McKinsey & Company

Strategy & Corporate Finance Practice

The board's role in embedding corporate purpose: Five actions directors can take today

A large spotlight is shining on corporate actions these days, and all stakeholders have growing expectations. A board's involvement in defining purpose helps meet those expectations.

by Celia Huber, Sebastian Leape, Larissa Mark, and Bruce Simpson

November 2020

Multiple forces have increased attention on stakeholder capitalism, and most boards have not sufficiently grappled with the significant implications for their organizations. Last year, Business Roundtable, an association of CEOs who run major US corporations, committed member companies to serving the interests of all stakeholders, but their signatories have found it challenging to deliver fully on their promise. While 181 chief executives signed the roundtable's statement, only one did so with board approval.[1] Could boards have used this moment to engage more deeply with management teams to embed corporate purpose within their organizations—a role that fits squarely within a board's obligation to enhance the company's long-term performance?

Democratization of information has increased scrutiny of corporate actions and raised the standards. As one board member told us, "Corporations exist with the permission of society, and any sector can be regulated out of business." Purpose serves as the foundation that guides those actions and behaviors. In a nutshell, it is a company's core reason for being. It answers the question, "What would the world lose if our company disappeared?" By articulating a clear purpose, anchored in measurable environmental, social, and governance (ESG) commitments and goals, companies can better deliver on societal expectations. Organizations that define their purpose and use it to guide their activities see a clear upside in improving company reputation, alerting management to risks early, establishing the organization as a leader in raising industry standards, and enhancing business performance.

But delivering authentically on corporate purpose is difficult. As such, boards must ensure that their companies' management teams understand the urgency of the issues that the purpose aims to address, and the potential value at stake.

The growing importance of purpose

Even before the pandemic, attention on corporate purpose and ESG was on the rise. Stakeholder groups, from investors and regulators to employees and customers, have increased pressure on businesses to address humanitarian, social, and environmental problems. A full third of global assets under management today are screened for ESG considerations,[2] and investors are taking increasingly activist stances for sustainable corporate practices. The Government Pension Fund of Norway, known as the Oil Fund, for example, has asked portfolio companies to share detailed plans to shift to a low-carbon economy,[3] and voted to exclude three companies from its portfolio due to perceived violations of human rights norms.

Employee and consumer pressure is also growing. The reputations of some tech firms have been undermined by allegations of inequitable working conditions inconsistent with external statements, brought to light by employee whistleblowers. Recently, 65 percent of consumers declared they will buy or boycott a brand depending on its actions during the COVID-19 crisis.[4]

Purpose and ESG commitments help companies address vulnerabilities and contribute to increasing shareholder returns. A compelling corporate purpose attracts talent and unleashes its potential, improving long-term employee well-being and quadrupling engagement.[5] In fact, we recently quantified five links between a strong ESG proposition and improved business performance and long-term value.

Yet despite the value associated with purpose and ESG, and the risks that inaction poses, many companies struggle to rise to stakeholders' expectations. Some take a check-the-box approach or bolt simplistic catchphrases onto existing corporate social responsibility reports. Superficial

[1] *Global Sustainable Investment Review 2018*, Global Sustainable Investment Alliance, 2018, gsi-alliance.org.
[2] Review of ESG considerations includes both positive and negative screening of assets.
[3] Gwladys Fouche, "Norway wealth fund to test business model of biggest CO2 emitters," *Reuters*, September 3, 2020, reuters.com.
[4] *Trust Barometer special report: Brand trust and the coronavirus pandemic*, Edelman, March 30, 2020, edelman.com.
[5] *Transforming culture in financial services: Driving purposeful cultures*, Financial Conduct Authority, March 2020, fca.org.uk.

branding efforts around purpose that are not anchored in the organizational DNA only serve to undermine leadership credibility.

The board's purpose agenda

How boards approach purpose and ESG differs based on regional regulations and norms, but a growing group of business leaders recognize that attention to all stakeholders is essential to protecting their companies' interests. Companies oriented to the long term outperform short-term companies, given the material impact purpose and ESG can have on companies' long-term performance, ensuring these commitments are ingrained within the organization and fall within the board's mandate.

Board directors can serve as thought partners to the management team in developing a purpose narrative and embedding it in the organization. Purpose can become a guiding lens for board engagement on strategy, investments, risk and performance management, HR and culture, governance, and external reporting (see sidebar, "Applying a purpose lens to a board's engagement with management"). In essence, purpose provides the North Star against which the board can stress-test key management decisions.

Below, we outline five specific actions around building, owning, assessing, reinforcing, and driving purpose (exhibit). These can assist board directors in partnering with management to create a purpose narrative with clear commitments and targets, fully embedding the purpose in the organization, and monitoring progress.

1. *Build an authentic purpose narrative with management.* The creation of a purpose statement and a supporting narrative should not be a branding exercise but rather a deeply reflective process. Accordingly, boards should encourage top executives to take the time to understand all stakeholders' perspectives on the company's strengths, vulnerabilities, and relevant industry trends in developing the purpose.

   Board members themselves should engage with stakeholders to listen to concerns, as these can simmer under the radar until they boil over into a public backlash. One board was recently caught off guard when an employee used social media to raise concerns about the company's contract with a foreign government. Boards need to create confidential channels through which employees can raise issues for their consideration in a safe way. They should also proactively monitor internal and external sentiment

Exhibit

Five actions can help boards further a company's purpose and environmental, social, and governance journey.

B	O	A	R	D
Build an authentic purpose narrative with management, engaging stakeholders proactively on the company's strengths, vulnerabilities, and possibilities	Own purpose in board practices; board composition should demonstrate diversity and ESG[1] competence; include purpose and ESG issues regularly on the board agenda	Assess purpose commitments ensuring management sets clear, measurable goals, actions, and accountability at all levels of the organization	Reinforce purpose lens in core board decisions; boards can use purpose to pressure test decisions and trade-offs in company strategy, investments, risk and performance management, HR and culture, governance, and external reporting	Drive organizational accountability for purpose through management evaluations and reporting; tie ESG metrics to executive compensation and celebrate purpose successes

[1]Environmental, social, and governance.

Applying a purpose lens to a board's engagement with management

Directors can help ensure that management decisions are guided by the company's purpose within six areas of board oversight.

Strategy: As part of its responsibility to challenge and approve the corporate strategy, the board should confirm that the long-term business vision aligns with the company's societal purpose.

Investments and M&A: In ensuring that major investments are consistent with multiyear value-creation commitments, the board should consider their impact from environmental, social, and governance (ESG) and stakeholder perspectives.

Risk: The board can broaden the definition of risk to include ESG considerations when defining a risk culture that embeds both compliance and the pursuit of profitable risk.

HR and culture: When approving executive succession plans and ensuring talent plans, organization, and culture are consistent with overall strategy, the board can monitor that management is also investing in employees as a stakeholder group (through compensation, training and diversity, equity, and inclusion initiatives).

Performance management: The board should tie executive compensation to ESG commitments as part of its monitoring of long-term KPIs, earnings, capital allocation performance, and non-financial measures linked to value creation.

Core governance and compliance: In overseeing external communications and reviewing and challenging reporting, compliance, and policies, the board should stress the importance of societal issues and reinforce the need for ESG accountability.

alongside management. For example, the board of a leading industrial company recently replaced a planned board meeting with a listening tour with employees on the shop floor. Such insights can help the board incorporate stakeholder concerns into the purpose orientation.

2. *Own purpose in board practices.* Boards should ensure that purpose and ESG considerations are regular parts of their discussions. Furthermore, one of the board committees should include purpose as part of its oversight. One UK financial services regulator pointed out that, given his agency's access to the minutes of board meetings, "I can measure whether or not purpose and ESG are taken seriously."

   Additionally, board composition criteria should include ESG expertise and diversity (in gender, ethnicity, age, and sexual identity). For example, only 10 percent of board members at companies on the Russell 3000 Index are considered ethnically diverse, and women hold only 19 percent of board seats,[6] suggesting significant room for improvement around diversity in governance.

3. *Assess purpose commitments, ensuring management sets clear and measurable goals, actions, and accountability.* Purpose is made real when it connects to clear commitments, targets, and action plans that cascade down through the organization. The purpose statement should be specific enough to guide decisions

[6] Subodh Mishra and Kosmas Papadopolous, "U.S. Board Diversity Trends in 2019," *Harvard Law School Forum on Corporate Governance*, June 18, 2019, corpgov.law.harvard.edu.

on investments in time, capital, and other resources. A powerful litmus test of a purpose statement is to ask what the company should *stop* doing because of it. Board members can guide the management along this process by posing questions, pressure testing answers, and suggesting ESG metrics.

The board should also encourage management to report externally on its progress in meeting the goals the company's purpose sets out. For example, the Brazilian cosmetics company Natura &Co's purpose is "to nurture beauty and relationships for a better way of living and doing business." To support it, the company set ambitious goals around climate change, human rights, and economic circularity. Each pillar of its purpose strategy features specific initiatives, such as engaging supply-chain partners in ensuring sustainable sourcing and bolstering female empowerment through microfinance loans. Natura tracks and reports progress to both the board and in its annual reports.[7] "They live and breathe this," says a board member about the company's management.

4. *Reinforce purpose lens in core board decisions.* Boards can use purpose to pressure test decisions and trade-offs in company strategy, investments, risk and performance management, HR and culture, governance, and external reporting. For example, in 2010, the board of directors of Danish power company Orsted approved a long-term vision shift to support a commitment to the environment. In subsequent years, the company moved its portfolio from primarily oil, natural gas, and coal generation to renewable energy. By 2017, wind power accounted for 91 percent of Orsted's earnings before interest, taxes, depreciation, and amortization and its market cap has grown 64 percent since its 2016 IPO.[8] Boards should also be vigilant in monitoring management decisions that could undermine the

A growing group of business leaders recognize that attention to all stakeholders is essential to protecting their companies' interests.

[7] *Creating the best beauty group for the world: 2019 report*, Natura, 2019, naturaeco.com.
[8] Meredith Annex and Tom Harries, "Orsted's profitable transformation from oil, gas and coal to renewables," Powering Past Coal Alliance, December 12, 2018, ppca.org.

stated purpose. For example, during COVID-19 some companies were criticized for laying off workers while instituting share buybacks or increasing executive compensation. Dissonance can also arise when a company engages with industry groups or lobbyists whose goals are inconsistent with the company's purpose orientation.

5. *Drive organizational accountability for purpose through management evaluations and reporting.* As part of its oversight role, the board should establish organizational accountability around purpose. At the highest level, it can link ESG performance metrics to compensation for the management team to ensure these goals are treated as seriously as profit and revenue targets. For example, Danone is factoring the cost of estimated emissions into its "carbon-adjusted" earnings reports.[9, 10] The board can also take the lead in celebrating purpose-linked achievements, and noble failures (such as products recalled for not meeting new ESG standards). Boards can encourage management to share inspiring stories with employees and the public, via annual reports, ESG reporting, and press releases.

Importantly, the board cannot allow purpose and ESG goals to drop off its agenda during crises. The COVID-19 pandemic and the subsequent economic downturn have imposed unprecedented difficulties on many companies, but purpose-related considerations should guide decisions even—or especially—when organizations must make hard choices. Purpose can help companies evaluate short-term costs, such as offering employee-retraining programs in place of layoffs and loans to suppliers, as important investments in a better future—for both their stakeholders and society as a whole. Fundamentally, purpose is about leadership, and companies need all their leaders to provide purpose-driven inspiration during difficult times.

Celia Huber is a senior partner in McKinsey's Silicon Valley office; **Sebastian Leape** and **Larissa Mark** are consultants in the Washington, DC, office; and **Bruce Simpson** is a senior partner in the Toronto office.

The authors wish to thank the following board members and experts for their contributions to this article: Jonathan Davidson (UK Financial Conduct Authority), Sir Ian Davis (Rolls-Royce, BP, Johnson & Johnson, Majid Al Futtaim), Conor Kehoe (International Integrated Reporting Council), Nancy Killefer (Natura, Cardinal Health, Facebook), Frithjof Lund, Nina Spielmann, and Ron Williams (American Express, Boeing, Johnson & Johnson).

Designed by McKinsey Global Publishing

[9] *Shell sustainability report 2018*, Shell, 2018, reports.shell.com.
[10] Dieter Holger, "Danone pledges $2.2 billion climate plan," *MarketWatch*, February 26, 2020, marketwatch.com.