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Financial Reporting Councils Corporate Governance Code consultation Acas response

13 September 2023

This is the Acas Executive response to the Financial Reporting Council's (FRC) Corporate Governance Code consultation.

Cover letter

Acas and CIPD have recently responded to the government's call for evidence on non-financial reporting, as well as the International Sustainability Standards Board's consultation. We are also submitting individual responses to your colleagues on the Corporate Governance Code.

The social aspect of environmental, social and governance (ESG) is less well developed or consistently reported upon as governance and environmental reporting. Together we commend to the Financial Reporting Council the critical value of social factors within environmental, social and governance to a pro-growth agenda and hence to value creation and risk mitigation.

While we recognise the economic imperatives and global climate emergencies that require attention, we also argue that matters of human and social capital also need to be prioritised by company boards. This was very much in evidence during the recent covid-19 (coronavirus) pandemic. Health and safety, labour and skill availability and job design and culture were all demonstrated to be material to company performance and therefore important and significant in their own right.

Our ask of the Financial Reporting Council is that you support a more strategic approach to social non-financial reporting over the medium to long term. While some investors are focused on a narrow set of ethical and diversity dimensions of 'good corporate social responsibility (CSR)', there is robust evidence pointing to a need for boards to identify a broader set of material 'Social' dimensions to help businesses thrive and manage risks during uncertain challenging times and ultimately to drive value over the longer term.

We recognise the rationale for propositions to move human capital reporting to Audit Committees, but suggest that individual companies are best placed to decide the best place for environmental, social and governance within the broader corporate governance structure (for example, a Sustainability Committee, a People and Culture Committee, and so on). What is critical is that risk and value are recognised and the whole Board appropriately informed about the breadth of the 'Social'.

Acas and CIPD have started to marshal the evidence on the evolving definitions of the 'Social' dimensions to understand implications for growth and risk mitigation we are seeking. We are also reviewing the non-financial social metrics in UK and international frameworks to understand areas of commonality and gaps. We can already see some clear patterns, for example around human rights issues and significant gaps around workplace factors including productivity, culture, flexible work and skills.

We would be happy to share and talk through the emerging evidence and models with you.

Meanwhile, we recommend:

- When considering changes to current legal requirements for companies to prepare non-financial information, that the Financial Reporting Council be cognisant of the importance of 'Social' factors to growth. There is a current gap in the way these are understood and used by stakeholders and investors, which is a risk to progress. More needs to be done to improve

understanding of the evidence on what has material impact.

- The Financial Reporting Council invites Acas and CIPD to present their findings based on the large body of evidence demonstrating the positive link between material 'Social' dimensions and long term value-creation and risk mitigation. Also on the implications for consistent reporting and benchmarking.
- That the Financial Reporting Council acknowledges, and makes greater use of, the large body of management information available from Acas and CIPD on the causes of, and solutions to conflict at work and what measurable practices create and build healthy, productive workforces.
- Using the shared convening powers of Acas and CIPD we have a process of investor and corporate engagement planned before year end, and the Financial Reporting Council's involvement would be most welcomed.

We would welcome further ongoing conversations to advance the UK's competitive advantage by engaging in a pro-growth conversation about the Social in environmental, social and governance.

Full response

Question 12: Do you agree that the remit of audit committees should be expanded to include narrative reporting, including sustainability reporting, and where appropriate environmental, social and governance 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 Financial Reporting Council'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 can either generate value, or create risks to success.

Summary

We welcome the Financial Reporting Council's focus on narrative reporting, including sustainability reporting, and environmental, social and governance 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 'Social' in environmental, social and governance – what evidence exists around different aspects of 'Social' 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 environmental, social and governance 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 'Social'. 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 environmental, social and governance metrics.

Annex A sets out the evidence base, which shows that there is a correlation between effective corporate social reporting and value creation and 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 Financial Reporting Council's view that 'environmental, social and governance 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'.

Indeed, environmental, social and governance reporting is becoming more common, but there is a lack of clarity on the definition and scope of 'Social'. There are also striking gaps across most frameworks currently in use relating to the 'Social'. Acas is currently undertaking a review (further insight will be shared with stakeholders over autumn and winter of 2023 to 2024) of the non-financial social metrics in use across different UK and international frameworks, including commonalities and gaps. Our developing model definition of the 'Social' in environmental, social and governance captures 6 broad areas:

- organisation purpose and reputation
- human rights
- equality, diversity and inclusion (EDI)
- 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 factors at work 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 have different definitions of 'Social'. For example, some focus on equality diversity and inclusion 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.

This is seen in the role of ratings agencies, where OUP's public finance found in November 2022 that 'environmental, social and governance rating divergence decreases companies' incentives to improve their environmental, social and governance performance. Companies receive mixed signals from rating agencies about which actions are expected and will be valued by the market'.

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 'Social', for example around community impacts and ethical products. Many of these wider 'Social' 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's (DBT) 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 'Social' factors, particularly those which link to an engaged workforce, to a growth agenda.

Acas also responded to the International Sustainability Standards Board's (ISSB) Request for Information Consultation on Agenda Priorities to seek feedback on its priorities for its next 2-year work plan. We welcomed the International Sustainability Standard Board's mission to issue International Sustainability Standards Board Standards that address 'climate first, but not climate only' and their focus on research topics (PDF, 284KB) that will ensure entities meet the information needs of investors on sustainability topics beyond climate. Our ask of the International Sustainability Standards Board was that they support a more strategic approach to human capital reporting over the medium to long term, recognising the importance of the 'Social' factors, particularly factors at work, 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 do not achieve consistent traction or high levels of engagement (beyond mandated requirements in different jurisdictions). We recommend that the full breath of 'Social' be reflected in national and international reported standards.

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

An emphasis on sustainability reporting is vital and welcome, and environmental, social and corporate governance is crucial to that. But we would argue that this must include an emphasis on 'Social' factors – particularly in relation to the workforce. Although it is arguably harder to define than its counterparts, 'Social' 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 'Social' 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 does not at work. 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 3 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 to 2000, suggests that countries with higher job quality have higher levels of labour productivity and the other way round.

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 7 dimensions of 'good work'

and productivity measures, identified by the Carnegie UK Trust-RSA Working Group on Measuring Job Quality (PDF, 1.7MB).

The Warwick Institute reports a positive correlation between 4 of the 7 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 (PDF, 696KB) – 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 (PDF, 616KB) 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 organisational citizenship. It found that employee engagement is related to each of the 11 performance outcomes studied. Results indicated high 'generalisability', for instance the correlations were consistent across different organisations.

In addition to the above, analysis of the 2017 Skills and Employment Survey (PDF, 2.1MB) – 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 Workplace Employment Relations Survey – 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 (PDF, 400KB) analysed data from the 2004 and 2011 Workplace Employment Relations Survey, finding that – in both the pre and post (2008) recessionary period – there is a positive relationship between 3 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 (PDF, 622KB) found that a 1% rise in the share of the workforce with a university education raises the level of productivity by 0.2 to 0.5% in the long run. Research from the Quarterly journal of Economics 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 Research and Development (R&D) investments. A recent paper from the OECD reached a similar conclusion.

A 2009 paper exploring the link between skills and productivity (PDF, 1MB) 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), Office of National Statistics (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, for instance more highly skilled people produce more high value goods and services more efficiently.

In summary: the Financial Reporting Council should be cognisant of the importance of 'Social' 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 'Social' in environmental, social and governance, including: management practice; dimensions of 'good' work (for example 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 'Social' 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 at work across the UK, 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 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: conflict at work 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 conflict at work 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 environmental, social and governance practices, including social reporting, and financial performance. 2016 corporate sustainability research from Harvard Business School (PDF, 785KB) 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 2 meta-analyses (for instance the statistical combination of results from 2 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 environmental, social and governance factors and financial performance; they argued that companies can – and should – 'do well while doing good'. Earlier 2012 research from Deutsche Bank 'ESG and Corporate Financial Performance' (PDF, 960KB) 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 environmental, social and governance strategies and strong financial performance – and that this correlation has remained relatively stable since the mid-1990s.

2019 research from McKinsey 'Five ways ESG creates value' (PDF, 718KB) highlights the importance of social reporting to investors, pointing to 'investors and executives who realise that a strong environmental, social and governance proposition can safeguard a company's long-term success', and that 'the magnitude of investment flow suggests that environmental, social and governance is much more than a fad or a feel-good exercise'. A 2022 McKinsey 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 environmental, social and corporate governance 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 "Does ESG really matter?" argues that social reporting is conducive to gaining consumers' trust. It argues that organisations must 'take adequate account of social licence – 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 environmental, social and governance 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'.