

Aviva Investors Corporate Governance
Human Capital Research Paper

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Executive Summary

Aviva Investors is leading the way in corporate governance with the release of a third policy paper – Human Capital – linking culture and people to organisational performance. The essence of the Human Capital Policy Paper is incorporated in Aviva Investors' company valuation process.

Aviva Investors is of the opinion that the existence of a company culture based on ethics and integrity not only leads to the positive and ethical treatment of staff, but also can enhance company performance. We believe that a thorough review of a company's people management practices is the optimal method by which to measure the integrity and ethics of a company's culture and people management practices. In summary, it is our view that there is a direct link between a company's culture and values, people management practices, and company profitability and long term performance.

With an increasing amount of external pressure placed on companies (eg compliance legislation, a push for good corporate governance, and economic pressures of tight margins and competition) companies must become more effective and efficient in their quest to reach their bottom line goals. In order to do this, and gain competitive advantage, we believe a company's approach to positive and strategic people management is not only the best, but perhaps the only way in which to achieve these goals.

To validate our views, Aviva Investors recently undertook a literature review to investigate the link between a corporate culture based on ethics and integrity and company performance. Recent research indicates a significant correlation between ethical corporate conduct, people management activities and company performance.

A British research project found that employee attitudes and organisational commitment can impact company profitability by up to 5%, and productivity by up to 16%. This research indicated that human resources management practices can contribute to a 19% variation between companies in terms of profitability, and up to 18% variation in productivity.

The British research also compared the impact of people management practices against other management strategies such as business strategy, emphasis on quality, use of technology and investment into research and development. The findings were surprising; strategy, emphasis on quality, and technology accounted for between 1 and 2% variation in profitability and productivity, whilst research and development accounted for up to 8% variation in profitability (the impact on productivity was not considered to be statistically significant). Compared with the impact of human resource management practices (18% variation in productivity and 19% variation in profitability), it is clear which is a more powerful predictor of company performance.

Furthermore, a recent US-based study found conclusive empirical evidence that the presence of an 'ethical tone' set by senior management tended to permeate all levels of an organisation leading to superior company performance and enhanced corporate reputation.

A key outcome of our research has been the development of a 'human capital survey'. It is our aim to collect and analyse information that will then help provide insights into a company's long term performance. Company responses will be assessed against an index and an overall

rating will be applied. Companies that complete the Human Capital survey will, upon request, receive guidance as to the types of measures and people management practices that can improve corporate governance and their long-term bottom line returns. To our knowledge, we believe that Australian fund managers have not considered a formal review of human capital like this in their company research process.

It is our opinion that this initiative will result in a win-win situation for all stakeholders concerned: Aviva Investors will be better equipped to accurately evaluate the risk component of a company valuation; Companies will have access to up to date information on best practice in terms of corporate culture and people management practices; employees of participating companies will benefit from improved people management practices; and shareholders of those companies should realise better returns in the long term.

This paper offers several ideas for responding to a call for improved social reporting practices. The Human Capital survey could provide a checklist for CEOs, MDs, and HR executives when considering a more strategic approach to corporate culture and people management. However, before culture and people management can become more effective, and strategic, CEOs and other senior executives and management at all levels must be committed to the view that all staff *are* valuable, and that the values of ethics and integrity are paramount to business success.

Aviva Investors is leading the way in corporate governance with the release of a third policy paper – Human Capital – linking culture and people to organisational performance. The essence of the Human Capital Policy Paper is incorporated in Aviva Investors' company valuation process.

In mid 2003, Aviva Investors (then operating as Portfolio Partners) released two policy papers: Corporate Governance and Voting Rights, and Environmental Reporting.

Abstract

Research into the link between a corporate culture based on ethics and integrity and company performance indicates a significant correlation between ethical corporate conduct and company performanceⁱ. A recent US-based study found conclusive empirical evidence that the presence of an 'ethical tone' set by senior management tended to permeate all levels of an organisation leading to superior performance and enhanced corporate reputationⁱⁱ.

Furthermore, a number of overseas research studies have validated this correlation by concluding that a company can minimise risk to its bottom line, gain advantage over its competitors, and ensure long term survival and growth through an integrated and strategic approach to its people management activities. Based on this, if a corporate culture is based on ethics and integrity, these values will most likely be present in all business activities, policies, procedures and systems. It is Aviva Investors' belief that these companies will out perform their competitors in the long term.

The Importance of Aviva Investors' Human Capital Policy

Australian companies are seeking guidance rather than prescriptive measures to improve their corporate governance.

While CLERP has introduced a range of corporate governance guidelines, Aviva Investors felt it was imperative to provoke discussion on an area of corporate governance – human capital – that is rarely considered as a contributor to a company's performance. Also, while many annual reports are now disclosing the triple bottom line – it is our opinion that the social reporting component (human capital) requires more disclosure.

To further the discussion on human capital and provide guidance to Australian companies, Aviva Investors is in the opinion that the existence of a company culture based on ethics and integrity is a pre-requisite for the positive and ethical treatment of staff. This in turn can be measured via a company's approach to people management through human resources (HR) activities.

We also believe that a thorough review of a company's people management practices is the optimal method in which to measure the integrity and ethics of a company's culture; this is because by its very nature, people management impacts staff at all levels.

It is our view, supported by qualitative research, that there is a direct link between a company's culture and values and company profitability and long term performance.

Research Methodology

Aviva Investors' qualitative research was to test the hypothesis: "There is a positive link between a company's culture and values based on ethics and integrity and people management practices and its profitability and long term performance".

Our literature review of current Australian and overseas research concluded that there is a positive link between a company's culture and profitability and long term performance.

Practical Application of Research Findings

Aviva Investors has applied its research findings to the development of a *human capital risk-rating system* in its company valuation process. The risk-rating process incorporates three key areas – Corporate Culture (ethics and integrity), Strategic People Management Indicators and Human Resources Activities (see definitions at the end of this section).

Survey questionnaire

A survey has been developed based upon the research to collect data on the three key areas. Company responses to the survey will be assessed against an index, and an overall rating will be applied. The survey questions that will be employed to elicit information from participating organisations are based on the types of indicators found to be present in high performing organisations and are related to culture and people management practices.

It is not our intention to rate companies relative to other companies – rather we will rate them in relation to our index. This rating is then considered as part of Aviva Investors' comprehensive valuation process. In addition, our analysts will share their assessment of each company (at their request) with key personnel to assist them in the ongoing development of their people management practices. This may assist (or prompt) companies with their social reporting and corporate governance considerations.

The benefit of this tool is that we can track the performance and profitability of companies to quantify the relationship between culture and people and organisational performance.

For ease of interpretation by the reader, the concepts of Strategic People Management and People Management Practices are defined below.

- Strategic People Management:
- Strategic People Management (SPM) is the pattern of planned human resource deployments and activities intended to enable an organisation to achieve its goalsⁱⁱⁱ.
- People Management Practices:

People management practices involve all management decisions and actions that affect the nature of the relationship between the organisation and employees - its human resources^{iv}.

- Ethics

A Company's attitude and conduct toward its employees, customers, community, and stockholders – it involves fully understanding the company's values and behaving in such a way that supports them. This includes encouraging questions and giving honest and public answers.

- Integrity:

Integrity involves being honest, loyal, trustworthy, reliable, truthful, dependable, sincere, principled, reputable fair, just and credible. Behaviours which integrity implies are being forthright, keeping one's word, truth-seeking and telling, being honest not deceptive, showing respect, being reliable, acting honourably and acting in a way which does not question one's reputation, or the reputation of others. In an organisational context, an organisation has integrity if it has a clear statement of values and principles which lives up to.^v

Human Capital – Discussion

It is fair to say that most people value fairness, respect and integrity, and want to be treated in such a way by their employers. In a work environment, people will feel valued and respected if they believe that people management policies and practices are fair, transparent and ethical. This is especially relevant in relation to emotion-laden areas such as remuneration, bonus payments, performance appraisals, hiring, promoting, and decisions regarding terminations and retrenchments.

We therefore believe that if a corporate culture is based on ethics and integrity, combined with ethical leadership at board and senior level management, that these values will flow through to people management systems, policies and practices resulting in positive staff morale, and ultimately superior company performance.

Ethics and Integrity – Impact on Company

Performance

In the last ten years compliance has become an integral part of many businesses. However, in today's environment of corporate collapses and scandals (eg, HIH, Arthur Anderson, OneTel, Enron) company stakeholders, such as investors and employees, want to know where an organisation is placed in regards to corporate governance, ethics and integrity, all of which goes beyond the realms of compliance.

As stated earlier, ethics and integrity appear to be increasingly important for employees. When a staff member feels disconnected from their employer due to a mismatch of values related to ethics and integrity, they may resign, or become withdrawn and unmotivated. In either case, these behaviours can have an adverse effect on the employee, the organisation, and the organisation's performance^{vi}.

Aviva Investors therefore believes that organisations which focus on creating and sustaining corporate cultures based on ethics and integrity, will have higher levels of staff morale and motivation, and will therefore outperform those who do not.

A review of research, articles and speeches (by corporate senior executives) indicates the degree to which ethics is now discussed and viewed as critical to long-term business performance and employee morale:

“As a firm, being ethical and demanding ethical behaviour from a firm's employees, is far from easy. But it is absolutely essential. A firm's commitment to ethics is a reflection of its commitment to its clients. And in both good and bad market environments, it is this commitment to clients that makes a firm successful.”^{vii}

“...employees say that their organisation's concern for ethics is an important reason they continue to work there....adherence to high moral values can become a strategic advantage.....”^{viii}

“Our high standards have rewarded us with an enviable reputation in today's marketplace....a reputation of integrity, honesty and trustworthiness....that strong ethical reputation is a vital asset.”^{ix}

As seen above, ethics and integrity are important when considering the long term performance and profitability of an organisation. In a business context, integrity can be seen as supported or undermined by a variety of factors, such as:

Supporting Values

- Personal values held by an individual (eg, employees, senior executives)
- Norms developed by a group
- Legal norms and regulations
- Organisational culture

Undermining Values

- Personal attributes of individuals such as self deception, hypocrisy, selfishness or moral cowardice (note, these can be screened for in recruitment & selection processes)
- Conflict of interest between an individual's needs and business goals
- A lack of clarity about the values and goals of the organisation
- Institutional opportunities that provide temptations for unethical or fraudulent behaviour (eg, lack of clarity around 'soft money' gifts for clients, or lack of rigour around expense reimbursement procedures)
- Organisational culture^x

Note: Organisational culture appears in both lists, as culture can either support or undermine corporate ethics and integrity.

Triple Bottom Line Reporting – Social Component

In combination with the increased interest in business ethics and integrity there is also a ground swell of interest in what is referred to as 'triple bottom line' reporting. Triple bottom line (TBL) reporting goes beyond the traditional model by including environmental and social reporting with standard financial reporting. It is the social reporting component of the TBL that our guidelines seek to address.

To date, Australian companies do not appear to report on the social component of the TBL in regards to staff issues other than Occupational Health & Safety (OHS) and relationships with Trade Unions. Aviva Investors believes that this aspect of the TBL is critical to a company's performance and as such we have created a model that measures this via people management practices. For this reason, Aviva Investors is interested in how corporate culture manifests itself in the people management practices within a company and how this then impacts performance.

Ethics and integrity need to be included in any discussion or investigation of the effectiveness of people management practices and their impact on company profits and performance. This is because it is only through the human application of ethics and integrity that people management practices can have a 'positive' impact on a company's performance. Aviva Investors recognises that certain people management practices could be designed in such a way as to have an immediate effect on short-term performance, but may not demonstrate the values of ethics and integrity.

Some activities may not be strictly unlawful, but may be designed to have an immediate positive impact on the 'bottom line' without regard for longer-term issues. For example, downsizing is frequently used by organisations as a 'quick win' off the bottom line. However, the longer term impacts are often negative (eg, loss in morale and productivity, increased turnover of key staff, loss of corporate knowledge, the need to replace those roles within 12 months and associated recruitment fees). Aviva Investors does not propose that downsizing is always unethical, but that it should be done with very careful consideration and a thorough understanding of impacts into the future.

In contrast to the above 'negative' impact example, Aviva Investors will review people management practices for 'positive' impacts. For example, we will seek evidence of a clearly stated code of conduct that is designed to guide behaviour and reinforce company values. The values within the code of conduct should then be encapsulated within a company's recruitment and selection processes, induction program, performance management, and training and development programs.

We will also look at proactive identification and risk minimisation of OHS issues. For example, potential hazard investigations should be conducted on a regular basis, and designed to actively recognise potential hazards before an incident occurs.

Strategic People Management

In order for human resources activities to effectively contribute to a company's bottom line, a degree of integration of these activities must be present. In the context of corporate culture and people management practices, Aviva Investors is interested in the presence of what we refer to as Strategic People Management (SPM).

SPM is essentially an integrated approach to human resources activities, whereby an activity such as performance management is directly linked to remuneration. SPM recognises that staff are a 'strategic resource' by which a company can achieve competitive advantage^{xi}. Thus, the strategic integration of people management activities can add value to and contribute to the profitability of an organisation^{xii}.

Human Capital – Return on Investment

For many Australian companies, especially those in the service sector, labour is estimated to be among the costliest of all organisational assets and staff remuneration can reach as much as 70 - 90 % of operating costs^{xiii}. Despite this, companies typically base competitive strategies on factors such as product or technological processes^{xiv}.

In an increasingly competitive environment, replete with technological innovations, and changing market boundaries^{xv}, a company can minimise risk to its bottom line, gain advantage over its competitors, and ensure its long-term survival and growth through an integrated and strategic approach to its people management activities^{xvi}. The former is especially true when people management activities and a human resources plan are aligned with a company's strategic goals^{xvii}.

In today's environment, competitor companies can easily replicate tangible competitive advantage through the acquisition of information technology, equipment, land, products and market share. However, it is not normally as easy to replicate competitive advantage gained through intangible assets such as superior business leadership and high-calibre highly trained staff, which is why SPM systems can offer sustainable competitive advantage.

Strategic People Management – Indicators

Listed below are indicators of the presence of SPM within a company. In the next section of these guidelines micro level HR activities that support the SPM indicators will be highlighted. In combination with the SPM indicators, it is the micro level activities for which Aviva Investors intends to gather data as part of their company valuation process.
Indicators of Strategic People Management

Strategic People Management

Bottom Line: people management policies and practices are measured and contribute to overall organisational performance and minimisation of risk to the bottom line.

Internal and external environmental monitoring and benchmarking of people management activities.

Knowledge: Staff are viewed as valuable assets, training and development is viewed as an investment.

Inclusion of HR staff in corporate strategy formulation. Visible and genuine senior management commitment to human resources activities.

Decentralisation of people management responsibilities throughout all levels of management.

Integration: (a) of HR activities (eg remuneration & performance management)
 (b) of HR functions and corporate strategy; and
 (c) of HR activities and code of ethics

Link between HR activities and long-term business planning.

People Management Practices and Activities

Corporate Culture and People Management Practices

There are various ways in which people management practices can contribute to a company's performance. As mentioned earlier, the presence of a corporate culture based on ethics and integrity is essential in order for people management practices to have a positive impact on the profitability and performance of an organisation. For example, research has shown that the success of recruitment and selection processes to attract candidates is in part based on an company's reputation surrounding ethics and integrity combined with the company's reputation in terms of how employees are treated^{xviii}.

Following on the above, the combination of a supportive corporate culture and appropriate people management practices can lead to positive morale and motivation, which results in beneficial outcomes for both individuals and the companies they work for^{xix}. The importance of positive morale and a supportive corporate culture can not be underestimated.

A British research project found that employee attitudes and organisational commitment can impact company profitability by up to 5%, and productivity by up to 16%. This research indicated that human resources management practices can contribute to a 19% variation between companies in terms of profitability, and up to 18% variation in productivity^{xx}.

This British research also compared the impact of people management practices against other management strategies such as business strategy, emphasis on quality, use of technology and investment into research and development. The findings were surprising; strategy, emphasis on quality, and technology accounted for between 1 and 2% variation in profitability and productivity, whilst research and development accounted for up to 8% variation in profitability (the impact on productivity was not considered to be statistically significant). Compared with the impact of human resource management practices (18% variation in productivity and 19% variation in profitability), it is clear which is a more powerful predictor of company performance.

High Performance People Management Practices – Link to bottom line

A comprehensive US-based research project by Mark Huselid in 1995^{xxi} evaluated the link between HR activities and company financial performance in nearly 1,000 American organisations. Huselid's research found that comprehensive HR systems (eg, recruitment & selection procedures, remuneration linked to performance reviews, and extensive training opportunities) improved the knowledge, skills and abilities of staff, increased motivation levels, and discouraged shirking. These factors then led to better retention of high quality staff, and at the same time encouraged poor performing staff to exit the organisation.

In the selection of the people management practices critical to company performance, Aviva Investors' review of recent literature regarding the link between corporate culture, people management activities, and organisational performance revealed the following themes:

- Careful and targeted recruitment and selection consistent with the company's strategy and goals;
- Remuneration and reward strategies linked to performance appraisal systems; and
- An emphasis on training and development linked to organisational goals

Whilst we will review separate people management activities (eg recruitment, remuneration, training) the links between these activities (eg, remuneration linked to performance management systems) is critical.

Other types of cultural indicators present within a company that help shape and support people management practices and policies include:

- sharing of business plans amongst all staff;
- policies and practices that are seen to be fair and promote high expectations;
- a culture that celebrates successes publicly;
- training and development of staff is ongoing, linked to competencies aligned with the corporate strategic plan, and focuses on initiative and interpersonal skills;
- teamwork is the norm and is encouraged; and
- communication is bottom up, top down and across teams and functions^{xxii}

Rating Process

The proceeding model provides a high level overview of our Human Capital Valuation Process. This three-fold process (see below) will involve a review of certain aspects of corporate culture, combined with indicators of the presence of SPM, and the various micro level HR activities that support corporate culture and SPM. Responses to the questions asked in relation to these activities will be assessed, and will allow us to provide an overall rating to an organisation. It is not our intention to rate a company relative to other companies; rather, we will rate them in relation to our index.

Three-fold Rating process:



Conclusion

The combination of a corporate culture based on ethics and a strategic approach to people management is important to a company's long term performance and bottom line. With an increasing amount of external pressure on company's through compliance legislation, a push for good corporate governance and the economic pressures of tighter margins and competition, there is increasing pressure on companies to become more effective and efficient, and to reach their bottom line goals through their staff. Now, and increasingly in the future in regard to competitive advantage, a company's approach to strategic people management is not only the best, but perhaps the only way in which to improve organisational effectiveness and performance.

The findings from the research undertaken for this Human Capital paper have been used to create a methodology by which Aviva Investors can collect and analyse information provided that will help determine a company's long term performance. The companies that complete the Human Capital survey will in return receive guidance as to the types of measures that can improve corporate governance and their long-term bottom line returns.

This initiative should result in a win-win situation for all stakeholders concerned: Aviva Investors will be better equipped to accurately evaluate the risk component of a company valuation; Companies will have access to up to date information on best practice in terms of corporate culture and people management practices; employees of participating companies will benefit from improved people management practices; and shareholders of those companies should realise better returns in the long term.

This paper has offered several ideas for responding to a call for improved social reporting practices. The Human Capital survey could provide a checklist for CEOs, MDs, and HR executives when considering a more strategic approach to corporate culture and people management. However, before culture and people management can become more effective, and strategic, CEOs and other senior executives and management at all levels must be committed to the view that all staff *are* valuable.

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