

EY Center for Board Matters
**How long-term value
can be redefined
and communicated**

Boards can strengthen their oversight role by guiding management to focus on the long term, understand stakeholder objectives and communicate the many ways their companies create value.

A shift from shareholder to stakeholder capitalism

Transformation of business, society and governments has accelerated over the last decade. Disruption, especially in business, is an increasing challenge for governments, society and companies to navigate and manage. In this environment, a growing and increasingly diverse group of market participants is supporting greater corporate focus on creating long-term value for multiple stakeholders. As companies consider why and how to address such considerations, a consensus is emerging about how companies can redefine and communicate corporate value through an expanded lens.

There is an ongoing shift from the view that the primary purpose of companies is to enhance and protect value for shareholders (shareholder capitalism) to the view that corporations are better able to deliver long-term value to shareholders when they understand and address the needs of their customers, employees, investors, regulators and other key stakeholders (stakeholder capitalism).

As boards examine these changing dynamics and expectations, they should consider recent market-driven approaches and regulatory views on measuring and communicating corporate value with an expanded and longer-term perspective.

The board's role

A board's primary responsibilities are to provide oversight, insight and foresight. Being well-informed is foundational to a board's ability to effectively execute those primary responsibilities. For this reason, boards have an obligation to seek a clearer understanding of stakeholder capitalism and its underlying rationales. Through this understanding, boards may see opportunities for their companies to deliver improved value over the long term by considering and addressing key stakeholder needs and demands.

To facilitate more informed and “patient” investment, many investors are asking companies to report on how they identify and measure both their intangible assets and the environmental, social and governance (ESG or sustainability) initiatives that are influencing long-term corporate value. They and other stakeholders are also seeking disclosure about whether and how those measurements are used to inform and improve strategic planning, risk management, executive compensation, sustainable operations, growth and, ultimately, long-term corporate value.

To more fully respond to these points of view, boards should consider how their company’s value is reflected in intangible assets such as culture, human capital, innovation, corporate governance and ESG initiatives. Some have concerns that corporate balance sheets may not fully reflect the value of these and other intangibles, which can represent over 50% of an entity’s market capitalization.¹

Boards can encourage their companies to develop better ways to identify, measure and communicate corporate value, including through narrative disclosures and nonfinancial metrics, and consider how a longer-term focus can lead to investment and innovation that promotes growth and value creation.

This article highlights five market-driven and regulatory initiatives on long-term value that illustrate the shift to the longer-term, broader perspective of value suggested in stakeholder capitalism. Boards may consider how any of these initiatives might be useful for their companies to apply in ways that could clarify and support value creation.



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1. Companies, investors and other market participants – moving toward a longer-term perspective

To achieve long-term value, both companies and investors have expressed a need to look beyond the bottom line in quarterly financial reports. A narrow focus on short-term financial results has been reported as discouraging public companies from investment in research, innovation, technology and hiring, and private companies from going public. Companies, asset managers and investors are responding to this concern.

FCLTGlobal, a private organization whose membership includes companies, asset managers, investors, financial advisors and service providers, was formed in 2013 with a goal of addressing how market participants weigh immediate financial pressures against long-term objectives.² Believing that the balance was skewed toward investors and companies hitting near-term targets at the expense of long-term value creation, FCLTGlobal encourages a longer-term focus in business and investment decision-making and has developed practical tools to facilitate this focus, including:

- ▶ Objectives, questions and checklists for boards to use in assessing whether they have effective composition and are giving the appropriate focus, time and support to help their companies maximize long-term value
- ▶ Guidelines for investors, asset managers and companies on managing multi-horizon risks, including through communications on strategy, risk and performance and on strategic engagement that can enhance mutual understanding and support long-term value
- ▶ Guidelines for CEOs in developing a long-term road map designed to attract long-term investors, deter activist attacks, more accurately reflect company valuation, provide strategic clarity and address stakeholder concerns

The world’s largest institutional investors have explicitly expressed their belief that companies need to take a long-term view and embrace stakeholder capitalism as the best path to value creation.³ Many companies are already responding to this view. As other institutional investors continue to develop their own governance teams and as collaboration increases between those teams and their institutions’ portfolio managers, we see this investor shift accelerating. Although, even if this shift

occurs, certain activist and other investors will undoubtedly maintain focus on short-term performance. Companies will need to balance these competing investor demands.

Companies are also encouraging a longer view. In June 2018, Business Roundtable, an association of nearly 200 CEOs of major US companies, announced support for companies to end quarterly earnings guidance as a way to shift investors and the financial markets away from an “unhealthy focus on short-term profits at the expense of long-term strategy, growth and sustainability.”⁴ Recent reports suggest that companies may be listening.⁵

2. Embankment Project for Inclusive Capital (EPIC)

EPIC was formed by the Coalition for Inclusive Capitalism and EY, with the view that “the health of corporations and financial markets – and public trust in both – is critical to economic growth” and “market participants have a role to ensure long-term value creation that benefits all.” Guided by these views, EPIC brought together more than 30 global capital market leaders representing institutional investors, asset managers and companies to work on developing a standardized, material and comparable set of nonfinancial metrics for the measurement of company activities related to long-term value. Having such metrics, together with relevant narrative disclosures, would enable companies to clearly communicate to investors how current investments can create long-term value and provide a useful mix of both short-term and long-term performance measures on financial and nonfinancial matters. EPIC participants believed that by creating and communicating this information, companies would reduce the need for investors to disproportionately rely on short-term results to measure success.

Four key drivers of long-term value

In a report issued in November 2018,⁶ EPIC identified four key value drivers of long-term sustainable growth and value:

Talent: Employees have a significant impact on a company’s ability to create long-term value by implementing company strategy and developing new ideas for success and growth. EPIC identified three areas where a company’s actions on the talent front could influence its long-term prospects and proposed metrics and narrative disclosures for each:

- ▶ Human capital deployment, management, engagement and turnover
- ▶ Organizational culture and related employee views and data
- ▶ Employee health programs, participation and impact on productivity

Innovation and consumer trends: Companies must measure their interaction with and impact on consumers and other stakeholders to assess whether innovation is meeting evolving demands. EPIC identified three related factors for enhanced narrative disclosures and metric development:

- ▶ Innovation, with a narrative addressing overall innovation strategy and metrics demonstrating performance against strategy
- ▶ Consumer trust scores
- ▶ Consumer health impacts

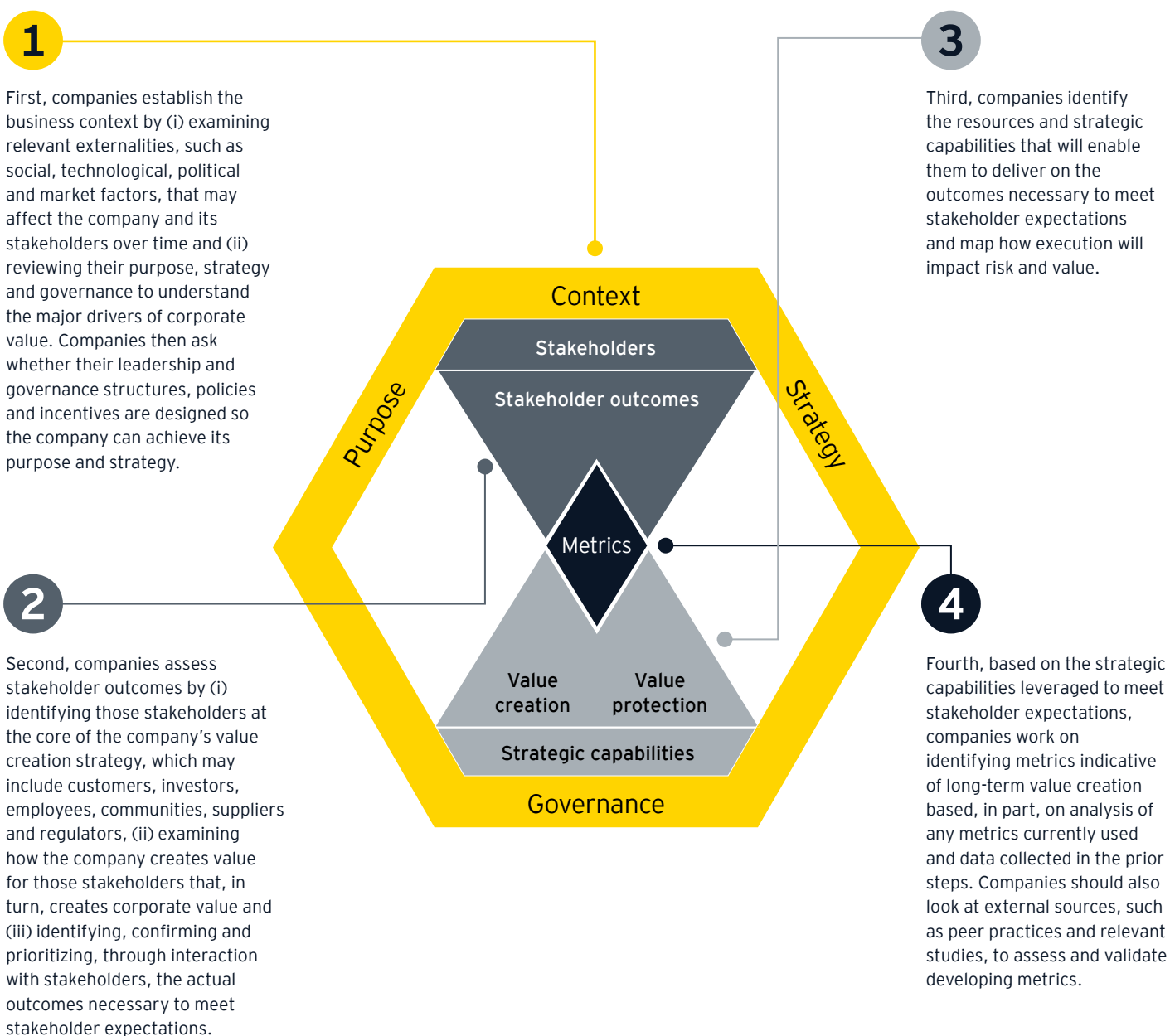
Society and the environment: To be successful in the long term, companies need to understand how they create the social value that provides competitive advantages in attracting talent and customers and that strengthens their “license to operate.” EPIC explored how companies can use the United Nations’ Sustainable Development Goals (SDGs) by linking them to strategy and explaining how their contribution to SDGs creates long-term value for the company.

Corporate governance: While companies already provide a great deal of disclosure about their boards and governance practices, current disclosures may not clearly demonstrate the quality of the board’s composition and governance frameworks and how those assets impact long-term value. EPIC suggests narrative disclosures for companies to consider in better making this demonstration, including:

- ▶ Whether the board has conducted a robust evaluation of its composition, dynamics and effectiveness
- ▶ Whether the board maintains a decision-useful skills matrix to guide its composition determinations
- ▶ Whether the company discloses (without risking competitive harm) strategic milestones achieved or to be achieved in execution of long-term strategy

Developing company-specific metrics to redefine corporate value using EPIC's Long Term Value Framework

EPIC's Long Term Value Framework provides an approach companies can take to identify and evaluate company-specific key value drivers and to develop nonfinancial metrics that can help clarify value and value creation. Any given general metric may not be most relevant to all companies; EPIC participants noted that company and industry differences are a key challenge to the development of any broadly applicable nonfinancial metrics or specific disclosure standards. For this reason, using a concept originally created by EY working with Cambridge University, EPIC participants further developed and validated the Long Term Value Framework. The Framework outlines four steps companies can take to develop company-specific metrics and accompanying narrative disclosures that enable them to better articulate the long-term value they create.



3. Sustainability Accounting Standards Board (SASB)

SASB, a private nonprofit organization, works with other prominent private organizations seeking to advance voluntary corporate reporting and disclosure on sustainability issues, including, among others, the Global Reporting Initiative, the International Integrated Reporting Committee and the Task Force on Climate-Related Financial Disclosures.

In November 2018, SASB published a set of detailed, industry-specific standards intended to enable companies to manage, measure and report on sustainability factors that drive value and affect financial performance.⁷ In developing its standards, SASB identified 26 broadly relevant sustainability issues and organized them into five groups:

Environment – addresses environmental impacts, either through the use of nonrenewable, natural resources as inputs to the factors of production or through harmful releases into the environment that may result in impacts to the company's financial condition or operating performance

Social capital – addresses the company's management of relationships with key outside parties, such as customers, local communities, the public and the government on issues related to human rights, local economic development, responsible business practices, customer privacy and other matters

Human capital – addresses the company's management of human resources as key assets to delivering long-term value on issues that affect employee productivity, labor relations, and the health and safety of employees



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Jay Clayton
SEC Chairman

Business model and innovation – addresses the integration of environmental, human and social issues into the company's value-creation process, including resource recovery, product innovation, and efficiency and responsibility in the design, use phase and disposal of products

Leadership and governance – addresses the company's management of issues that can create conflict between the business and stakeholders, and relating to regulatory compliance, risk management, safety management, supply-chain and materials sourcing, conflicts of interest, anticompetitive behavior, and corruption and bribery

SASB's standards acknowledge that sustainability issues will have different relevance to different companies. SASB's standards therefore are based on financial materiality and call for companies to report on "the handful of ESG and sustainability topics that most directly impact their long-term value creation."

4. Securities and Exchange Commission

Regulators are considering the development of new approaches to measuring and reporting value. Through its "Disclosure Effectiveness" and other initiatives, the U.S. Securities and Exchange Commission and its staff (SEC) is reviewing its disclosure requirements and considering and implementing ways to improve those requirements for the benefit of both companies and investors. Additionally, and in light of the SEC's initiatives, the U.S. Government Accountability Office has been asked to prepare a report on public company disclosures and SEC disclosure requirements relating to ESG matters.⁸

Earlier this year, SEC Chairman Jay Clayton spoke about human capital disclosures to the Investor Advisory Committee (IAC).⁹ In February, he noted that the SEC's current disclosure rules relating to human capital "date back to a time when companies relied significantly on plant, property and equipment to drive value."¹⁰ And that:

"Today, human capital and intellectual property often represent an essential resource and driver of performance for many companies. This is a shift from human capital being viewed, at least from an income statement perspective, as a cost."

In March, Clayton reiterated that “the strength of our economy and many of our public companies is due, in significant and increasing part, to human capital and that for some of these companies human capital is a mission-critical asset.”¹¹ Turning to disclosure of this asset, Clayton said, “The historical approach of disclosing only the costs of compensation and benefits is not enough to fully understand the value and impact of human capital on the performance and future prospects of an organization.”

Clayton suggested that investors would be better served by understanding how companies look at human capital. He also asked what do boards and investors ask management about human capital? Companies should provide public disclosures that address these questions and give investors management’s views on human capital, in particular how human capital is contributing to current performance and long-term value.

The SEC staff has also recently addressed ESG and sustainability disclosures. In March 2019, Bill Hinman, Director of the SEC’s Division of Corporation Finance, noted that ESG or “sustainability disclosure continues to be of interest to investors and other market participants.”¹² Hinman reiterated the effectiveness of a principles-based approach to disclosures, allowing investors to “see the company through the eyes of management.” He also reiterated that companies should consider “how management engages with board members” on the topic, noting that “there should not be material gaps between how the board is briefed and how shareholders are informed.”

5. International Organization of Securities Commissions (IOSCO)

In January 2019, IOSCO, an association of national securities regulators whose membership regulates more than 95% of the world’s securities markets, published a statement setting out the importance of corporate consideration of ESG matters when disclosing information material to investors’ decisions.¹³ The SEC did not vote on the publication of IOSCO’s statement and therefore the statement should not be viewed as an expression of the SEC’s views or as an endorsement by the SEC. IOSCO noted that ESG disclosures are increasing, particularly in some industries, and include “environmental factors related to sustainability and climate change, social factors including labor practices and diversity, and general

governance-related factors that have a material impact on [a company’s] business.”

In its publication, IOSCO “encourages [companies] to consider the materiality of ESG matters to their business and to assess risks and opportunities in light of their business strategy and risk assessment methodology. When ESG matters are considered to be material, [companies] should disclose the impact or potential impact on their financial performance and value creation.”

The IOSCO statement is further recognition, this time by global securities regulators, that ESG factors can be relevant to financial performance and corporate value.

Conclusion

Boards can guide companies by examining how an expanded view of corporate value over the long term can more accurately define and clarify corporate value in ways that give investors, other stakeholders and the financial markets a clearer view of corporate value, long-term sustainability and the company’s related strategy.

By redefining value using the broader and longer-term lens of stakeholder capitalism and linking key nonfinancial metrics of value to strategy execution, companies can better communicate how they are working to achieve long-term value creation and sustainability for themselves, their stakeholders, and society and economies generally. This will help ensure the wider stakeholder perspective is considered, deliver transparency that should increase trust in the business and capital markets, and support more long-term decision-making and investment.

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Questions for the board to consider

- ▶ How does the company define long-term value? Would a broader definition of value, supported by nonfinancial metrics, allow the company to better articulate its value to investors, other stakeholders and the markets?
- ▶ Does the company explain its purpose, culture, investments, innovations and other initiatives and how they are linked and incorporated into strategy in ways that are enhancing the company's competitive position?
- ▶ Do the company's communications adequately address the value of certain intangible assets, such as culture, human capital, innovation and corporate governance?
- ▶ Can the company quantify the benefits of its ESG or sustainability initiatives to determine their effectiveness and whether to adjust or expand them? Does the company communicate the effectiveness and value of these initiatives in ways that gain stakeholder support?
- ▶ What information or communications do key investors and other stakeholders say they need to invest their capital and resources in the company for the long term? Does the company clearly provide these communications in decision-useful ways?
- ▶ Do current company performance metrics and executive compensation packages reflect the objectives of the company's long-term strategy?
- ▶ How does the company communicate the value of its board, in view of its composition, effectiveness and leadership, and overall governance framework?

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Endnotes

- 1 See, e.g., *Global Intangible Finance Tracker (GIFT™) 2018*, <https://brandfinance.com/knowledge-centre/whitepapers/global-intangible-finance-tracker-gift-2018/>, 16 October 2018.
- 2 FCLT Global, Focusing Capital on the Long Term, <https://www.fcltglobal.org/home>
- 3 See, for example, BlackRock Chairman and CEO Larry Fink's 2019 Letter to CEOs "Purpose & Profit," available at: <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter> ("As we enter 2019, commitment to a long-term approach is more important than ever – the global landscape is increasingly fragile and, as a result, susceptible to short-term behavior by corporations and governments alike."); and State Street Global Advisors President and CEO Cyrus Taraporevala's 2019 letter to corporate board members "Aligning Corporate Culture with Long-Term Strategy," available at <https://www.ssga.com/investment-topics/environmental-social-governance/2019/01/2019%20Proxy%20Letter-Aligning%20Corporate%20Culture%20with%20Long-Term%20Strategy.pdf> ("Our focus in recent years has been on good governance and other practices that affect a company's ability to generate positive returns for investors over the long run. Those issues span a variety of environmental, social and governance (ESG) topics material to sustainable performance. We approach these issues from the perspective of long-term investment value, not from a political or social agenda (aka 'values')").
- 4 See "Business Roundtable Supports Move Away from Short-Term Guidance," available at: <https://www.businessroundtable.org/archive/media/news-releases/business-roundtable-supports-move-away-short-term-guidance>, and related opinion commentary "Short-Termism Is Harming The Economy," by Jamie Dimon, Chairman and CEO of JPMorgan Chase & Co. and Chairman of the Business Roundtable, and Warren E. Buffett, Chairman of Berkshire Hathaway, *Wall Street Journal*, June 7, 2018, available at: <https://www.wsj.com/articles/short-termism-is-harming-the-economy-1528336801>.
- 5 See "Dimon and Buffett's call to stop quarterly guidance by companies may already be having an impact," by Jeff Cox, CNBC, September 25, 2018, available at: <https://www.cnbc.com/2018/09/25/dimon-and-buffetts-call-to-stop-quarterly-guidance-may-be-having-an-impact.html>.
- 6 Embankment Project for Inclusive Capitalism report, available at: <https://www.epic-value.com/#report>
- 7 Sustainability Accounting Standards Board, Standards Overview, available at: <https://www.sasb.org/standards-overview/>
- 8 Letter dated July 19, 2018, from Mark R. Warner, Ranking Member, Subcommittee on Securities, Insurance and Investment, U.S. Senate, to The Honorable Gene Dodaro, Comptroller of the United States, U.S. Government Accountability Office, available at: <https://www.scribd.com/document/384237317/2018-07-19-Gao-Request-Esg>
- 9 The Investor Advisory Committee (IAC) was created under the Dodd-Frank Act and has a statutorily mandated advisory and consultative role on regulatory priorities of the SEC and initiatives that protect investor interests and promote investor confidence. The SEC is required to review any findings or recommendations that the IAC brings before it.
- 10 Jay Clayton, Remarks for Telephone Call with SEC Investor Advisory Committee Members, February 6, 2019, available at: <https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-call-020619>
- 11 Jay Clayton, Remarks to the SEC Investor Advisory Committee, March 28, 2019, available at: <https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-032819>
- 12 Bill Hinman, "Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks," March 15, 2019, available at: <https://www.sec.gov/news/speech/hinman-applying-principles-based-approach-disclosure-031519>
- 13 IOSCO Statement on Disclosure of ESG Matters by Issuers, January 18, 2019, available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOP619.pdf>