectual capital story' is useful, but it may not be a universal solution, at least, not in its current form. People working in the field now know that there is not an ideal solution just waiting for a bright person to figure out.

The SEC took a less neat, but perhaps more pragmatic approach when it adopted the Fair

Disclosure Regulation in 2000. This regulation recognized that much of the content of conference calls between CFOs and financial analysts concerned intangibles; for example, patents in the pipeline, new areas of research, and the comings and goings of key staff. Rather than saying what information over and above the financials should be reported, the regulation simply says that whatever it is, it must be made available to the general public (as the financials already are).

But the lack of progress on the issue should not be attributed solely to the inherent technical challenges. There is also institutional resistance in the form of vested interests who are happy with the status quo. Financial analysts were dead set against the fair disclosure regulation because their value-added was in getting access to things in the conference calls that the public did not know. Accountants have made clear they do not want intellectual capital formally introduced into the accounting framework. U.S. regulators expended their energy on Sarbanes-Oxley and are hesitant to push for new regulations.

Yet, human capital and other intangibles remain like a mountain overshadowing a valley. They are not going away and most of the way value is created in an economy has to do with these intangibles, not with the traditional assets reported in the balance sheet. While the OECD is quiescent on the topic, reporting on intangibles remains actively on the agenda of many institutions around the world. We will not wake up one day and suddenly find reporting on intellectual capital has been revolutionized. The area is too messy and as we have said, there is no magic solution just waiting to be found. However, it is fair to predict that more and more non-financial information will be reported by investors and no doubt in retrospect this history of hesitation and resistance will be hard to understand. It's been a long road to reporting on human capital, and that journey is by no means over, but the forces that brought the issue to the attention of the OECD in the early 1990s have only gotten stronger, and changed reporting requirements are only a matter of time.

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