CORPORATE PURPOSE AND CULTURE

By the end of 2019 a number of extraordinary pronouncements signaled that corporate governance had reached an inflection point. In the U.K., the British Academy published *Principles for Purposeful Business*. In the U.S., the Business Roundtable issued its *Statement on the Purpose of a Corporation*. In Switzerland, the World Economic Forum published *The Davos Manifesto 2020*.

These statements gave voice to evolving trends and assumptions that had been transforming corporate governance over the course of the last decade….

1. Recognition that environmental, social and corporate governance policies (ESG) represent material risks and opportunities directly impacting financial performance;

2. Reassessment of the shareholder primacy doctrine and the narrow view of corporations as nothing more than profit machines;

3. Adoption of "sustainability" as both a strategic goal for companies, an antidote to short-termism and a path to strengthen public trust in business and the capital markets;

4. Acknowledgement that companies must serve the interests of their "stakeholders" as well as their shareholders;

5. Reassertion of the principle that corporations must be accountable for the human, social and public policy implications of their activities, with an urgent focus on climate change;

6. Understanding that a corporation's "culture" is reflective of its integrity, its internal well-being, its sustainability and its reputation.

7. Acceptance of expanded board accountability for ESG issues, sustainability, purpose and culture and working with the CEO to integrate these factors into business strategy;

8. Emergence of the integrated reporting movement [www.integratedreporting.org] with its program of integrated thinking and integrated management as the basis for corporate reporting.

BlackRock's Annual Letter

On January 14, 2020, right on cue, BlackRock Chairman and Chief Executive Larry Fink published his annual letter to corporate CEOs. This year's letter, entitled "A Fundamental Reshaping of Finance," is clearly intended as a wake-up call for both corporations and institutional investors. It explains what sustainability and corporate purpose mean to BlackRock and predicts that a tectonic governance shift will lead to "a fundamental reshaping of finance." BlackRock does not mince words. The letter calls upon corporations to (1) provide "a clearer picture of how [they] are managing sustainability-related questions" and (2) explain how they serve their “full set of stakeholders.” To make sure these demands are taken seriously, the letter outlines the measures available to BlackRock if portfolio companies fall short of achieving sustainability goals: votes against management, accelerated public disclosure of voting decisions and greater involvement in collective engagement campaigns.

In setting forth its expectations for sustainability reporting by portfolio companies, BlackRock cuts through the tangle of competing standard-setters and recommends that companies utilize SASB materiality standards and TCFB climate metrics. In our view, individual companies should regard these recommendations as a starting point – not a blueprint – for their own sustainability reporting. No single analytical framework can work for the universe of companies of different sizes, in different industries, in different stages of development, in different markets. If a company determines that it needs to rely on different standards and metrics, the business and strategic reasons that justify its choices will be an effective basis for a customized sustainability report and statement of purpose.

As ESG casts such a wide net, not all variables can be studied at once to concretely conclude that all forms of ESG management demonstrably improve company performance. Ongoing research is still needed to identify the most relevant ESG factors that influence performance of individual companies in diverse industries. However, the economic relevance of ESG factors has been confirmed and is now building momentum among investors and companies alike.

Corporate Purpose

The immediate practical challenge facing companies and boards is how to assemble a statement of corporate purpose. What should it say? What form should it take?

In discussions with clients we are finding that a standardized approach is not the best way to answer these questions. Defining corporate purpose is not a compliance exercise. It does not lend itself to benchmarking. One size cannot fit all. No two companies have the same stakeholders, ESG policies, risk profile, value drivers, competitive position, culture, developmental history, strategic goals. These topics are endogenous and unique to individual companies. Collecting information and assembling all the elements that play a role in corporate purpose requires a deep dive into the inner workings of the company. It has to be a collaborative effort that reaches across different levels, departments and operations within the company. The goal of these efforts is to produce a customized, holistic business profile.

Other approaches that suggest a more standardized approach to corporate purpose and sustainability are also worth consideration:

- Hermes EOS and Bob Eccles published a "Statement of Purpose Guidance Document" in August 2019. It envisions "a simple one-page declaration, issued by the company's board of directors, that clearly articulates the company's purpose and how to harmonize commercial success with social accountability and responsibility."

- CECP (Chief Executives for Corporate Purpose) has for 20 years been monitoring and scoring "best practices of companies leading in Corporate Purpose." Many of CECP's best practices take the form of short mission statements that do not necessarily include specific content relating to ESG issues or stakeholders. However, CECP is fully aware that times are changing. Its most recent publication, *Investing in Society*, acknowledges that the "stakeholder sea change in 2019 has redefined corporate purpose."

A case can be made for combining the statement of purpose and sustainability report into a single document. Both are built on the same foundational information. Both are intended for a broad-based audience of stakeholders rather than just shareholders. Both seek to "tell the company's story" in a holistic narrative that goes beyond traditional disclosure to reveal the business fundamentals, character and culture of the enterprise as well as its strategy and financial goals. Does it make sense in some cases for the statement of corporate purpose to be subsumed within a more comprehensive sustainability report?

Corporate Culture

Corporate culture, like corporate purpose, does not lend itself to a standard definition. Of the many intangible factors that are now recognized as relevant to a company's risk profile and performance, culture is one of the most important and one of the most difficult to explain. There are, however, three proverbial certainties that have developed around corporate culture: (1) We know it when we see it -- and worse, we know it most clearly when its failure leads to a crisis. (2) It is a responsibility of the board of directors, defined by their "tone at the top." (3) It is the foundation for a company's most precious asset, its reputation.

A recent posting on the International Corporate Governance Network web site provides a prototypical statement about corporate culture:

> A healthy corporate culture attracts capital and is a key factor in investors' decision making. The issue of corporate culture should be at the top of every board's agenda and it is important that boards take a proactive rather than reactive approach to creating and sustaining a healthy corporate culture, necessary for long-term success.

The policies that shape corporate culture will vary for individual companies, but in every case the board of directors plays the defining role. The critical task for a "proactive" board is to establish through its policies a clear "tone at the top" and then to ensure that there is an effective program to implement, monitor and measure the impact of those policies at all levels within the company. In many cases, existing business metrics will be sufficient to monitor cultural health. Some obvious examples: employee satisfaction and retention, customer experience, safety statistics, whistle-blower complaints, legal problems, regulatory penalties, media commentary, etc. For purposes of assessing culture, these diagnostics need to be systematically reviewed and reported up to the board of directors with the same rigor as internal financial reporting.

In this emerging era of sustainability and purposeful governance, investors and other stakeholders will continue to increase their demand for greater transparency about what goes on in the boardroom and how directors fulfill their oversight responsibilities. A proactive board must also be a transparent board. The challenge for directors: How can they provide the expected level of transparency while still preserving confidentiality, collegiality, independence and a strategic working relationship with the CEO?

As boards ponder this question, they may want to consider whether the annual board evaluation can be made more useful and relevant. During its annual evaluation process, could the board not only review its governance structure and internal processes, but also examine how effectively it is fulfilling its duties with respect to sustainability, purpose, culture and stakeholder representation? Could the board establish its own KPIs on these topics and review progress annually? How much of an expanded evaluation process and its findings could the board disclose publicly?

Conclusion – A Sea Change?

In addition to the challenges discussed here, the evolving governance environment brings some good news for companies. First, the emphasis on ESG, sustainability, corporate purpose, culture and stakeholder interests should help to reduce reliance on external box-ticking and one-size-fits-all ESG evaluation standards. Second, the constraints on shareholder communication in a rules-based disclosure framework will be loosened as companies seek to tell their story holistically in sustainability reports and statements of purpose. Third, as the BlackRock letters make clear, institutional investors will be subject to the same pressures and scrutiny as companies with respect to their integration of ESG factors into investment decisions and accountability for supporting climate change and sustainability. Fourth, collaborative engagement, rather than confrontation and activism, will play an increasingly important role in resolving misunderstandings and disputes between companies and shareholders.

The 2020 annual meeting season will mark the beginning of a new era in governance and shareholder relations.

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If you would to like assistance in drafting or refining your existing ESG disclosures, please get in touch with one of our experts.

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