# The Board-Centric Annual Meeting

For 30 years shareholders have called the shots at annual meetings.
It's time for boards to take charge.

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For a growing number of listed companies around the world the annual shareholder meeting has come to resemble a trial by ordeal. Instead of the traditional town-meeting business forum, the AGM has morphed into a jousting field where activists, proxy advisors and various special interest groups play a dominant role. This state of affairs has evolved because for the past three decades companies have been resistant to change and defensive about governance reform, while shareholders and activists have taken the lead in successfully promoting greater board accountability and stronger governance rules. Corporate scandals, the financial crisis, escalating CEO pay, declining public trust in business leaders together with enhanced shareholder rights have transformed the annual meeting into an event where companies often focus on damage control rather than showcasing their business.

The challenge for companies is to restore balance to the AGM so that it can fulfill its many important governance, accountability and business functions. To do so, we believe that the focus of the AGM should be shifted away from shareholders and back to the board of directors. The AGM should be a board-centric event that brings control back into the company where it belongs, while giving shareholders what they have always wanted – greater boardroom transparency and director accountability.

The first step toward a board-centric meeting is for companies to acknowledge that the AGM (by which we mean the entire process of disclosure, communication, proxy solicitation and engagement, as well as the meeting itself) should be treated as a governance event. It should be an occasion for directors to answer the question "How are we doing?" with respect to their long list of duties and responsibilities relating to corporate governance, sustainability and strategic oversight of the business.

The second step is for companies to recognize that as the list of directors' duties and responsibilities has grown, the list of stakeholders and other audiences whose interests the board must represent has also expanded. The board's question "How are we doing?" needs to be responsive not only to the electorate of shareholders and investors, but also to the management, employees, suppliers, customers, communities in which the business operates and to future generations affected by the company's activities over the long term. Renewed attention to the idea of the corporate social compact means that boards should also consider the macro-economic impact and political implications of their decisions.

At the same time that the board's governance responsibilities and audiences are expanding, a parallel set of related rules and best practice guidelines are raising the bar for institutional investors at the AGM. Legislation and stewardship codes now require asset managers to increase their oversight and engagement with portfolio companies, monitor and evaluate directors diligently and exercise voting rights with the same fiduciary care that governs their investment decisions.

The AGM is the point of convergence for all of these trends.

A proposal that we believe could lead the way to the development of board-centric annual meetings appears in a Working Paper entitled "Materiality in Corporate Governance: The Statement of Significant Audiences and Materiality," published on September 3, 2015[1].

The authors are well-known governance experts Professor Robert G. Eccles and Tim Youmans of Harvard Business School. Their proposal builds on the work of the International Integrated Reporting Council (IIRC) and is supported by the American Bar Association's Task Force on Sustainable Development and the UN Global Compact.

The Working Paper announces an ambitious goal: "... ***by 2025 the board of directors of every listed company will be issuing an annual Statement of Significant Audiences and Materiality.***"[2]

The authors further assert that this goal is applicable to "... ***all listed companies regardless of reporting regime or nationality.***"[3]

The Working Paper's call for an annual board statement is not unprecedented. As far back as 1992 the Cadbury Report described the board's role in the following terms: "The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and *reporting to shareholders on their stewardship*." (Italics added) For many years voluntary board reporting has been mandated in principles-based governance systems, where comply-or-explain is the primary accountability mechanism. Despite these deep governance roots, board reporting has been held back by restrictive disclosure rules and by concerns about confidentiality, selective disclosure, marketplace confusion and director liability.

Recognizing that there are persistent legal and cultural obstacles to boardroom transparency and communication, the Working Paper builds its case for an annual board report on a careful step-by-step analysis that includes the following assertions:

- The primary fiduciary duty board of a board of directors is to the corporation itself, not to shareholders. The doctrine of shareholder primacy is "... ideology, not law."[4]
- The board is responsible for "... taking a long-term view and ensuring that management is doing so ... ."[5]
- The board should apply a "materiality" standard as the basis for its strategic decision-making and corporate reporting: "The board must ... decide which audiences are most significant for the ability of the corporation to create value over the short, medium and long term. Once it has done so, it has laid the foundation of the materiality determination process for corporate reporting."[6]
- The "audiences" the board must consider in determining materiality are not just shareholders and stakeholders, but also society and future generations. The authors refer to a company's "intergenerational commitment," for which the board serves in a fiduciary capacity as "trustee."[7]

1. Eccles R.G., Youmans T., *Materiality in Corporate Governance: The Statement of Significant Audiences and Materiality,* 2015.
   See also, The Federation of European Accountants, The Future of Corporate Reporting – creating the dynamics for change, 12 October 2015, at www.fee.be
2. Eccles R.G., Youmans T., 2015, p.9
3. Eccles R.G., Youmans T., 2015, p.1
4. Eccles R.G., Youmans T., 2015, p.2
5. Eccles R.G., Youmans T., 2015, p.4
6. Eccles R.G., Youmans T., 2015, p.7
7. Eccles R.G., Youmans T., 2015, p.4

- The board should issue an annual "Statement of Significant Audiences and Materiality" that "... clearly communicates the board's view of the company's priorities ... . The Statement, like the audited financial statement, is ultimately a responsibility of the board – not management."[8]

This analysis breaks new ground in three ways: (i) it adds a materiality standard to the concept of the board's fiduciary duty; (ii) it calls for an annual written board statement; and (iii) it necessitates a process of "integrated thinking" within the company.

In our view, this line of reasoning represents a governance model that would increase the board's power, while also satisfying shareholder demand for greater board transparency and accountability. As we have long maintained, aligning the interests of the company and the shareholders is a board responsibility and is best accomplished by the board itself rather than by the imposition of external governance standards. Viewed from this perspective, the Working Paper's recommendations strengthen board power rather than diminishing it, thereby supporting the principle of board-centric corporate governance.

## I. THE "MATERIALITY" STANDARD

A materiality standard that is defined as "entity-specific"[9] and based on the judgment of the board of directors grants substantial power and discretion to the board. It assumes that: (i) the board should determine how governance policies are prioritized and implemented; (ii) corporate governance should serve business goals; and (iii) the board should explain through the lens of materiality how its decisions serve the interests of the corporation.

Similarly, a materiality statement that has no prescribed format also gives the board flexibility to decide how best to "... inform management, providers of financial capital and all other stakeholders of the audiences the board believes are important to the survival of the corporation."[10] This flexible and expansive approach recognizes that every business is unique and that one size of corporate governance does not fit all companies and all business circumstances. Formal rules cannot dictate which audiences and issues are material with respect to an individual company. The company's board and management are best positioned to make that determination and are obligated to do so.

Governance rules guarantee that shareholders and activists have the right to disagree with how the board determines materiality and prioritizes audiences. But when a disagreement between the board and shareholders does arise, the ensuing engagement is more likely to be constructive if discussion focuses on business issues rather than on compliance with a governance check list.

From the perspective of developing a board-centric AGM, the materiality standard accomplishes three important goals: (i) it reinforces director-centric governance; (ii) it empowers boards to give business and strategic goals priority over governance compliance; and (iii) it allows for a customized approach to governance and board reporting that can be adapted to the needs of individual companies. An added benefit is that the materiality standard encourages boards to include in their strategic explanation the type of forward-looking information about the business that shareholders and investors prefer.

8. Eccles R.G., Youmans T., 2015, p.6
9. Eccles R.G., Youmans T., 2015, p.5
10. Eccles R.G., Youmans T., 2015, p.6


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## II. AN ANNUAL BOARD REPORT

Although demands to improve the quality of board reporting have been part of the governance conversation for more than a decade, the idea of an annual board report has failed to gain traction. Sodali is among those advisors who have called for companies to establish direct communication between boards and shareholders as a means to align their interests. In addition, we have specifically recommended that companies should publish an annual Directors Discussion and Analysis (DD&A) that deals with governance and other board responsibilities not covered by the financial reports, management reports or the annual report to shareholders.[11]

The Working Paper's recommendation for an annual board materiality Statement takes a big step in this direction.

Small steps have already been taken. Many companies routinely publish a board report or an annual chairman's letter that summarizes governance policies. Board members are often personally involved in communication with shareholders about controversial proxy issues and contested elections. During the past decade say-on-pay has opened the door to face-to-face communication and robust exchanges between directors and shareholders. It is now common practice for directors to step forward and explain the business rationale for their pay decisions whenever proxy advisors recommend votes against a compensation proposal.

Statistics verify that these engagements have been highly effective. Their success reinforces an important fact that is highly relevant to the concept of a director-centric AGM: Institutional investors are generally willing to support the board's business judgment when a reasonable explanation is provided.

As a result of these positive results, "engagement" has become the remedy du jour for companies facing shareholder activism and dissident campaigns. It is important to remember, however, that most of these engagements have been reactive -- i.e., launched only after activists or proxy advisors have fired the first shot across the company's bow. These after-the-fact campaigns come with significant risks for companies. They are stressful, time-consuming, costly, inefficient, difficult to manage and of uncertain outcome. These problems are exemplified by the recent high-profile, last-minute engagement conducted by Bank of America to obtain shareholder approval for combining the roles of CEO and Chairman. Despite achieving a passing vote, the process created a circus atmosphere, attracted unwanted public attention, produced unfavorable commentary in the media, put a spotlight on the company's underperformance and left a residue of dissatisfaction with the board. This type of confrontation might have been avoided if the board had been fully informed in advance about the negative implications of its decision and had then been willing to provide a convincing explanation and reach out to shareholders before battle lines were drawn.

Prevention is always better than a remedy. A written report that explains the board's governance decisions, particularly when they are noncompliant or based on extraordinary circumstances, would go a long way toward reducing the risk of confrontation with shareholders. A written board narrative would also reduce the legal risk of selective disclosure that makes many companies reluctant to have their directors engage in unscripted communication with shareholders. In voluntary principles-based governance jurisdictions around the world, including the EU, the board statement would provide an opportunity to justify and give context to governance policies, thereby improving the quality of explanations and strengthening the comply-or-explain system without resort to additional regulation.

In our view, an annual report would be a vehicle for the board to address in advance the issues and questions likely to be raised by shareholders and activists at an annual meeting. In addition to co-opting these issues, a

11. Wilcox J., The Autonomous Board, 2014; Rethinking the Annual Meeting, 2013

convincing explanation of the board's governance policies would also dilute the impact of proxy advisors and reduce the importance of one-size-fits-all governance box-ticking.

## III. INTEGRATED REPORTING (<IR>)

The Working Paper's case for an annual board report builds directly on the work of the International Integrated Reporting Council (IIRC), a well-established international movement supported by the global business community. Many companies have already embraced the concept of integrated thinking and have issued integrated reports on a variety of topics and in various formats.

The subject of <IR> is beyond the scope of this memorandum, but a brief look at the movement's objectives demonstrates why it is relevant to corporate governance and board reporting. Here is the IIRC's definition of an integrated report:

> An integrated report is a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term.[12]

This definition summarizes what a materiality statement or annual board report should do. It also defines what a board-centric AGM should be. Materiality and integrated thinking are complementary concepts. Requiring companies to produce the type of materiality-based, integrated board narrative envisioned by both the IIRC and the Working Paper would have a positive impact in several ways. The process of information-gathering and composition would alter behavior both inside the boardroom and through the ranks of management and employees. Holistic thinking about the business would break down operational silos and introduce more nuanced perceptions about how the parts of the business interact, how governance policies affect business operations, how cultural and non-financial issues affect risk and performance, how short and long-term objectives are linked. An integrated picture of the business would make shareholders better informed and less inclined to focus on single-issue concerns.

## RECOMMENDATIONS

If the Working Paper's prediction is correct, within a decade every listed company around the world will be issuing an integrated board report annually. The report, explaining the board's actions in terms of material audiences and business conditions, will in turn function as an organizing document for a board-centric annual meeting. In anticipation of these developments, we encourage companies and boards to take the following steps:

- The board of directors and executive management should become familiar with the IIRC's concepts of integrated thinking, integrated management and integrated reporting. These topics should be the subject of educational sessions within operating management and at the board's annual strategic retreat. Integrated reporting should also be discussed with the company's auditors, financial advisors, management consultants and communications and investor relations professionals.
- The board should take steps to meet the materiality standard described in the Working Paper: "... identify audiences relevant to the corporation, their interests (including where they conflict), and the relative weight attached to each." This will require the board to work closely with management to identify all audiences with a stake in the business and to prioritize their interests in the context of the company's business circumstances.

12. Integrated Reporting, www.integratedreporting.org


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- The board should review the company's ownership profile. As the board is directly answerable to the electorate of shareholders and institutional investors, this audience is of greatest concern in preparing for the annual meeting. The board must have up-to-date knowledge of the shareholders' governance policies and voting practices, must understand how their interests may be affected by board actions and must be able to prioritize their interests against those of other audiences.
- The board should review, update and benchmark its Corporate Governance Principles. The Principles should be revised as needed to include ESG issues, non-financial metrics, sustainability and the principles of integrated thinking and reporting. The board should explain how its governance principles align with best practice and with peer companies, how it determines the materiality of audiences and how its decisions are expected to achieve long-term economic goals.
- The board should establish a policy for directors to communicate and engage with shareholders proactively. If such a policy is already in place, it should be expanded to include not just governance issues but also the broad array of topics that the board must consider and prioritize in preparing its integrated annual report.
- The board should have a detailed timetable and schedule of responsibilities in preparation for the annual meeting, which should be a collaborative undertaking within the company. The board's annual report will play an important role in setting the AGM agenda and will influence how shareholders vote on resolutions at the meeting. Directors as well as management should be prepared to engage directly with shareholders on controversial matters in advance of the AGM.
- The board should be well informed about the company's Investor Relations program. It is the responsibility of both the board and management to ensure that financial and sustainability goals are fully integrated into the company's periodic meetings with financial analysts and portfolio managers. The messages delivered by the IR team should be consistent with the messages delivered to institutional investors by the board on governance policy and proxy voting issues.
- The agenda for board's annual self-assessment and its annual retreat should include information and deliberations necessary to prepare the annual board report. The annual retreat may require participation by members of operating management and outside advisors who can provide expertise and information for the board report.

## CONCLUSION

With corporate boards under siege and facing a growing number of governance and activist challenges, the concepts of integrated reporting, an annual board report and a board-centric annual meeting have the potential to change the governance game entirely. After 30 years of governance reforms imposed by outside parties, companies and boards should welcome the opportunity to exercise the powers these reforms have given to directors, to take charge of their relations with shareholders and to make the annual shareholder meeting a meaningful governance event that aligns the interests of the business and all its stakeholders.