



Unlocking Human Capital

Engagement on Employment Best Practice

LAPFF Trustee Guide
June 2007

www.lapffforum.org

The Local Authority Pension Fund Forum, which was set up in 1991, is a voluntary association of 40 public sector pension funds based in the UK. It exists 'to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest.' The Forum's members currently have combined assets of £75 billion.

Stuart Imeson
LAPFF Secretariat
Bradford City Council
Britannia House
Hall Ings
Bradford
West Yorkshire
BD1 1HX
Tel +44 (0)1274 43 23 17
Fax +44 (0)1274 43 77 00
info@lapfforum.org

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This guide has been prepared and written by Ebba Schmidt and Peter Southwood of PIRC, LAPFF's research and engagement partner. For further information, please contact EbbaS@pirc.co.uk

Structure of guide

This guide is set out in two sections:

- **Core indicators of good practice.** This section contains the common set of core indicators which can be applied across all companies and sectors to assess the quality of investee companies' reporting of employment policies and practice. The outcome of this assessment will be the identification of underperforming companies in the area of employment practices.
- **Engagement strategy.** This section outlines how an engagement strategy can be developed, in order to address underperformance with companies, by discussing employment issues at strategic levels and proposing ways in which companies could improve communication with investors.

Benefits for the fund

The guide will enable pension fund trustees, officers or fund managers to review companies' reporting on employment issues, and identify appropriate engagement strategies, in order to:

- Develop an understanding of the specific employment risks that individual companies are facing, and transfer this understanding to other companies in the industry, in order that these risks might be mitigated through investor engagement;
- Discuss employment issues not only in the context of corporate responsibility, but as part of an integrated approach to business strategy;
- Address a much neglected area of business strategy the financial impact of which is commonly underestimated..

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Chapter 1 – Introduction



All too often companies state that employees are crucial to their business success, without explicitly linking that recognition to their business strategy in a transparent and meaningful way.

The Local Authority Pension Fund Forum (LAPFF) believes that good employment practices are linked to long-term corporate prosperity and hence the creation of investment value. The Forum is committed to improving the quality of employment reporting by listed companies. It regards narrative reporting, in the form of business reviews or voluntary operating and

financial reviews (OFRs), as an opportunity to be grasped in achieving this objective but without neglecting the broader foundation of CSR, and especially employment reporting, on which it must be based.

In 2003, the 'Accounting for People Task Force' report (Kingsmill Report)¹ concluded that 'there is no single set of

¹ DTI, *Accounting for People: Report of the Task Force on Human Capital Management*, October 2003



As a result of experiences from active engagement with companies on employee practices on the basis of the 2005 report, as well as the introduction of narrative reporting in the form of business reviews and/or voluntary OFRs, the approach outlined in the 2005 report was revised. The current version of this Trustee Guide is the result of that revision.

The Forum is committed to continuing active engagement on behalf of its members with companies on the types of employment information it expects companies to include in their business reviews or voluntary OFRs, and will develop its approach on the basis of lessons learnt from the engagement.



[human capital management] practices widely accepted as "best practice" applicable to all organisations, nor agreement on a set of universally relevant indicators.' Since then a consensus has been achieved amongst LAPFF members on a set of core indicators that FTSE 100 companies (with 500 or more employees) ought to be reporting against. These indicators were published by the Forum in April 2005 in its first report on Company Workforce Practices, available at www.lapfforum.org

How to Use this Guide

This LAPFF Trustee Guide on Company Workforce Practices aims to assist local authority pension fund trustees in assessing the quality of investee companies' reporting of employment policies and practices, and in adopting an engagement strategy to address underperformance with companies.

The Guide proposes three stages:

- Identification of companies within a pension fund's equity portfolios that do not meet a minimum standard of reporting on the basis of a common core of performance indicators;
- Strategic evaluation of the materiality of employment factors in the business review or voluntary OFRs of these companies, and identification of an engagement strategy;
- Engagement with underperforming companies, in order to establish company-specific employment risks, and a set of specific key performance indicators that the company should be disclosing.

While the guide has a strong emphasis on disclosure, the ultimate intention is

to assess how effectively companies are applying their strategic approach to risk and opportunities associated with workforce issues, in order to protect and enhance long-term shareholder value. Good reporting is a crucial requirement for the ability of investors to hold companies and their boards accountable for this key management area.

The development of an engagement strategy on the basis of disclosures in business reviews or voluntary OFRs introduces the concept of materiality, and facilitates the discussion of employment issues in relation to companies' business strategies. This approach is underpinned by the recognition that seeking an in-depth understanding of a company's business context and corporate strategy is likely to achieve a better engagement outcome than simply prescribing specific criteria for comparable and consistent reporting. This framework enables pension funds themselves to develop an engagement strategy and to enlist their fund manager's support where appropriate.

Chapter 2 - Background to the Trustee Guide

The proposed engagement strategy of the 2005 Report on Company Workforce Practices was based on the following three-pronged approach to:

- Require a minimum standard of reporting on employment practices applicable to all publicly listed companies above a certain size;
- Identify material industry-specific employment risks and opportunities;
- Seek directors' views on the materiality of employment issues in the preparation and publishing of the business review or similar reports.

The template contained in the 2005 Report drew on:

- A 2003 report commissioned by the West Midlands Pension Fund (a LAPFF member), which identified those FTSE 100 companies that are leaders in promoting good employment practices and also those companies that are doing less well, with the long-term aim of seeking improvements to protect shareholder value.

- The consideration of the findings of the 2003 Kingsmill Report which took account of a wide range of investor and stakeholder views. The Forum produced a new template of core indicators, qualitative and quantitative, on which all publicly listed companies should be required to report, especially those with 500 or more employees. The core indicators were published in 2005 in the first LAPFF Report on Company Workforce Practices.

The Trustee Guide. The Trustee Guide takes into account experiences drawn from active engagement on workforce practices with companies in the hotels/leisure sector and in the food producer sector. The dialogue was conducted in 2005/2006 both by correspondence and in face-to-face meetings. It was evident, from the assessment of the effectiveness of these engagement activities, that the original three-pronged approach (see above) needed to be revised.

New narrative reporting. The Forum's engagement strategy evolved over time as a result of the aborted implementation of the OFR, and the subsequent implementation of the business review. Whether companies opt for publication of a business review or a voluntary OFR, they should now put in place the systems and procedures to ensure that relevant KPIs and other quantitative and qualitative measures can be used by directors to evaluate progress in their management of employees. In 2006, the Forum adopted the ASB Reporting Statement (previously

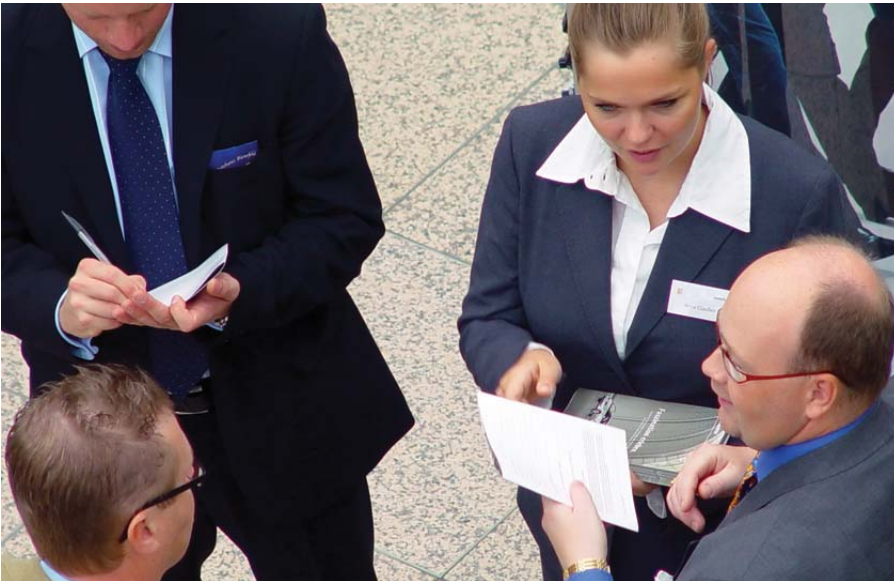
ASB Reporting Standard 1) as the framework under which it expects FTSE 350 companies to provide narrative reporting. Consequently, engagement efforts were increasingly underpinned by the expectation that employee matters should be addressed at a strategic level, supported by relevant key performance indicators.

Industry versus company perspective.

One lesson learnt from the Forum's engagement activities is that the identification of examples of industry-specific employment risks and opportunities is not straightforward.



Chapter 3 - Core Indicators of Good Practice



While the understanding of industry-specific issues is useful when analysing a great number of companies, a more focused engagement approach should take into account the varying situations of individual businesses.

Gender and equal pay. The Forum has also adopted the best practice guidance set out by the Equal Opportunities Commission (EOC) for equal pay policies and equal pay audits as the framework under which it expects listed companies

to identify, address and report on equal pay issues. This Trustee Guide has been extended to cover equal pay with regard to gender.



Practice area	Management area	Indicators
Principles, policies and business strategy	Employment policies	Policy includes the following objectives (in so far as local laws allow): <ul style="list-style-type: none"> • Health & safety • Diversity/equal opportunities • Equal pay • Freedom of association • Information, consultation and participation • Training and development • Remuneration • Social responsibility
	Link between employment strategy and business strategy	The company discloses the nature of this link.
Responsibility and accountability	Board level responsibility	The company identifies the board member or members responsible for human resource issues.
	Senior management responsibility	A human resource or equivalent function exists with senior management reporting to the main board.
	Group programmes with targets	The company discloses group programmes with targets for improvement: <ul style="list-style-type: none"> • Health & safety • Diversity/equal opportunities • Equal pay • Training and development • Remuneration
Engagement with employees	Human rights	The company explains how it promotes the benefits of human rights at the workplace (in so far as local laws allow).

Practice area	Management area	Indicators
	Communication and consultation	The company demonstrates that it has mechanisms for: <ul style="list-style-type: none"> • Communication on strategic and operational matters • Two-way communication or consultation at group, regional and divisional/business unit levels • Participation in management decision-making and/or collective bargaining arrangements.
	Employee views	<ul style="list-style-type: none"> • The company has regular employee satisfaction surveys or other means of ascertaining employee views on relevant subjects.
Key performance indicators	Size and composition of the workforce	The company discloses annually the size and composition of the workforce in the company's main areas of operation, including a breakdown by: <ul style="list-style-type: none"> • Age, gender and ethnic profile • Full-time and part-time employees • Management and non-management • Direct and indirect (where significant)
	Retention and motivation	The company discloses annually, in the company's main areas of operation, staff turnover overall and by significant groups.
	Health and safety	The company discloses annually, in the company's main areas of operation, any fatalities, fines and prosecutions.
	Equal pay	The company discloses periodically, in the company's main areas of operation, outcomes of equal pay audits.

Practice area	Management area	Indicators
Standards, reporting and audit	Accreditation	Monitoring and evaluation of employment practices is accredited against at least one recognised and relevant general management standard in the company's main areas of operation.
	Link between employment strategy and business strategy	Reporting of the Board's assessment of the links between the company's approach to employment strategy, its business strategy and its performance covers at least one of these areas: <ul style="list-style-type: none"> • Size and composition of the workforce • Retention and motivation of employees • Skills and competencies necessary for business success, and training to achieve them • Remuneration and fair employment practices • Leadership and succession planning
	Independent audit	The information on which the board's reporting on employment issues is based has been audited by an independent, external reviewer.

Chapter 4 - Engagement Strategy

Identification of issues at companies

The first step in an engagement campaign should be the establishment of risk exposure in a fund portfolio. The Forum has established a consensus amongst its members on a set of core indicators that FTSE 100 companies should be reporting against (chapter 1, above). These indicators aid identification of underperforming companies with respect to employment standards.

When deciding on worthwhile targets for engagement, other considerations should also be taken into account, such as (but not limited to):

- Size of the fund's investment in the company
- Percentage of fund assets allocated to this company
- Potential for achieving changes at the company that will create value in the long-term.

Strategic focus on disclosures in business reviews/OFR

While the Guide has an emphasis on disclosure, to enable funds to hold investee companies and their boards accountable on employment risks and their mitigation, the ultimate intention is to assess how effectively companies' employment policies and practices are in helping to generate shareholder value in the long-term. In developing an engagement strategy for underperforming companies, focusing the analysis of companies' disclosures on employment practices in business reviews and voluntary OFRs will be of significant value. With the regulatory framework for material, non-financial disclosures by directors now in place, this new narrative reporting will form a useful foundation for strategic discussions of a company's employment practices. Other company publications, such as CSR reports or website content, should of course be consulted as well, but these are less likely to emphasise materiality or a business strategy context.

Example considerations	
Group-wide employment policy	In the case of serial acquirers that do not fully integrate their acquisitions, but apply financial controls only, the requirement for a group-wide employment policy may be out of sync with the hands-off approach in other business areas. The fund should consider, however, that the Group has ultimate responsibility for employment practices in its various businesses, and that employment risks at businesses ultimately represent risks for the group as a whole.
Inclusion of material employment issues	A company may state on its website or in its CSR report that employees are a crucial resource for its business success; however, no reference to this resource is included in its business review/voluntary OFR.

Example questions

1a	Is there anything about the business strategy as outlined in the business review/voluntary OFR that will limit the applicability of the key performance indicators in Chapter 1 (above)?
1b	If so, how would these key performance indicators need to be adapted to be adequate for the company's specific situation?
2	Are employment risks and their mitigation that the fund considers material, addressed adequately and in a business strategy context in the business review/voluntary OFR?

Company-specific risk assessment

When assessing the employment risk that a company faces, business context and corporate strategy need to be taken into account. Being prescriptive about a set of industry-specific risks that applies to all sector constituents is unlikely to achieve a positive engagement outcome, even though comparable and consistent reporting is desirable. The analysis of company-specific employment risk factors should take into account comparisons between different firms in the same sector, but while benchmarking against peers is important, the specific employment risks that a company faces will depend on more than just the sector it operates in.

If information on company-specific employment risks is not provided in business reviews/voluntary OFRs, these matters should be discussed with boards of investee companies, with a view to encouraging better disclosure, and gaining an understanding of how the board integrates employment issues into its wider business strategy.

Example considerations	
Attraction and retention	Most people-intensive companies would probably agree that attraction and retention of talented staff is an issue for them, but whilst some businesses are involved in an outright 'war for talent', others may be less exposed to this risk.
Health and safety	Health and safety affects office-based companies far less than those where operations involve machinery or hazardous materials.
Diversification	Diversified companies will face a spread of risk exposure in their different businesses, and investors will need to seek an in-depth understanding of a company's specific situation. One consideration is that diversification may well lead to a reduction of risk for the group overall.

Example questions

3	Which company-specific employment risks and ways to mitigate them does the company disclose in its business review or voluntary OFR?
4	Are there any material omissions of risks that should be applicable to this company, for example by way of comparison with a peer?

Company-specific key performance indicators (KPIs)

Investors need to assess how effectively companies are applying their strategic approach to risk and opportunities associated with workforce issues, in order to protect and enhance long-term shareholder value. Good reporting is a crucial requirement for the ability of investors to do so, and the disclosure of KPIs on material non-financial performance areas such as employment factors is now firmly embedded in the requirements of the statutory business review.

When engaging with companies on relevant KPIs that will describe their approach to and performance in the area of employment practices accurately and comprehensively, the set of core indicators set out in section 1 can provide a useful starting point. For a more focused approach, the proposed set can be altered or expanded to take into account the varying situations, issues, problems and risks applicable to the specific company. Once a good understanding of KPIs for an individual business has been developed, it may be possible to identify industry-wide patterns and determine industry-specific KPIs that are useful when analysing a great number of companies. Conversely, a pattern may also apply to a type of business or management structure, such as franchise businesses (see example below), in which case KPIs apply across sector boundaries.



www.lapfforum.org

info@lapfforum.org