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Making Work Better

Response to BIS Consultation on *The Future of Narrative Reporting*

WorkMatters Consulting's Response to BIS Consultation on the Future of Narrative Reporting

About WorkMatters Consulting
WorkMatters Consulting is a private limited company and was founded in 2010 by David Coats, former Associate Director-Policy at The Work Foundation and Head of Economic and Social Affairs at the TUC. It offers advice to employers and trade unions to improve the quality of workplace relationships, produces research on key labour market issues and lobbies for changes in public policy to improve the quality of the working environment. Further details can be found at www.workmattersconsulting.co.uk.

Introduction
The coalition government's intention to reintroduce the requirement for listed companies to produce and operating and financial review is a very welcome development. The previous government's decision to abandon the OFR was met with dismay by a range of stakeholders. A good deal of preparatory work had been done and it seemed rather absurd that the initiative should have been discarded to generate some favourable headlines for the then chancellor of the exchequer.

It is generally accepted today that the value of many organisations is to be located in their human capital. This is a natural consequence of the move to more knowledge intensive economic activity and reflects the rising skill levels across the economy. Somewhat paradoxically, however, recent research by the UK Commission for Employment and Skills has identified the prevalence of the phenomenon of skills under-utilisation. In other words, some of the productive potential of the workforce is being wasted[1]. Moreover, there is evidence to show that high quality management is a critical element in strong organisational performance and the relative weakness of UK management (in this case in manufacturing) can help to explain our disappointing productivity record[2].

If this were not enough to cause concern, some commentators have pointed out that job quality in the UK is worse than in other comparable countries[3]. Employee engagement remains more of an aspiration than a reality and the Chartered Institute for Personnel and Development have been honest enough to admit that barely a third of employees have the attitudes supposedly associated with the delivery of strong organisational performance[4].

These problems would have been serious enough during a period of robust economic growth but they now raise a serious question about the speed of the recovery and the sustainability of the pre-crisis economic model. The coalition government's desire to rebalance the economy is admirable. But there is a strong case for saying that a people management paradigm failed at the same time as the economic paradigm. British businesses will need to manage people differently in the future if the country is to return to full employment and offer high quality jobs to all.

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[1] See *Ambition 2020: World Class Skills and Jobs in the UK, The 2009 Report*, UKCES (2009)
[2] Kretschmer, *Explaining Productivity and Growth in Europe, America and Asia,* Anglo-German Foundation (2009), Bloom and Van Reenen*, Management Matters,* CEP mimeo *(2009)*
[3] Coats and Lekhi, *Good Work: Job Quality in a Changing Economy*, The Work Foundation (2008), Gallie, *Employment Regimes and the Quality of Work* (2007)
[4] CIPD *Employee Engagement Survey 2006* (2007)

Obviously a change in the reporting requirements for listed companies cannot resolve all of these difficulties, but there is a strong case for saying that more robust reporting arrangements in the revived OFR could create a set of incentives for senior managers to take the management of the workforce more seriously. Furthermore, there is a powerful argument that investors should take a much closer interest in these issues, particularly if the goal of public policy is to encourage patient, long-term and responsible investment. After all, companies are most resilient when they can respond well to external shocks or the challenges of new markets, new technologies or new sources of competition. And a critical test of resilience is the ability of the workforce to remain motivated and committed in an environment of continuing change and uncertainty. Obviously this raises questions about the management instruments used to create and sustain trust, including effective communication with employees and the scope that workers have (whether individually or collectively) to influence critical employer decisions.

Many of these issues were considered in Baroness Kingsmill's review of human capital reporting, the findings of which were published in *Accounting for People* (2003). While those proposals were rejected at the same time as the OFR was abandoned, ministers today would be well advised to return to the Kingsmill recommendations. No doubt some business stakeholders will complain about having to disclose more information about the management of the workforce, but they will be collecting the information anyway and it is difficult to see how investors can be offered a fair view of the business without some reference to HR policies and strategy.

Given the interests of WorkMatters Consulting, this response focuses exclusively on the human capital and employee voice content of a revived OFR. The government has a great opportunity here to begin to address some of the most intractable problems in the world of work by creating new incentives for the improvement of people management. It is not too fanciful to say that the UK's continued prosperity depends on the development of a new model for the responsible corporation, not necessarily institutionalising the stakeholder model applied in Germany, but recognising that the maximisation of shareholder value alone is an attenuated and rather unsophisticated measure of corporate success.

A "burden on business" or an indispensable measure of corporate responsibility?

The previous arrangements for the OFR were ostensibly rejected because they were an intolerable burden on business. Quite why this conclusion should have been reached by the previous government is not entirely clear. Certainly, Digby Jones, then director-general of the CBI, endorsed Gordon Brown's actions, but as the consultation document makes clear, the business review seems in principle to make many of the same demands of corporations of the OFR, albeit that the audit requirements and statutory recognition of a reporting standard were dropped.

One consequence of the global financial crisis has been a general decline of public trust in business generally and banks in particular. There is a strong case for saying that part of the government's plan for growth (if it has one) ought to be focused on re-legitimising business decisions in the eyes of the public. Limited liability is a privilege not a right and it is entirely appropriate for corporations to be open, transparent and willing to listen to criticism. To do nothing is simply not an option, not least because politicians will continue to be blamed when the decisions of individual corporations have a widespread negative social impact. In other words, openness is the price that corporations have to pay for public acceptance. Transparency is a prerequisite for accountability both to investors and the wider community. Policy should recognise that the public interest is not always the same as the interests of business. Regulations on reporting and disclosure should be based on that principle.

This brings us to the question of voluntarism and prescription. The "old" OFR would have been audited and subject to clear reporting standards, whereas the business review is subject to no audit

requirement and eaves most decisions about disclosure to the individual corporation. Not only does this make comparisons between corporations problematic, but it can also mean that change can be difficult to track over time if companies adopt one approach to narrative reporting today and do something entirely different tomorrow.
A higher degree of prescription than is currently demanded is therefore desirable but just how much more prescription is a fine judgment. At the very least, listed companies ought to be subject so *some* common standard. Of course, the Accounting Standards Board has continued to endorse a reporting standard for the OFR as non-mandatory best practice guidance. This was a constructive response to the previous government's abandonment of the OFR, but is hardly adequate given the extent of the challenge to corporate legitimacy. Government should therefore reinstate statutory recognition of the standard and invite the ASB to consider whether the standard should be reviewed in the light of responses to this consultation. This is especially important in relation to the human capital issues. While the ASB standard does include some consideration of employee motivation and commitment, the examples given relate only to accident rates and employee satisfaction ratings. There are other issues outside the scope of the current guidance that demand attention and these are outlined in more detail below.

The enhanced audit requirement was allegedly the most burdensome part of the OFR and it may be sensible, at least initially, to accept that a similar approach should be avoided in the new legislation. Nonetheless, government should leave the issue open. If it becomes clear that an audit requirement would improve the quality and usefulness of the OFR then the previous arrangements should be reinstated. This of course will require BIS to review the operation of the new regime after, say, a four year period.

The consultation document suggests that a voluntary approach might be just as acceptable to the government as long as policymakers can be confident that there will be real changes in behaviour. One can understand the desire to consider all the options, but the consultation document could be read as a step back from the apparently clear commitment to reintroduce the OFR on a statutory basis. If the financial crisis has proved anything it is that self-regulation can go catastrophically wrong. There is little evidence to suggest that all companies will increase transparency unless they are compelled to do so by statute. In this instance the commitment to legislate should not be abandoned. Moreover, a degree of prescription about the precise information to be disclosed may be necessary to ensure that all listed companies comply.

The ASB standard should therefore be revised to include the additional material discussed later in this response. Obviously it is important to allow scope for innovation, but a simple application of the "comply or explain" principle is as relevant here as in other aspects of corporate governance. If an organisation decides not to report on some aspects of HR policy and strategy it is entirely appropriate for investors to demand that some reasons be given.

Human Capital: What should be included in the OFR? (Qs 9 and 10)
The critical question of course is to decide on the nature and scope of the information to be disclosed in the OFR. We would do well to remember that the goal is to give investors and other users of the OFR a "fair view of the business". Once again, a good deal of work was done under the previous government through Rosemary Radcliffe's review of the notion of "materiality" for the purposes of the OFR. This should remain the starting point for policymakers today. Nonetheless, events have moved on since the early part of the decade and we know rather more about the relationships between organisational performance, work organisation, job design and employee commitment. While some simple hard data ought to appear in the OFR, there is a strong case for offering more contextual information so that investors and others can get a clear sense of what it is like to work for the organisation.

Perhaps we should begin by recording that by requiring listed companies to report more extensively on the management of their employees, the state is setting a standard that cuts with the grain of social expectations. Most citizens believe that corporations should behave responsibly and there is a real risk to corporate reputation (with a consequential effect on the share price) if good practice is not followed. Moreover, the state is also reshaping the incentive structure for directors by making it clear that good management of people is a prerequisite for a well managed business. No doubt some sceptics will say that such obligations lead to more box ticking or boilerplate reporting, but if well managed corporations adopt good practice in reporting it is likely that the more recalcitrant will follow.

Another important objective must be to reshape investor behaviour. If there is anything at all to the knowledge economy story and if human capital is really becoming a distinctive source of competitive advantage then investors need to know just how well a listed company is managing employees. At present most investors pay only lip service to this maxim, partly because they are uncertain about how such performance might be measured and the ASB standard offers only limited help. But a sophisticated assessment of the management of the workforce may be a better guide to the long term potential of the company than supposedly harder benchmarks like increases in share price or earnings per share (which are, by definition, backward looking measures).

The approach adopted in this response is that the new OFR should be used to extend the definition of corporate success. Even before the crisis there a discussion developing amongst commentators and public intellectuals. Will Hutton has argued for some time that property ownership (including the ownership of shares) creates rights and imposes obligations. Investors should be seen as holding their property in trust for other stakeholders – workers and the wider community – who will be affected by the behaviour of the business[5]. John Kay makes an analogous point when he argues that successful companies are those that build their capabilities over time and successfully adapt to changing conditions[6]. A relentless focus on shareholder is a very crude, not to say trivial, measure of corporate success. There is no shortage of material available to help rethink the role of the large corporation in a reformed model of responsible capitalism.

The ASB standard already contains suggestions about the information to be disclosed including:

- Health and safety performance
- Recruitment, retention and labour turnover
- Investment in training and development
- Morale and motivation
- Productivity

Assuming that these guidelines are followed, any reader of an annual report should therefore have a rough and ready understanding of the safety of the workplace, the ability of the organisation to recruit and retain a skilled workforce and an outline assessment of employee satisfaction derived from the staff survey. These are all useful measures, but apart from the fourth element (morale and motivation) they give only a partial account of what it is like to work for that organisation. There is a lack or richness and texture in this information, suggesting that a more ambitious set of requirements might be needed.

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[5] Hutton, *The State We're In* (1995), *The World We're In* (2002)
[6] Kay, *The Truth About Markets* (2003)

Most importantly, perhaps, employee satisfaction measures have themselves been subject to some criticism. Central to the argument is the belief that individuals display adaptive behaviour – it is possible to get used to almost anything and then say that the room for improvement is limited. According to the European Working Conditions Survey the UK has the second highest job satisfaction rating in the EU (only the Danes are more satisfied), but applying a different set of indicators suggests that the UK has a more serious job quality problem[7].

A further objection is that all but one of these indicators (employee motivation) depends on companies evaluating their own performance. Some additional objective measures are needed so that the annual report describes the life of the organisation. A partial solution might lie in the publication of detailed results from the most recent staff survey, accompanied by an account of the action taken either to sustain good performance or to remedy deficiencies. But a more radical approach would require the publication of data related directly to more objective measures of job quality.

To understand how progress might be made we need to have a general understanding of those factors that affect the quality of employment. There is an extensive body of research confirming that the following are particularly important:

- The security of employment
- Whether work is characterised by monotony and repetition?
- Whether employees have autonomy control and task discretion?
- The extent to which there is an appropriate balance between the rewards workers receive and the efforts that they make.
- Whether employees possess the skills they need to cope with periods of intense work pressure?
- Whether the workplace is seen to be fair? Do workers believe that the employer observes the principles of procedural justice?
- The strength of workplace relationships – or what some researchers have described as social capital[8].

The suggestion here is that a more sophisticated staff survey could begin to assess the extent to which quality employment is on offer. So, for example, a number of questions could be added to explore the following:

- To what extent do workers have real control and autonomy? This can be measured by asking questions about the source of external influence over work effort (clients, supervisors, fellow workers or technology), about the choice of tasks and working methods and the setting of quality standards.
- Do employees believe that the workplace is fair?
- Do employees possess the skills they need to do their jobs? Are these skills fully utilised?
- Do employees believe that they are fairly rewarded for the work that they do?
- Do employees trust senior managers?

By implication, the answers to these questions will also give a strong indication of the organisation's capacity to adapt to changing circumstances. As we have already observed, it is much more likely that a business characterised by high skills, high trust and high autonomy with high quality

[7] Gallie, op cit. Coats and Lekhi, op cit.
[8] Marmot, *Status Syndrome* (2004)

management will be better able to weather the storms of the business cycle, technological change and intensifying competition.

Voice and Employment Relations (Q10, iii)

Perhaps the most problematic "good work" indicator is the collective voice element. Research tells us that high trust relationships are sustained most effectively where a strong relationship exists between the employer and a recognised trade union. The worst of all possible worlds is a weak trade union raising workers' expectations, confronting the employer. At an intermediate point between the two extremes we can find the union-free high commitment management model[9].

Investors know that the quality of employment relations, although less of a serious issue than in the past, can have a significant impact on organisational performance, customer satisfaction and employee motivation and commitment. It is entirely appropriate then for listed companies to be required to offer a narrative account of the conduct of employment relations over the preceding year, with some forecasts offered of the prospects for the next year. One can understand why a company might want to keep some information confidential – it would not be sensible, for example, to reveal the pay bargaining strategy for the forthcoming year. But it is essential for investors to know whether a strike is likely, whether relationships have improved and whether high trust between the union and the employer is genuinely having a positive effect on employee motivation and commitment.

There could also be a requirement to offer an account of the structures in place both for individual employee involvement and collective employee participation, whether through a trade union or some other vehicle. So, for example, a company could be required to disclose the arrangements it has made to comply with the Information and Consultation Regulations. What voice arrangements are in place? How effective are they? What information is being disclosed to employee representatives and when? What discussions have taken place over the last year and on which issues? Is the relationship adversarial or co-operative? If a trade union is recognised is the focus simply on collective bargaining or are joint problem solving activities taking place too?

Assuming that answers are given to all these questions then investors can, with appropriate advice, make their own judgments about the quality of work on offer and the quality of the employment relationship. Sceptical commentators may say that these issues are essentially management decisions and investors should be satisfied if the share price is high and rising or if dividends are being paid regularly. Of course there is some truth in this, but if the aim is to convince investors to take a more long term view then all those factors affecting the resilience of the firm, including job quality and employment relations, need to be included in the narrative account of the company's activities over the previous year.

Advice and guidance (Q11)

As has been made clear in the preceding sections, there is a strong case for the ASB to revise the reporting standard to include the human capital and employment relations issues discussed above. This means that the Key Performance Indicators relating to the management of employees will need some significant revision. Practical examples of a model OFR dealing with the job quality issues would be a significant step in the right direction. Unless this is done companies may be uncertain what they should report and may struggle to explain inclusions and exclusions. Of course, the problem here is not really one of reporting. The challenges are more related to management styles and cultures, approaches to people management and employer enthusiasm for or antipathy to

[9] Bryson, *Union effects on managerial and employee perceptions of employee relations in Britain*, CEP (2001)

collective voice. The purpose of the OFR is to change the incentive structures for managers, but it is only one instrument of many that might be used to transform the landscape and is by no means the most important[10].

Shareholders' advisory vote on the business review/OFR (Q 12)

One can understand the rationale for a shareholders' vote on the business review, not least because it would allow shareholders to express a degree of satisfaction or dissatisfaction with overall performance. But this is a very crude instrument and takes no account of the complexity of the issues. So, for example, shareholders might be very happy with environmental performance or the progress of research and development and much less happy with the management of employees. Alternatively, it may be clear that HR policy and strategy is working well in some parts of the business but not so well in others. How is an informed investor supposed to react at the AGM? They could vote against the whole of the business review/OFR, but that would suggest that the company was in some way generally underperforming. Or they could vote for the OFR, which might be taken to reflect general satisfaction with the state of affairs. Neither option would be an accurate reflection of the investor's views and it would give a misleading signal to the directors too. Perhaps it would be better to see the business review/OFR as an engagement tool, allowing committed investors to open up a conversation with directors about the strengths and weaknesses of the business. It is a device to ensure that investors are properly informed so that they can hold directors accountable. Moreover, there is a wider public interest in the highest possible level of openness so that corporate decisions can be subjected to proper scrutiny by other stakeholders. There is a risk that an advisory vote could create risk aversion amongst directors. A fear of the wrath of the AGM might lead to a lower level of disclosure.

Non-regulatory solutions (Q13)

We have already made clear our preference for a stronger regulatory framework, with statutory recognition of a reporting standard for the OFR. Nonetheless, that does not mean there is no scope for softer forms of intervention. Indeed, one would hope to see a competitive element developing in the process of narrative reporting, with the best listed companies aspiring to improve their performance and the lower performers following suit. The proposals for an expert panel described in the consultation document are helpful, although it might be best to leave this to voluntary initiative (with government offering moral support) rather than develop a new government led scheme. The Investors in People standard offers a possible model; the government obviously plays a role (IiP is now under the purview of UKCES) but the standard is independently verified and administered.

The Public Sector

Imposing new obligations on listed companies is one thing and encouraging similar disclosures across the public sector quite another. In principle the public sector could be an exemplar. Analogous obligations to those applying to listed companies could be imposed on local authorities, NHS trusts, the civil service and universities for example. The Cabinet Office could require all central government departments to publish an account of their people management outcomes alongside a wider range of performance outcomes. Indeed, a degree of cross-fertilisation from public to private sector and vice versa could prove very useful. Of course, this is beyond the scope of the current consultation, but one would hope that there will be enough co-ordination across departments to ensure that the public sector adopts the good practices expected of the private sector. There is also

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[10] For a longer discussion of potential policy interventions see Coats, *Advancing Opportunity: The Future of Good Work* (2009) and *Time to Cut the Gordian Knot: The Case for Consensus and Reform of the Employment Relations System* (2010), both available from the Smith Institute, www.smith-institute.org.uk.

a case for a more formal approach to these matters, perhaps by establishing a human capital management network involving representatives of both public and private sectors.

Executive Remuneration (Q14)
The current disclosure requirements were introduced to try and create some countervailing pressure to the upward spiral of executive pay. Given that goal, the provisions have largely failed. Greater transparency has led to leap-frogging as remuneration committees try to ensure that directors are paid in the upper quartile of the reward distribution. Occasionally shareholders become enraged by what they see as a peculiarly egregious offence, but in general the process operates without interruption. If business is to restore its legitimacy then this culture must change.

There is a particular problem in the financial services sector, where perverse incentives seem to have encouraged high risk investments. Other measures may be needed to deal with that problem and it would be unwise to place too much weight on pay disclosure requirements alone – the Basel 3 agreement on capital requirements may be more important for example.

Nonetheless, there are further measures that could be taken that might lead to the reinstatement of some generally accepted norms of fairness in pay determination. The Prime Minister has suggested that a ratio of 20:1 between the highest and lowest paid is a useful rule of thumb in the public sector. Will Hutton, who is undertaking a review of fair pay in the public sector, is likely to use this as a benchmark. However, the big risk is that if top salaries are falling in the public sector all the management traffic will be one way – from public to private sectors where the rewards are greater. Of course the public sector can be an exemplar as we have already suggested, but there are other measures that could be taken to use the power of public embarrassment to encourage a higher level of self-restraint amongst remuneration committees.

For example, the disclosure requirements could be expanded to include the following:

- The ratio of top pay to bottom pay in the organisation
- The relationship between the highest paid director and median earnings in the organisation
- The distribution of pay across the organisation, with a clear statement of the number of employees in each earnings bracket.

The first two of these proposals are to be found in the new legislation about to come into operation in the USA – the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010. It would not be completely astonishing if British listed companies were to be subjected to a similar regime. Indeed, those companies listed in both New York and London will have to comply with this legislation in relation to their US operations. Surely, they would not argue that such an obligation would be intolerably burdensome were it to be imposed in the UK?

Conclusion
It would be wrong to suggest that these measures will solve all the problems we have identified in the introduction or that the changes in behaviour will be rapid. Nonetheless, there is a serious opportunity to encourage more reflective behaviour by both listed companies and investors. Policymakers have a great deal to gain and very little to lose, particularly during a period when public confidence in business is very low. Improving narrative reporting could be a very useful route to the relegitimisation of business activity. It is an opportunity too good to be missed.

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