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FRC Corporate Governance Code consultation

Q12: Do you agree that the remit of audit committees should be expanded to include narrative reporting, including sustainability reporting, and where appropriate ESG metrics, where such matters are not reserved for the board?

Introduction

Acas (the Advisory, Conciliation and Arbitration Service) welcomes the opportunity to respond to the the FRC's Corporate Governance Code consultation.

Acas is an independent and impartial non-departmental public body with a statutory duty to promote the improvement of industrial relations in Great Britain. In carrying out this duty, Acas offers conciliation in both individual and collective disputes; good practice advisory services for employers, and a website and national helpline which assists millions of employers and employees each year.

Our work gives us unique insight into what is and is not conducive to good industrial relations and, in turn, what has potential to drive productivity, value and growth. It also makes Acas the evidential authority on the risks generated by poor workplace relations. We have examples from Tata Steel, to Phoenix Group to the NHS and railways which offer investors insight into how Board assurance and decisions which can either generate value, or create risks to success.

Summary

We welcome FRC's focus on narrative reporting, including sustainability reporting, and ESG metrics. Our insight suggests that a focus on the material non-financial information has potential to support financial return – to companies, investors and to the wider UK economy – and that this is currently undermined by a lack of understanding of social factors. Acas is therefore working with a range of partners to explore the 'S' in ESG– what evidence exists around different aspects of 'S' reporting to generate value creation, where the commonalities of approach exist between international frameworks, and what these tell us about what investors, shareholders and corporates value.

We recognise the rationale for propositions to expand the remit of audit committees to include non-financial reporting but suggest that individual companies are best placed to decide who is responsible for ESG within the broader corporate governance structure. What is critical is that risk and value are recognised and the whole Board appropriately informed about the breadth of the 'S'. More broadly, we suggest that non-financial reporting should be reflected in national and global reporting standards.

The following sections outline our thinking on these issues.

Benefits of non-financial reporting

We acknowledge the importance and benefits of narrative reporting, including sustainability reporting, and, where appropriate, the use of ESG metrics.

Annex A sets out the evidence base, which shows that there is a correlation between effective corporate social reporting and value creation/risk mitigation. Ensuring investors and shareholders have what they need to make effective decisions is key to avoiding unclear, inconsistent reporting measurements.

Current weaknesses in non-financial reporting

We recognise the FRC's view that "Environmental, Social and Governance (ESG) factors and sustainability have become essential considerations for companies throughout the world" and that "the current reporting landscape is fragmented with investors, regulators and stakeholders seeking more information, some of which is linked to regulations or targets."[1]

Indeed, ESG reporting is becoming more common, but there is lack of clarity on the definition and scope of 'S'. There are also striking gaps across most frameworks currently in use relating to the 'S'. Acas is currently undertaking a review[2] of the non-financial social metrics in use across different UK and International frameworks, including commonalities and gaps. Our developing model definition of the 'S' in ESG captures six broad areas:

- Organisation Purpose and reputation
- Human Rights
- Equality, Diversity and Inclusion
- Workforce Loyalty and engagement
- Workforce capability
- Employee Health and Safety

While there are consistencies around key human rights issues, for example, forced labour, child labour and modern slavery in the frameworks we looked at, our initial findings suggest significant gaps around workplace factors including productivity, flexible work and skills.

The absence of agreed standards and metrics results in an ad-hoc approach from organisations. Our preliminary conversations suggest that material stakeholders also

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[1] https://www.frc.org.uk/getattachment/a92c8f2d-d119-4c4b-b45f-660696af7a6c/Corporate-Governance-Code-consultation-document.pdf
[2] Further insight will be shared with stakeholders over Autumn/Winter 2023-4.

have different definitions of 'S'. For example, some focus on EDI issues; some on health and safety elements; and some (the majority) on the current legislative frameworks on gender pay and modern slavery. This lack of consistency poses a challenge in terms of benchmarking.[3]

While it does not sit within Acas's core areas of expertise, we also note there are also evidence gaps in wider reporting of the 'S', for example around community impacts and ethical products. Many of these wider 'S' factors may be determined by the reporting entity, depending on what is material to their business. However, we believe the workforce elements are of universal value.

Given the importance of non-financial reporting, we suggest that it should be reflected in national and global reporting standards.

Acas recently responded to the Department for Business and Trade (DBT's) *Non-Financial Reporting Review Call for Evidence*. When considering changes to current legal requirements for companies to prepare non-financial information, we recommended that the Government be cognisant of the importance of 'S' factors, particularly those which link to an engaged workforce, to a growth agenda.

Acas also responded to the ISSB's *Request for Information Consultation on Agenda Priorities* to seek feedback on its priorities for its next two-year work plan. We welcomed the ISSBs' mission to issue ISSB Standards that address 'climate first, but not climate only' and their focus on research topics that will ensure entities meet the information needs of investors on sustainability topics beyond climate. Our ask of ISSB was that they support a more strategic approach to human capital reporting over the medium to long term, recognising the importance of the 'S' factors, particularly workplace factors, in their forthcoming research agenda.

In summary: social reporting is not as advanced as either governance reporting or environmental reporting. While there are a number of models available – they don't achieve consistent traction or high levels of engagement (beyond mandated requirements in different jurisdictions). We recommend that the full breath of 'S' be reflected in national and international reported standards.

[3] This is seen in the role of ratings agencies, where OUP's Public Finance found in November 2022 that "ESG rating divergence decreases companies' incentives to improve their ESG performance. Companies receive mixed signals from rating agencies about which actions are expected and will be valued by the market".

The case for a focus on 'S' factors: the link to productivity and growth

An emphasis on sustainability reporting is vital and welcome, and ESG is crucial to that. But we would argue that this must include an emphasis on 'S' factors—particularly in relation to the workforce. Although it is arguably harder to define than its counterparts, 'S' factors are material to investors and should be recognised in reporting standards. They have, for example, a demonstrable link to growth, value creation and productivity—as outlined below.

Acas has a long-standing interest—and proven track-record—in these material 'S' factors. For example, we have helped UK organisations close the 'productivity gap' through a focus on workforce dimensions including, for example, skilled managers, employee voice, fairness, and well-designed work. This is evidenced by the 'Acas Productivity Tool', one of several outputs designed to help organisations identify their strengths and weaknesses, and, in turn, find solutions to productivity problems through a series of simple practical steps. Indeed, this tool builds and draws on the substantial body of evidence that shows the positive relationship between broader social factors and value-creation, productivity and growth. These factors are material to directors, investors and other stakeholders in the fulfilment of their duty to ensure the success of a company and pay regard to future strategy, opportunities and risk.

This submission focuses on Acas's evidence and experience. Acas is the evidential authority on what works – and what doesn't – in a workplace. Evidence on a number of workforce factors relevant to value-creation is outlined below (please note, our full definition and model of the most impactful reporting domains will be shared later this year).

Management practice

There is evidence to suggest that productivity problems can, at least in part, be attributed to relatively poorer management practices. Bloom and Van Reenan's World Management Survey (WMS) has, since 2003, mapped management practices across more than 20,000 businesses, hospitals and schools in 35 countries. It finds that firms ranked amongst the top fifth for 'management quality' are more than three times as profitable as the bottom fifth.

'Good work'

There is also evidence that good work can help deliver productivity gains. The 2017 Taylor Review defined good work as "working practices that benefit employees through good reward schemes and terms and conditions, having a secure position, better training and development, good communication and ways of working that support task discretion and involve employees in securing business improvements".

Indeed, academic research from 2005, based on an analysis of European data from 1995-2000, suggests that countries with higher job quality have higher levels of labour productivity and vice versa.

More recent 2020 research from the Warwick Institute for Employment Research found evidence of a link between good work and productivity. Their research comprised a literature review of the grey and academic literature examining seven dimensions of 'good work' and productivity measures, identified by the Carnegie UK Trust-RSA Working Group on Measuring Job Quality..

The Warwick Institute reports a positive correlation between four of the seven dimensions of good work (for which evidence exists) and productivity: particularly pay and benefits; health, safety and psychological wellbeing; job design and the nature of work; and voice and representation.

Employee engagement

Research has shown that employee engagement can have a positive impact on organisational performance. The Institute for Employment Studies—a British centre of research and consultancy on human resources and employment—has published a large body of research on this topic, and points to an "increasing awareness that employee engagement is pivotal to successful commercial and business performance", describing engaged employees as "the backbone of good working environments".

Further evidence is found in a 2020 meta-analysis from Gallup on the relationship between engagement at work and organisational outcomes. Performance outcomes included: customer loyalty/ engagement, profitability, productivity, turnover, safety incidents, absenteeism, shrinkage, patient safety incidents, quality (defects), wellbeing and organizational citizenship. It found that employee engagement is related to each of the 11 performance outcomes studied. Results indicated high 'generalisability', i.e. the correlations were consistent across different organisations.

In addition to the above, analysis of the 2017 Skills and Employment Survey—a survey of over 3,000 workers across Britain—found strong evidence for the links between employee engagement and innovation at work.

Finally, evidence from the 2011 Workplace Employment Relations Survey (WERS) shows a positive relationship between employee trust and firm performance. The WERS—co-sponsored by a range of organisations including Acas—was last carried out in 2011, comprising a sample of 22,000 employees. A 2013 paper from the University of Sheffield's Institute for Economic Analysis of Decision-making analysed data from the 2004 and 2011 WERS, finding that—in both the pre and post (2008)

recessionary period—there is a positive relationship between three measures of workplace performance (financial performance, labour productivity and product or service quality) and employee trust.

Skills

Education and skills are important drivers of productivity. Various econometric studies have confirmed the importance of skills and education for productivity growth. For example, a 2013 BIS research paper found that a 1% rise in the share of the workforce with a university education raises the level of productivity by 0.2-0.5 per cent in the long run. Research from the US suggests that skills play a key role in the effective use of information technology and there is evidence—based on analysis of linked-employer-employee data—that innovation at firm level is enhanced by a combination of skills and R&D investments. Recent papers from the Productivity Insights Network and the OECD reached a similar conclusion.

A 2009 paper from the Warwick Institute for Employment Research found similar evidence. It examined data from a number of sources, including the Labour Force Survey (LFS), the National Employers Skills Survey (NESS), ONS Regional Accounts, Global Entrepreneurship Monitor (GEM) and BERR "Business Start-ups and Closures: VAT registrations and de-registrations in 2007. It concluded that, in general, the evidence suggests that skills levels are related to productivity, i.e. more highly skilled people produce more high value goods and services more efficiently.

In summary: the FRC should be cognisant of the importance of 'S' factors to growth. There is a substantial body of evidence that shows the positive relationship between value-creation, productivity, growth and a range of workforce factors within the 'S' in ESG, including: management practice; dimensions of 'good' work (e.g. adequate pay and benefits, ensuring employees' health, safety and wellbeing); employee engagement; and skills). There is a gap in investors' understanding of this evidence, which is a risk to progress.

The case for a focus on 'S' factors: the link to risk

There is scope for non-financial social reporting to help companies identify and address broader risks or threats to their productivity and growth, and empower investors in both investment decisions and their ongoing approach to risk and sustainability.

2021 Acas-commissioned research mapped the incidence of conflict across UK workplaces, showing the impact on individuals and their employers. This found that the cost of conflict to UK organisations was £28.5 billion—the equivalent of more than £1,000 for each employee. Close to 10 million people experienced conflict at

work. Of these, over half suffer stress, anxiety or depression as a result; just under 900,000 took time off work; nearly half a million resigned, and more than 300,000 employees were dismissed.

The vast majority of those who suffer from stress, anxiety and/or depression due to conflict continue to work. This 'presenteeism' has a negative impact on productivity with an annual cost estimated between £590 million and £2.3 billion.

The same study showed that conflict leading to dispute triggers further costs and risks. It calculates that the total cost of management time spent dealing with potential and actual litigation is estimated at £282 million each year with a further £264 million spent on legal fees. In addition, we calculate that £225 million in compensation is awarded against employers per year.

More broadly, insufficient focus on workforce factors, reporting and deep understanding can lead to damage to reputation and therefore profits. Several recent cases have been in the media where poor management practices and insufficient focus at Board level to respond effectively to risks have led to reduced influence and drop in profit.

In summary: workplace conflict represents a significant cost to individual firms and the UK economy as a whole. A lack of focus on non-financial reporting to enable board assurance also creates risks to reputation and market value. Expanding the scope of non-financial reporting to include key workforce factors would empower investors to identify and address the risk that workplace conflict poses to firm performance. There is a lack of awareness of these material risks amongst investors and stakeholders.

Annex A

Benefits of non-financial reporting – the evidence base

There is a vast body of research showing a positive correlation between good ESG practices, including social reporting, and financial performance. 2016 research from Harvard Business School provides empirical evidence that companies focusing on addressing material sustainability issues report better financial performance, as measured by return on assets and return on equity. Similar findings have been reported by two meta-analyses (i.e. the statistical combination of results from two or more separate studies). Based on the findings of more than 200 academic studies, corporate reports, and books, Clark, Feiner and Viehs (2015) found that around 90% of them showed a positive correlation between ESG factors and financial performance; they argued that companies can—and should—"do well while doing good". Earlier 2012 research from Deutsche Bank paints a similar picture. It examined "more than 2,000 academic studies published since 1970", finding that almost two thirds (62.6%) showed a positive correlation between ESG strategies and strong financial performance—and that this correlation has remained relatively stable since the mid-1990s.

2019 research from McKinsey highlights the importance of social reporting to investors, pointing to "investors and executives who realize that a strong ESG proposition can safeguard a company's long-term success", and that "the magnitude of investment flow suggests that ESG is much more than a fad or a feel-good exercise". A 2022 paper from Pérez et al. shows the compelling evidence for this: "inflows into sustainable funds, for example, rose from $5 billion in 2018 to more than $50 billion in 2020—and then to nearly $70 billion in 2021".
George Serafeim, writing in 2020 for the Harvard Business Review goes further, arguing that "companies don't win over investors just by issuing sustainability reports and engaging in other standard ESG practices", instead they must be integrated into an organisation's "strategy and operations"—this is because, he says, "investors are becoming sophisticated enough to tell the difference between greenwashing and value creation".

More specifically, there is "growing evidence"—according to Bhattacharya, Sen and Korschun (2008)—that a company's corporate social responsibility activities comprise a legitimate, compelling and increasingly important way to attract and retain good employees.

A 2022 McKinsey paper argues that social reporting is conducive to gaining consumers' trust. It argues that organisations must "take adequate account of social license—that is, the perception by stakeholders that a business or industry is acting in a way that is fair, appropriate, and deserving of trust".

A 2021 poll from PwC involving over 5,000 consumers found that 83% think companies should be actively shaping ESG best practices, with 76% agreeing with the following statement: “I will discontinue my relationship with companies that treat the environment, employees, or the community in which they operate poorly”.