SLAUGHTER AND MAY/

IS YOUR PURPOSE GOOD ENOUGH?

Governance and Impact - part of the Horizon Scanning series

In February 2019, we hosted a roundtable **discussion** to consider the role of corporate purpose, what it can bring to a company, why it matters and how companies should report against it. Since then, the focus on a broader approach to sustainable, purposeful business has continued to grow. In the US, the Business Roundtable's updated **Statement on the Purpose of a Corporation** signalled a notable shift away from shareholder primacy towards delivering for a wider range of stakeholders. Similarly, the British Academy's **Principles for Purposeful Business Report** (2019) concluded that "the purpose of business is to solve the problems of people and planet profitably, and not profit from causing problems."

In the UK, these themes are reflected in the broader, more purpose-oriented requirements of the UK Corporate Governance Code 2018 (**2018 Code**) which is applicable to all companies with a premium listing and applies to financial years beginning on or after 1 January 2019. So, many listed companies will be reporting against these requirements for the first time in the coming months. At the same time, investors are increasingly demanding that companies show a commitment to environmental, social and governance issues. The UK Stewardship Code 2020 to which many large institutional investors are signatories applies to financial years beginning on or after 1 January 2020. It requires investors to consider ESG issues as part of their investment strategy.

It seems not a week goes by without a new shareholder initiative supporting or encouraging ESG reporting and metrics. Indeed, only this week the Investment Association published its **statement** on what it thinks shareholder priorities for 2020 should be, including the climate related disclosures a company makes, stakeholder engagement and diversity. If anything, the concept of purpose – new to the 2018 Code – has expanded over the last 12 months and the way companies deal with it is likely to be watched closely.

Creating (or refreshing) your company's purpose

The 2018 Code requirement is for listed companies to articulate and report against their purpose. A company must ensure that its purpose is aligned with its values, strategy and culture. In January 2020, the FRC's Annual Review (**FRC Report**) included its view both on how early adopters of the 2018 Code had done in complying with this requirement and its expectations for companies reporting after January 2020.

The early adopter purpose statements were deemed to be of varying quality. The FRC suggested that companies are not adequately considering their culture, strategy or stakeholders and warned that this would not be acceptable when reporting against the 2018 Code.

The FRC Report reflects the difficulties involved in articulating a well-formulated, effective purpose statement. Companies must, however, grapple with this challenge to comply with the 2018 Code and demonstrate their commitment to doing business in a way that is consistent with the company's values and support its long-term sustainable success. We set out below some considerations that may assist this process.

Make clear why your company exists and what makes it unique: A company's purpose should, ultimately, answer the question of why that company exists and describe its unique contribution to the market and its wider stakeholders. The FRC Report emphasised that "the best reporting described purpose by considering it alongside culture and strategy" – a view echoed in the British Academy's Principles for Purposeful Business Report (2019), which suggested that a company should use its purpose statement to make clear "what problems it is solving, for whom, how, when and why it is best suited to do that". The FRC's Financial Reporting Lab **Report** (Business Model reporting; Risk and viability reporting (2018)) highlighted the purpose statements of Land Securities Group plc (in its 2018 Annual Report) and SSE plc (in its 2017 Annual Report) as examples of good practice in this regard.

Devise your purpose and let the other aspects of your business flow from it: The FRC Report notes that companies tended to mix up the concepts of mission and vision -which themselves are based on an underlying purpose - with purpose itself. An effective purpose statement should be linked to, and considered, alongside a company's wider strategy, values and culture, but should not be confused with them.

Do not limit your purpose to profit or mere marketing puff: It is clear that the FRC is demanding more than aspirational or clichéd window dressing. Companies also need to ensure that they articulate a purpose that extends beyond profit. Profit naturally remains a product of a company's purpose, but companies should use the opportunity, when devising their purpose, to show support for broader, more long-term values.

Practise what you preach: Companies should ensure they are able to do this – a company's purpose statement should chime with how it actually behaves. There is clear reputational risk where a company's actions do not align with its statement of purpose and the extent to which a company is seen to "live and breathe" its purpose may well be a key determinant of its perceived legitimacy and credibility in the future. The 2018 Code is clear that a company must align its strategy and culture with its purpose and values. In addition, the 2018's Code requirement for the board to consult with its stakeholders provides an obvious route for companies to test whether employees and stakeholders see alignment between behaviour and purpose.

Be inclusive when formulating and evaluating your purpose: A company's purpose – in its formulation, realisation and ongoing review – should be the result of an inclusive process that seeks the views of all relevant stakeholders. By using such a process, a company's purpose statement can be authentic and a source of energy and commitment for its stakeholders. The FRC Report supports this, noting that companies ought to "consider the views of stakeholders in their purpose statements".

Remuneration policies

Although the 2018 Code does not prescribe particular structures for remuneration schemes (whether long-term performance-related plans or otherwise), in order to promote long-term sustainable success, encourage behaviours consistent with their purpose, values and strategy and show a commitment to a wider range of stakeholders, companies may want to consider amending their schemes to explicitly incentivise these objectives. Traditionally, remuneration arrangements have been linked to metrics closely aligned to shareholder return and/or audited financial performance.

A recent review of practice in the FTSE 100 indicates that very few have made significant progress in linking executive remuneration to corporate purpose and sustainability metrics. In 2019, less than a quarter of FTSE 100 companies made reference, in their directors' remuneration reports, to executive pay being tied to the company's achievement of sustainability or other non-traditional targets.

The FRC Report also noted that all of the sample companies used financial KPIs to set annual bonus and LTIP awards, albeit there was some movement towards the use of additional non-financial KPIs based on diversity, culture and health and safety targets. Consistent with the 2018 Code's emphasis on purpose and sustainability, the FRC encourages the inclusion of such non-financial metrics.

Following the 2018 Code, remuneration committees may, in exceptional circumstances (such as an environmental disaster), already have the ability to override the vesting of annual bonus and long-term incentive plans. It is, however, difficult to see how UK-listed companies can actively reward sustainable performance without the core framework of performance conditions (summarised in directors' remuneration reports) explicitly referring to objectives in this area. Institutional shareholders have already voiced their scepticism about any remuneration committee discretion being used to increase the vesting level above the out-turn of the main published conditions.

It is clear that certain sectors are further down this road than others, with energy and resource companies in the vanguard. For example, Royal Dutch Shell has incorporated into its long-term incentive plan published net carbon footprint reduction targets, along with other sustainability-related metrics focussing on biofuels and carbon capture technology. Other energy and mining companies, such as Anglo American plc, Antofagasta plc, BHP plc, BP plc and SSE plc also include environmental or sustainability metrics in their annual bonus scorecards, albeit providing less detail as to how these targets will be measured. Outside the energy sector, Unilever stands out as a company that incorporates the assessment of sustainability metrics into its long-term co-investment plan for senior management.

The current directors' remuneration reporting regime requires UK-listed companies to submit their directors' remuneration policies to shareholders every three years. The 2020 AGM season will therefore, for most listed companies, be an occasion when they will be required to submit their renewed pay policies for approval. It will be interesting to see whether, as part of the 2020 AGM season, companies seek to tie more explicitly the pay of their senior management to environmental and sustainability targets. The challenges in doing so are material, as creating a robust framework of assessing performance will require careful consideration of the company's individual risks and objectives. We are not aware of material numbers of companies for whom this overhaul is a work in progress and question whether this is sustainable, given the fact companies may not then reconsider their policy on long-term incentivisation metrics for three years.

Looking ahead

The next few months will see many companies looking at what others are doing and few will perceive first mover advantage. The last twelve months have definitely raised expectations for corporate purpose and alignment of strategy, culture and values. There is a real opportunity for companies that stretch themselves to meet these expectations – in meeting investor demands, in their stakeholder engagement and just being ahead of the pack at a time when reputation feeds strongly into a social licence to operate. It is clear however that this is the first step in an evolving framework and that, over the next twelve months and into the next reporting season, companies are likely to have to go further. We will come back to these subjects in coming months to review how things have developed.

This briefing is part of the Slaughter and May Horizon Scanning series

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