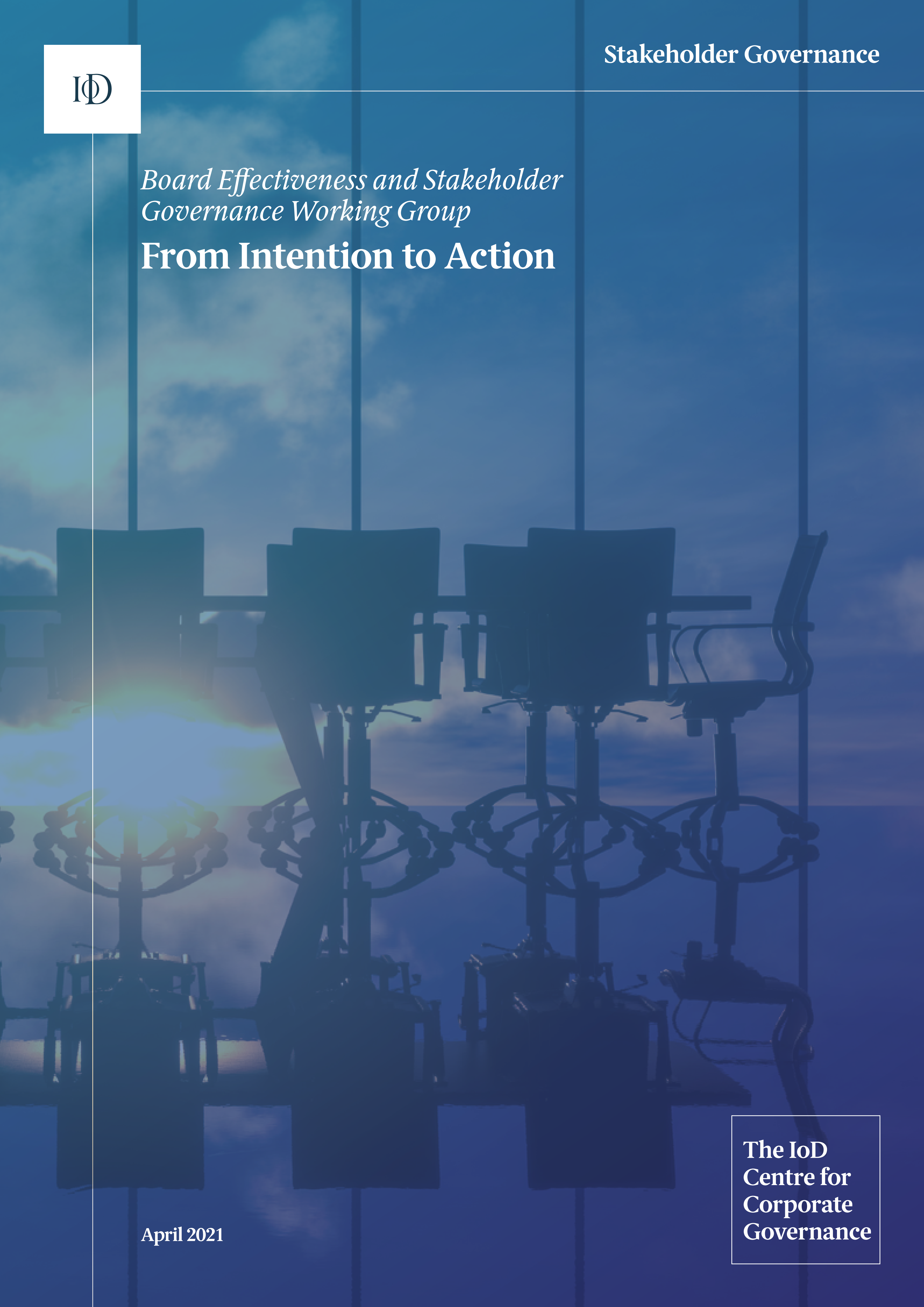



*Board Effectiveness and Stakeholder Governance Working Group*

# From Intention to Action

April 2021

The IoD Centre for Corporate Governance

"What makes a board effective in how it governs in the interests of stakeholders?"

It is a question that is being explored by individuals and groups globally, based on well-developed arguments on the merits or otherwise of stakeholder governance. There is a body of academic research, direction in corporate governance codes, guidance from regulatory bodies and new global commitments towards common metrics for measuring stakeholder capitalism[1].

Given the breadth and depth of the debate, the goal is to gather additional insights on both the practical challenges of implementing stakeholder governance approaches, and the ways in which boards can address these challenges. A recent World Economic Forum White Paper, 'The Future of the Corporation', also offers practical considerations on stakeholder governance implementation and is a welcome contribution to the debate[2].

As a first step, we reached out to a small group of governance organisations and respected opinion leaders that work with a large number of boards in the UK, and therefore have a broad view of the issues. These included board evaluators, corporate governance consultancies, and two members of the Financial Reporting Council (FRC). Preliminary discussions were held with ten expert practitioners to gather insights and identify themes and topics that could be explored further as part of the IoD's Centre for Corporate Governance ongoing dialogue on key governance issues.

Our discussions were based on a framework informed by the FRC's Guidance on Board Effectiveness[3], and covered the following areas:

1. Boards and company purpose
2. Board composition and training
3. Division of responsibilities and board activities in relation to stakeholders
4. Organisational and board culture
5. Accountability, evaluation, remuneration and reporting
6. Lessons and strategies for boards.

Our interviewees were able to address any of the questions they felt were most relevant to their experiences, including the areas that boards would be advised to focus on to become more effective decision-makers in relation to stakeholders.

[1] https://www.weforum.org/reports/measuring-stakeholder-capitalism-towards-common-metrics-and-consistent-reporting-of-sustainable-value-creation
[2] https://www.weforum.org/whitepapers/the-future-of-the-corporation-moving-from-balance-sheet-to-value-sheet
[3] https://www.frc.org.uk/getattachment/61232f60-a338-471b-ba5a-bfed25219147/2018-Guidance-on-Board-Effectiveness-FINAL.PDF

# General Observations from Interviewees

The current focus on stakeholder governance is not new to many organisations, particularly those founded with a clear social or environmental purpose. However, a range of factors have led to a renewed focus, including the climate crisis, the global pandemic, evolving compliance and legal requirements, sustainability-linked finance and investment criteria, and reputational considerations. Boards are being held to account by regulators, institutional investors, employees and society more broadly, driven in part by the democratisation of information via social media.

The dynamics of the boardroom are often complex, and for some adaptability and flexibility can be a challenge, particularly where board culture may act as an inhibitor. The FRC is determined to embed stakeholders – particularly employees – in the Corporate Governance Code and is currently studying the link between purpose and strategy. Fundamentally, the FRC's focus is on changing behaviours and as such, board culture is key.

It is acknowledged that many shareholders remain short-termists and such financial performance considerations have shaped the mindset of many senior decision-makers, often with little incentive to consider the needs of other stakeholders. This is however beginning to change, as Gillian Karran Cumberlege, Head of Chair and Board Practice, Fidelio Partners comments:

*'By now, generally boards have recognised that they need to be better corporate citizens... At the very least the right statements are being made. Many of these statements are now backed by genuine intentions. The challenge boards are facing is how to make practical changes.'*

However, Susan Stenson, Head of Europe at Independent Audit highlights a key concern for directors: *'There is still some justifiable nervousness amongst non-executives around how a stakeholder governance approach aligns with their legal and fiduciary responsibilities. Clarifying this aspect of company law would be beneficial if we are to see all non-executives embrace the scale and pace of change that is needed'.*

Further observations from interviewees are summarised below, as themes. Practical challenges, as well as suggestions on what works in practice, are included.

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# Responsibility for Company Purpose

Whilst the management team is often the driver of stakeholder-related initiatives, the board must ensure it takes formal responsibility for company purpose and stakeholder governance. Bob Eccles of Enacting Purpose in a Modern Corporation Initiative underscores that *'A Statement of Purpose must begin with the board and drive management's strategy. There is a clear difference between Purpose as philanthropy vs. Purpose as part of strategy that is central to decision-making. Purpose as Strategy, accountable for by the board, informs financial, strategic and capital allocation decisions.'*

Once a stakeholder governance approach has been agreed by the board and the management team, the board should ask the right questions to steer efforts, to ensure accountability and that the agreed approach is reflected in culture and strategy. *'Having a stakeholder policy that lives at the board level will be a step towards not only* ***having*** *a Purpose, but* ***embedding*** *it'*, recommends Susan Stenson.

# Stakeholder Expertise on Boards

Having historically focused on sector and functional skills, boards do not necessarily have the right level of sustainability or stakeholder engagement expertise. The shift to a stakeholder-focused culture is therefore yet to take place on the necessary scale. 'Boards are not asking enough of the right and specific questions regarding stakeholders as they may not know what questions to ask and what analyses to request. Hence directors are not challenging the executive team enough in this area' explains Gillian Karran Cumberlege.

*'Developing stakeholder knowledge on boards, starting with Chairs, should become a top priority'* says John Jeffcock, Chief Executive of Winmark. It is a matter of defining new skills for directors, such as those related to ESG issues, and building an understanding of how stakeholder engagement can inform board decision making, and therefore, how stakeholder engagement becomes stakeholder governance. Building directors' understanding of purpose, identifying and prioritising stakeholders, and analysing the associated issues is key.

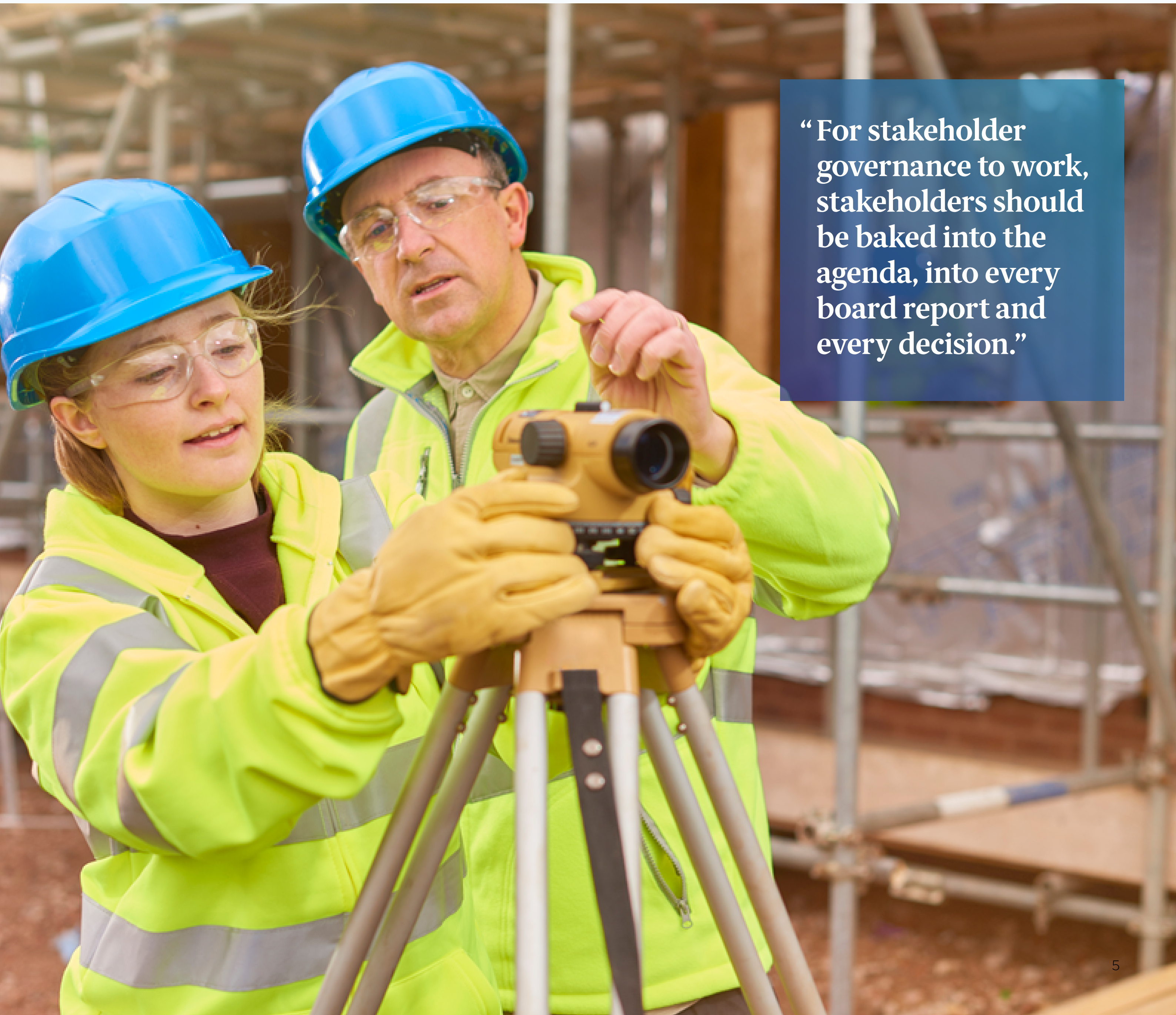
Part of diversity training needs to be about better understanding various stakeholder groups. Board succession plans also need to be reviewed in line with acquiring these skills.

There is often resistance to having stakeholder representatives on boards, particularly in the case of multinationals, although continental Europe has many examples of employee representation. In the UK, it may be one director that has employee responsibility. *'Finding the right representatives is viewed as a challenge. However, diversity – different backgrounds and experiences – is playing a positive role, tackling biases'* comments Susan Stenson.

# The Board Agenda

Board agendas are full, and stakeholder discussions may not be part of the regular agenda, which may be guided by a shareholder focus. ‘In many cases, stakeholders are mentioned, but without in-depth discussions’ observes one of the interviewees. Stakeholder-related discussions that take place often have no clear objectives, KPIs, or importantly a link to remuneration and broader decision making.

*‘Stakeholder governance is not about tacking on an extra agenda item. It is about whether each agenda item considers and reflects stakeholder issues and priorities. In other words, for stakeholder governance to work, stakeholders should be baked into the agenda, into every board report and every decision’* concludes Jennifer Sundberg, Co-Chief Executive, Board Intelligence.



“For stakeholder governance to work, stakeholders should be baked into the agenda, into every board report and every decision.”

# Board-Level Stakeholder Data

What data and analyses gets delivered to the board is often determined by what boards have received over many years. In turn, the board's expectations with regard to stakeholder insights are connected to the depth of stakeholder expertise on the board.

One solution for enabling delivery of relevant and timely stakeholder data – as advocated by Professor Mervyn King – is through a senior specialised stakeholder function: *'In the most effective scenario, it would be a Corporate Stakeholder Relations Officer who would pull all information together for a cohesive report to the board that would be made part of the board agenda'.*

Board reports can also be a weakness in the system – boards are reliant on the right level of detail and insight in reporting if it is to effectively inform decision-making. Stakeholder feedback is often either missed or inferred with the result that there might be little connection between board discussions and the stakeholder engagement work of the management team. This in turn can mean a lack of follow-up at the board on important and emerging stakeholder issues. *'More and more boards understand their duty to govern in the interests of wider stakeholder groups. But board agendas and papers are stuck in formaldehyde. Board reports and proposals still focus on financial implications to the exclusion of much else. Information drives the board conversation and so if we're to see a real shift to stakeholder governance, we must change how we brief the board'* notes Jennifer Sundberg.

Professor Mervyn King observes that *'A board that is practicing good governance would always ask these key questions on stakeholders: 1) In resource constrained environment, is the company creating value in a sustainable manner? 2) Is the company run by conscious leaders who are creating value in a culture of ethical and effective leadership in the interest of the long-term health of the company? 3) Are there adequate controls with informed oversight for the boards? 4) Does the company have the trust of the community it is operating in? This creates a basis for a mindful outcomes-based governance'.*

Traditional tools for assessing stakeholder feedback – e.g., annual employee surveys, social media monitoring – are mostly backward-looking. More active gathering of information via engagement and focusing on the outcomes of this engagement is what should inform stakeholder reports.

To inform board decision-making, feedback mechanisms need to be put in place to ensure the board hears, and can act on, stakeholder engagement outcomes: *'Boards must require comprehensive and relevant stakeholder-related information: what is the current relationship with each stakeholder? What are the engagement methods and outcomes? Companies should report on what messages went back into boardroom and how they informed board discussions and decisions'*, recommends David Styles, Director of Corporate Governance at FRC. Every board report and every decision needs to have a stakeholder consideration. This is how the flow of information between the boardroom and the executive team becomes circular and robust. *'This determines if the board is indeed an effective decision maker'*, concludes David Styles.

This is how stakeholder engagement evolves into stakeholder governance.

# Oversight of Stakeholder-related Issues and Deliverables

It is recognized that boards have the ultimate role in advancing stakeholder related objectives; however, these objectives need to get embedded in decision making and follow up. *'The role of the Chair is critical'*, argues John Jeffcock. It takes one visionary leader to turn words into action – by putting stakeholder governance structures in place, integrating stakeholders into the board agenda, owning and communicating the long-term vision to shareholders, explaining sustainability driven decisions, how various stakeholder issues are informing priorities and decision-making, and finally how this kind of decision-making aligns with shareholders' interests. *'Whilst all of the board members are clearly accountable for action in this area, the Independent Directors, as the real long-term custodians of the organisation, have a particular responsibility for the development of board effectiveness concerning stakeholder governance and engagement'*, says Gerry Brown, Chairman and Independent Director of a number of public and private company boards over the past 25 years and author of The Independent Director.

Stakeholder focused NEDs and committees would also go a long way towards forming an effective system of oversight. *'All board committees have a role to play in the promotion of Stakeholder Governance and Engagement. For example, the Chair of the Remuneration Committee and its members have a clear accountability for the development of remuneration policy and practice to reward those directors who take these issues seriously and deliver results',* adds Gerry Brown.

The efficacy of this system is underpinned by the management team's knowledge and commitment, with concrete stakeholder-related objectives and KPIs – such as, for example, workforce engagement or climate objectives. These internal processes should be auditable as to their efficacy, with audit results feeding remuneration decisions.

# Reporting and Accountability

Reporting is more than merely a matter of accountability. Reporting and strategic thinking (and re-thinking!) are two sides of the same coin – both necessary to enhance alignment within the organisation and enhanced communication on value creation. Many organisations are finding that transparency can be a strong driving force for innovation and more sustainable value creation. *'Section 172 statements don't always reflect how the board balances the needs of different stakeholders in their decision making'* notes Phil Fitz-Gerald, Director of Financial Reporting Lab at the FRC.

Quality stakeholder reporting does require resources. For some companies it is a more natural discussion than for others, but this should be approached is an opportunity for a positive narrative. Bob Eccles of Enacting Purpose in a Modern Corporation Initiative emphasises that *'Non-financial reporting needs to be of the same standard and rigour as financial reporting, reflecting both positive and negative externalities. A statement of Purpose, that is specific, unique, stakeholder-inclusive, talking about the role of the company in society, is used as the foundation for integrated reporting and represents a public commitment by the Board*'.

In terms of sustainability reporting, little or no sustainability disclosure makes organisations more vulnerable in the environment of heightened awareness and scrutiny from both investors and stakeholders. While mandated sustainability reporting can be a box-ticking exercise, voluntary disclosure is better at shining a light on improvements, competitive advantage and most importantly to the long-term health and viability of the organisation. It needs to be culturally normal to share what has not gone well and what remedies have proven effective. *'For any performance report to be credible it needs to be candid. It can't just be a good news story. As well as the successes these reports should highlight the challenges and the areas to improve'* says Jennifer Sundberg.

Progress in stakeholder governance should be approached as a continuous process rather than a milestone. *'Companies are keen to report full compliance, but they should not favour strict compliance over effective governance and transparency. The FRC encourages companies to embrace the flexibility offered by "comply or explain"*, echoes David Styles. *'Reporting on stakeholder governance should be about activities and outcomes, and the FRC is focusing on this now'*, he adds.

Too many reporting frameworks have been onerous for the limited resources of compliance teams. A comprehensive corporate reporting system that came out at the end of December 2020 is a promising step towards the proliferation of sustainability and, ultimately, integrated reporting.

# Summary findings

| Area of Focus | Challenges | Potential Improvement Strategies |
|---|---|---|
| **Formal responsibility for Company Purpose** | – Stakeholder governance is a developing debate; hence board responsibilities do not necessarily refer to stakeholders explicitly | – A formalised stakeholder policy at board level ensures responsibility is vested with boards<br>– Developing a shared understanding of stakeholder approaches between the executive and the board |
| **Board stakeholder expertise** | – Lack of knowledge of stakeholder priorities; lack of stakeholder-oriented culture<br>– Knowing what questions to ask/analyses to request<br>– Resistance to stakeholder representatives on boards<br>– Finding the right stakeholder representatives | – Focus on board and NED skills, training and development on issues including ESG, and how stakeholder engagement can inform board decision making<br>– Expand diversity training to include different stakeholder groups<br>– Review succession planning in line with acquiring the stakeholder-related expertise |

| Area of Focus | Challenges | Potential Improvement Strategies |
|---|---|---|
| **Board Agenda Setting** | – Board agendas are already very busy<br>– Stakeholder issues are not always part of the regular agenda<br>– In-depth discussion on stakeholder issues can be lacking | – Inclusion of stakeholder issues in board agenda to inform key decisions<br>– Stakeholder discussions need to be baked IN, not added ON |
| **Board Level Stakeholder Insights** | – No specialised stakeholder function<br>– Quality of stakeholder related board information and getting relevant, timely information on stakeholder priorities can be challenging<br>– Limited connection between board agenda/discussion and broader stakeholder engagement<br>– Assessment tools are mostly retrospective (e.g. employee surveys, social media reviews) | – Consistently engage with stakeholders to inform decision making<br>– Establish process to bring stakeholder engagement outputs into board discussions<br>– Robust circular information flow between executive team and board<br>– Require comprehensive and relevant board-level stakeholder information |
| **Oversight of stakeholder-related issues and deliverables** | – No formal responsibility for following-up on stakeholder related analyses/discussions | – Role of the Chair key, as are stakeholder focused NEDs and committees<br>– Strengthen stakeholder understanding at all management levels<br>– Ensure stakeholder related objectives and KPIs, linked to remuneration<br>– Auditable practices to evaluate the efficacy of internal processes/initiatives |
| **Reporting** | – Reporting can be superficial<br>– Organisations are keen to report full compliance, but mandated reporting can become a 'box ticking' exercise<br>– Too many reporting frameworks for limited resources of compliance teams | – Integrate governance reporting<br>– Focus on activities and outcomes, not just compliance<br>– Develop the cultural norms of sharing what works, does not work and actions taken/required<br>– Transparency through voluntary disclosure will support development/sharing of best practice;<br>– Becomes an opportunity for a positive narrative |

# The Outlook

On a positive note, interviewees refer to boards increasingly understanding the need for a shift in thinking. *'I believe the drive amongst business leaders to build back better is genuine in its intent. The concern for future generations is heightened right now and it's possible that home working has added to this, blurring the separation between who we are as directors and who we are as parents and grandparents – one of the few positives to come out of this crisis'* remarks Jennifer Sundberg.

Board directors are more aware and ask questions about stakeholders, particularly employees and unions, and more discussions are taking place about suppliers and the environment. Board papers are being reshaped to reflect how stakeholders are engaged and considered, and more boards are enlisting support from management consultants and ESG consultancies to support these changes. Organisations are using this engagement and thinking to drive change in behaviour and reshape long-term strategy.

Financial services firms have been early adopters – thanks to early regulation. Investors are beginning to engage with boards more broadly, rather than focusing purely on short-term financial performance, and to hold directors accountable for decision-making reflective of a sustainable long-term vision. Through active stewardship and sustainable finance standards, the financial services sector is an important catalyst of a more socially responsible corporate sector.

2020 may come to be viewed as a year of acceleration for stakeholder governance practice as organisations respond to the significant global crises and contribute to efforts to build more sustainable, equitable economies based on a deeper understanding of stakeholder issues. Whether the present momentum continues depends on a continued effort by all. In 2021 we may see evidence in every CEO report of the work done to integrate stakeholders into decision-making, which will be a milestone in the long-term journey of creating more positive outcomes for the world.

In the meantime, the conversation will continue via this working group, and the many discussions that are already taking place, including the work of the Centre for Corporate Governance.

**"Whether the present momentum continues depends on a continued effort by all. In 2021 we may see evidence in every CEO report of the work done to integrate stakeholders into decision-making, which will be a milestone in the long-term journey of creating more positive outcomes for the world."**

# Acknowledgements

### About the Authors

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### We extend our thanks to the following expert contributors

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**Gillian Karran Cumberlege**, Head of Chair and Board Practice, Fidelio Partners

**Professor Mervyn King**, Chair Emeritus of the International Integrated Reporting Council and of the Global Reporting Initiative; member of the Private Sector Advisory Group to the World Bank on Corporate Governance

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## About the IoD Centre for Corporate Governance

The IoD Centre for Corporate Governance exists to explore current issues in corporate governance, company stewardship and ESG - for the benefit of the business community, IoD members and wider society. The Centre arises from the IoD's Royal Charter obligation to "promote the study, research and development of the law and practice of corporate governance". The Centre functions as an independent, not-for-profit centre of excellence under the umbrella of the IoD. Please note that views expressed in Centre publications do not necessarily reflect the position of the IoD or the Centre Advisory Board, and are solely the responsibility of the authors.

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