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Five ways to enhance board oversight of culture

Corporate culture is defined by the implicit, unwritten rules that create expectations for how people choose to behave. It is reflected by what people actually do every day, by what's celebrated, emphasized and overlooked. Culture is also how companies create and protect value through people.

A company's intangible assets, which include talent and culture, are now estimated to make up 52% of a company's market value. And for some companies, it can be as high as 90%.[1] This is higher than at any point in modern history, and most likely to accelerate. Today, company value is defined less by industrial-era physical assets like plants and equipment and more by information-age human capital. It is clearer than ever that a company's talent, and the culture that enables that talent, are sources of quantifiable competitive differentiation.

Regulators and investors across the globe are interested in how companies are better leveraging talent strategy and culture to accelerate long-term success and enhance viability. As examples, recent changes to the UK Corporate

Governance Code require boards to assess and monitor culture, and revisions to Japan's Corporate Governance Code and the Dutch Corporate Governance Code emphasize the importance of culture definition, measurement and oversight. The Embankment Project for Inclusive Capitalism (EPIC) identified talent and organizational culture among the key drivers of long-term value, and influential institutional investors are including company purpose, culture and human capital management among their global engagement priorities.[2]

Further, the Committee of Sponsoring Organizations' (COSO) recent update of its enterprise risk management (ERM) framework recognizes the foundational role that culture plays in ERM. The COSO update suggests that boards should embed culture into discussions about strategy and risk. It further suggests that boards consider whether the misalignment of desired and actual values and behaviors can represent a risk to the achievement of the organization's goals and seek assurance that adequate monitoring is in place to enable the board to identify and react to cultural issues in real time.[3]

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1   **Global Intangible Finance Tracker (GIFT™) 2018**, October 2018.

2   See **The UK Corporate Governance Code**, July 2018; **Embankment Project for Inclusive Capitalism**, November 2018; State Street Global Advisors **Aligning Corporate Culture with Long-Term Strategy**, 29 January 2019; **BlackRock Investment Stewardship Engagement Priorities for 2019**, January 2019.

3   See **COSO's 2017 ERM Framework Update**.

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For these reasons, oversight of culture is a growing priority in the boardroom – and rightly so. The board plays a critical oversight role for various dimensions that shape culture. Responsibility for defining the right culture for the company and embedding it within daily operations falls to management, but the board must oversee and hold management to account on how it is defining, aligning (to purpose and strategy), embodying and reporting on culture.

Accordingly, we identified accelerating the talent agenda and activating culture as a strategic asset as one of our 2019 board priorities.[4] In this report, we present five ways to help boards challenge how they govern culture and support management in realizing culture's value.

1. Oversee how culture is defined and aligned to strategy

Many leaders struggle with defining and operationalizing the culture that is right for their business. A corporate culture that clearly aligns with a company's purpose and strategy enables and accelerates that strategy. When alignment isn't there, culture can drag the organization down. It is difficult to accomplish new things with old ways of working. As a first step, leaders should spend the time to define attributes of culture needed to both realize what the strategy calls for and engage their people.

As companies develop a blueprint for their purpose, vision, mission and strategy, they should include the cultural attributes needed to achieve the company's overall strategic objectives. Does the strategy call for putting quality first and prizing precision? Or does it call for putting the customer first and empowering local leaders to optimize customer responsiveness? Or is the key priority encouraging innovation and seeding disruptive ideas? To make it real, how do these translate into everyday decisions and behaviors in the company?

While leaders want their company to be great at everything, a company's strategy will call for a specific orientation in the market (e.g., the innovator, the best brand, the most efficient), and the culture should be intentionally designed by management in the context of that orientation. Doing so will help shape decisions

and behaviors, e.g., what kind of people are hired, what workplace policies and processes are put in place, what behaviors are rewarded.

Boards play a pivotal role in overseeing that management teams have defined their corporate culture in the context of their strategy. It should do more than sound good; it should actually fit well with the company's current ambitions. Management should be able to articulate the organization's desired culture, gaps that may exist and how the gaps are being closed. The board should oversee how management defines and harmonizes the culture and strategy, and help provide that culture modernization and evolution is an ongoing priority.

Values vs. culture

Stating values is one thing. Living them every day, beyond policies, procedures and controls is another.

Every company has a unique culture based on its past, present and the legacy it aims to leave in the future. While values are the fundamental ideals and beliefs that guide an organization, a company's culture is thousands of everyday decisions and behaviors that aggregate as social norms.

Values usually remain consistent over time, but culture should evolve and align with the company's mission and strategy. Unwritten rules guide behaviors. Stated culture must authentically reflect the company and clearly guide how its people can realize their personal and the company's collective ambition (i.e., achieve its strategy). Words matter – and behaviors matter more.

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4   See **Top priorities for boards in 2019**.

Five culture archetypes: modernizing the DNA of the company

Research shows that companies generally fall into one of five culture archetypes that defines who they are. Given innovation's urgent role in creating long-term value in today's disruptive era, many leaders are focused on properly calibrating their risk tolerance to cultivate a more innovative culture. Awareness of these archetypes may help boards ask better questions around how management is defining and shepherding the culture that best fits its business. -

Innovation
We innovate.

We are entrepreneurial, focus on anticipating market needs, encourage and recognize ideas, and support prudent risks.

Brand
We build and protect our brand.

We build strong commitment and pride in our products and services while operating with integrity and respect.

Customer
We make it all about the customer.

We gear everything we do to the customer, are relationship-based and empower our people locally to drive success.

Efficiency
We are efficient.

We optimize and are productive through a formal structure, defined roles and effective organization-wide coordination.

Quality
We focus on quality first.

We strive for precision and excellence through continuous improvement, collaboration and a long-term view.

2. Create accountability for how culture is communicated and lived – internally and to key external stakeholders

Everyone in the company contributes to culture. Each person is accountable for how she or he shows up every day. It only takes one event or sometimes just one person to disrupt harmony, prompt a wave of employee turnover, damage client relationships or impact share price. Organizations should have the right behaviors clearly identified, manage performance against those behaviors and have incentive structures that reinforce the behaviors. They should also be aware of and address the challenges of building a cohesive, "borderless" culture in a global organization, where desired cultural attributes may conflict with local norms (e.g., speaking up in a culture where hierarchy and politeness reign) and language barriers may compound challenges. Just as important, leaders at every level should "set the tone at the top" by modeling desired behavior. So, there is a system around behaviors in an organization to provide that the right ones are lived. If the system is weak or broken, sometimes unhealthy, divergent behaviors happen.

The board can play a role in supporting this system, including by aligning executive compensation, including senior executive performance metrics, to the behaviors/culture the business needs. Boards should discuss how the current incentive structures might impact behaviors and what changes might be required to align incentives to the desired behaviors. Including cultural indicators in performance metrics can also help to incentivize the executive management team to embed the values and behaviors throughout the organization.

The board should also regularly evaluate how the CEO and other senior executives are modeling desired behaviors and communicating the desired culture to the organization. Does the content and tone of training materials and internal communications consistently reinforce the desired cultural values and behaviors? How does management communicate what is unacceptable behavior to employees? How does leadership react to breaches of the company's stated values? Transgressions can be an opportunity to shift the culture of the company in the right direction. Hundreds of little shifts over time is how company culture evolves. This should be deliberately directed by executive leaders, with oversight from the board.

The board's responsibilities around succession planning and executive compensation give it meaningful opportunities to shape culture. If the leadership pipeline ultimately does not reflect the company's values, the board may need to make changes at the top to better support the cultural fitness of the organization.

Further, given that investors, regulators and other key stakeholders are paying closer attention to culture, it is important that boards understand how culture is communicated externally. This includes details about how the board is engaged and exercising oversight of culture. Communications should give stakeholders confidence that culture is clearly defined and shaped to align to strategy and purpose, and that the systems that reinforce the right behaviors are set and current.

3. Monitor how culture and talent metrics are measured to keep a pulse on how culture is evolving

Effectively governing culture calls for boards to understand and monitor the metrics that best reflect the health and strength of a company's culture. Culture is measurable; there are many options to directly and/or indirectly measure it. The 2017 COSO update notes that reporting on culture to the board may include consideration of analytics of cultural trends, benchmarking to other entities or standards,"lessons learned" analyses, reviews of behavioral trends, and surveys of risk attitudes and risk awareness. EPIC recommends that boards oversee, and companies report on, the different dimensions of culture, such as ethics and integrity, alignment with purpose and values, leading by example, performance and accountability, and inclusion and well-being.[5]

Companies are embarking on cultural assessments. In addition to these assessments, boards should expect data from as many sources as possible, and at different layers in the organization, on the culture of the company. Customers and employees are key sources of intelligence. Customer Net Promoter Scores, data from culture surveys, employee engagement scores, social media scans, employer review sites (e.g., Glassdoor) and other human capital metrics can provide the board with insights on the health and strength of the culture. The collected data should be interpreted in the context of the purpose and strategy of the company.

Data related to the company's policies, procedures and risk management efforts are also valuable. This includes whistle-blower hotline data, social media audits, compliance training results, and recent legal claims and litigation. Other sources of intelligence include operations (e.g., corporate responsibility policy, decision-making structure) and financial metrics (e.g., market share and shareholder return).

Most of this data already exists within the organization or externally, and advancements in analytics and technology make it easier than expected for companies to gather, use and learn from it. Data analytics can help the board readily gain a holistic view of culture of the company. This data should form part of the overall analysis that is used to drive further assurance and oversight efforts.

Further context from and discussion with management may be needed to understand how this data relates to the company's strategy, business model and culture evolution efforts. Leading boards are having regular interactions with and reporting from the Chief Human Resources Officer (CHRO) as they assume a greater role in overseeing the company's culture and talent goals and assessing the company's overall return on talent investment.

Through monitoring, it is critical that the board develop a deep understanding of the current culture's strengths, gaps to close and the path that needs to be driven to close the gaps. Depth of understanding is key for effective culture oversight and is increasingly expected by leading institutional investors that believe directors should be able to articulate where the company is on its culture path.[6]

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[5] See **Embankment Project for Inclusive Capitalism**, November 2018.

[6] See State Street Global Advisors **Aligning Corporate Culture with Long-Term Strategy**, 29 January 2019.

4. Provide oversight of intentional culture shifts to stay in step with strategy shifts

Culture must shift when strategy shifts. Consider a company that has been hyper-focused on efficiency that is shifting to a focus on innovation. That company's recruitment strategies, operating and incentive structures, its entire DNA, has been built around formal structures and defined roles. But now its success will depend on its ability to embrace an entrepreneurial, agile posture and empower employees with autonomy and creative freedom. For that shift to be successful, new ways of working and new workplace attitudes and behaviors must be lived every day.

A new CEO, a merger or acquisition, digital or functional transformation, regulatory changes or unethical behavior events are also potential drivers for shifts in a company's culture. The board's role is to confirm that management has adequate resources to operationalize culture shifts across the organization and to oversee the approaches management is using to execute such shifts.

Before moving to new ways of working and evolving culture, leaders need to clearly understand the social network of the company and identify the "influencers" within the organization. In addition to senior leadership setting the tone at the top, it is essential to engage other influencers who exist throughout the organization.

Changing culture takes a team that is incentivized to collaborate and do things differently. It also needs both top-down approaches (e.g., evolving operating models, performance systems, rewards systems and business processes) and bottom-up approaches (e.g., decisions and behavioral changes in local teams that, over time, create new norms that go viral).

As culture shifts are operationalized, the board should monitor progress towards the desired culture and help management challenge whether changes being made across the organization are superficial, which could feel disingenuous to employees, or truly changing the undertone of how the company works. The board should also help manage stakeholder expectations around the long-term nature of culture change.

5. Challenge the board's culture

The board sets the ultimate tone at the top regarding corporate culture – not just in the way that the board prioritizes and oversees the company's culture but also in the composition, dynamics and culture of the board itself. Does the board reflect the company's commitment to diversity and inclusion? Is the board innovating its own composition, structure and processes to support stronger oversight of company transformation, strategy and risk? Does the board's own culture reflect the cultural values against which senior executives are assessed?

The board's decisions and dynamics send a message to management as well as to investors and other key stakeholders. While conducting our investor outreach this year, a number of investors said that boards themselves are reflective of talent and culture objectives. They noted the value of board diversity in setting a tone at the top that reflects the company's inclusive view of talent. Some even characterized a lack of diversity among directors and executive leadership as a human capital risk, particularly given the spotlight on corporate culture and today's war on talent.[7] It is critical that the board assess itself through a culture lens and model the desired culture.

Further, boards should challenge whether they are dedicating sufficient time and attention to culture matters and whether any of the committees should have related responsibilities, e.g., the compensation committee expanding its purview to incorporate broader talent strategy and culture-related matters. Boards may consider leveraging the CHRO as a more strategic resource and having regular communications with and reporting from that individual in the same way that they are engaging with the CFO.

Conclusion

Organizations of all sizes, ages and risk tolerances must actively shepherd their culture to align with strategy. The board plays a critical role in hiring the right CEO who lives the company's values, to validating a defined culture that enables strategy, to overseeing how that defined culture is measured and communicated, to setting the ultimate tone at the top. Boards can help management realize culture as a strategic asset by enhancing their oversight of how culture is evolving in relation to strategy and purpose and by holding themselves and management to higher levels of accountability.

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[7] See our **2019 proxy season preview** for more investor insights.

Questions for the board to consider

- ‣ Does the board set the right tone at the top and give sufficient attention to culture as a key enabler of purpose and strategy? And does the board itself embody and reflect the company's values?

- ‣ How comprehensively and specifically has the board discussed the importance of culture and helped define the desired culture?

- ‣ How does culture appear on the board agenda? Is it a specific agenda item that features, for example, once a year, or is it considered in a more embedded way throughout all board discussions and decisions?

- ‣ Is the company's culture intentionally defined in the context of strategy, and is there a shared understanding of it throughout the organization? Further, for multinational organizations, has the executive team sought input from leaders in countries where language and/or culture differences might be a barrier to adopting the shared corporate culture?

- ‣ Can the board articulate the company's cultural strengths and gaps to close, along with the changes needed to best manage behavioral risks and align culture with strategy?

- ‣ Has the board discussed metrics that could be gathered and monitored as a barometer for cultural fitness? Does management's reporting to the board need to be adjusted to capture better data for the board's consideration related to culture matters?

- ‣ How does the board take into account the potential cultural context underlying the achievement of key performance indicators (KPIs)? For example, if all KPI targets are met or significantly exceeded, over an extended period of time, does the board ask why? Does the board examine any potential cultural pressures that may be present to artificially "keep up" certain metrics or KPIs and, if so, consider any related risks?

- ‣ How thoroughly has the board and/or committee discussed the impact of culture on risk, risk management and the internal control environment?

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