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Understanding corporate culture

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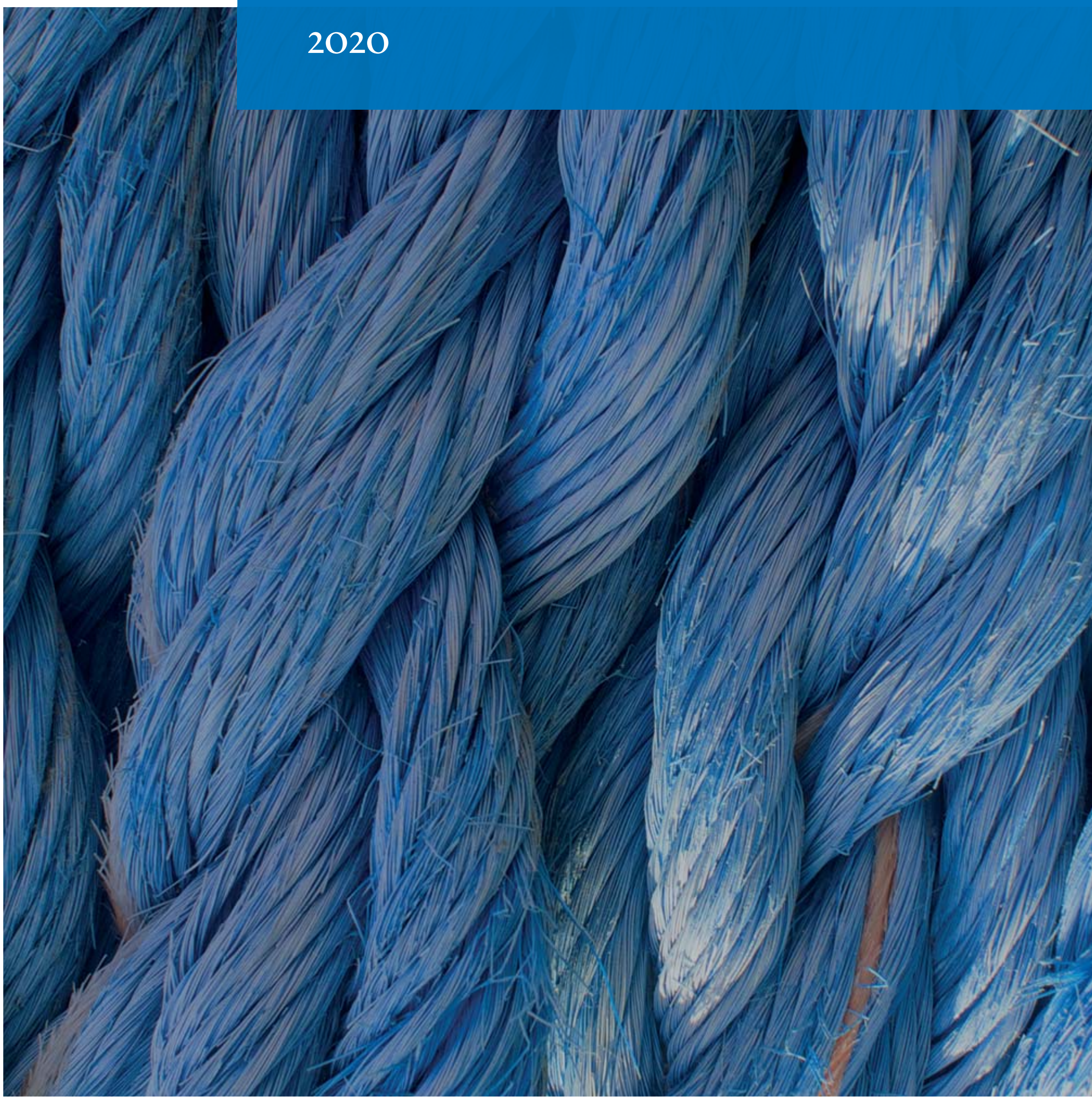

Legal & General
INVESTMENT MANAGEMENT

Understanding corporate culture

As part of our corporate engagement activity, we have often set ambitious diversity targets for companies as well as standards for inclusion. Anyone who has ever worked in a team knows the importance of a strong culture. Developing a strong culture is both a key part of these efforts and a means for us to assess the success of a company.

We have written this guide to provide an insight into how we understand culture and ways in which culture informs the behaviours, performance and outcomes in companies, helping leaders to build and engage with their people as assets: their 'human capital'. A corporate culture that is genuinely inclusive can be the defining success factor of the business strategy. As company value becomes increasingly intangible, it is the human capital – the collective knowledge, skills and experiences of the workforce – that typically drives innovation.

Despite an intense focus in recent years from boards, investors and even regulators, there are still many questions about 'corporate culture' – a key topic but one with little guidance. Our experience with policymakers and dialogue with many company board members globally, along with the guidance published by UK organisations and regulators, has helped inform this guide as to what makes a strong corporate culture.

Company culture can be defined as a system of shared values that demonstrate what it is that a company stands for – the expected behaviours and performance of its employees and how those employees should be incentivised. Plainly speaking, a corporate culture defines what is encouraged, discouraged, accepted or rejected. The Harvard Business Review set out the four generally accepted of culture:

Shared	Culture is a group phenomenon
Pervasive	Culture permeates multiple levels and applies across an organisation
Enduring	Culture can direct the thoughts and actions of group members over the long term
Implicit	Despite its subliminal nature people are hardwired to recognise and respond to it instinctively

Source: Harvard Business Review - How Corporate Cultures Differ Around the World.

A company's culture is manifest not only in its operations and relations with its employees, but with all stakeholders – including investors, communities, customers, suppliers and the broader environment. Whether openly discussed or silently understood, culture plays an enormous role in an organisation's performance and success since strong relationships are required with every one of the above stakeholders.

The importance of culture

In its role of developing the UK's Corporate Governance and Stewardship Codes, the Financial Reporting Council (FRC) announced that "there needs to be a concerted effort to improve trust in the motivations and integrity of business".[1]

1. Financial Reporting Council, Corporate Culture and the Role of Boards, July 2016

Culture is one of the top two reasons why employees join and remain at a company.[2] Over the long term, a healthy business culture can drive successful business strategy and sustainable value. Conversely, a flawed or damaged culture can impede strategic outcomes, erode business performance, diminish customer satisfaction and loyalty, and discourage employee engagement. In short, a company's culture can make or break even the most insightful strategy or the most experienced executives.

But despite its significant and proven contribution to business results, few company boards oversee culture with the same rigor with which they assess strategy, risk or CEO succession planning.

There can often be many major external catalysts which require cultural change, managed by company leadership:

- **Mergers** – The company may need to bring together cultures from two organisations, retaining the strong elements of both
- **Disruptive change** – Leadership may want to create an environment in which new ideas and innovation can flourish
- **Globalisation** – Company expansion across borders can create significant issues and require cultural change in order for new strategies to be executed successfully

Developing culture

Strategy and culture are not mutually exclusive goals; neither do they exist in parallel universes. Rather, they reinforce each other. While often thought of as organically grown, successful culture needs to be established by a leadership team with the same rigour applied to business strategy. As no one size fits all it cannot be set by industry regulation. It is not a set of static or homogeneous values either: as the business changes, the values may also need to change to reflect a new strategic direction.

In its report on the subject, the FRC highlighted a framework for companies to develop their culture, which we believe can help guide companies in this task:[3]

1) Connecting purpose and strategy with culture
2) Aligning corporate values with incentives
3) Designing methods to assess and measure culture

Communication on all of the above points is crucial. Leaders need to make clear their desired culture to the rest of the business – organisational culture will follow from leaders who are role models in terms of illustrated behaviours. Yet 75% of organisations' leaders still do not identify and communicate their organisational culture to a great extent and just 32% of executives say that their culture is aligned to their business strategy, according to management consulting firm Korn Ferry.[4]

A company's culture and strategy can help reinforce each other; a strong strategy that is well executed will change a culture. For example, if a company's strategy is to emphasise growth through product innovation, yet its culture is built around results and stability, performance will probably not be achieved as the two are not aligned. Detailed and thoughtful plans for strategy and execution can be de-railed because the power of culture is not understood.

2. HAYS, What Workers Want 2018, 2018
3. Financial Reporting Council, Corporate Culture and the Role of Boards, July 2016
4. Korn Ferry, Creating an engaging culture for greater impact, January 2016

The FRC advises that as a result, boards have a role in developing and overseeing both culture and strategy alike. Just as they evaluate and challenge business strategy on an ongoing basis, boards must be willing to discuss cultural change when necessary. If a company's culture is not consistently aligned with its strategy, organisational structure and operational practices, performance is likely to suffer and strategic goals may not be met. Therefore, boards should have culture on their agendas every year, not just in the challenging years.

Assessment and measurement

Assessing and measuring culture may be more complicated than initially thought. For instance, the Financial Conduct Authority (FCA) measures culture by looking at a firm's purpose, leadership, approach to rewarding and managing people and its governance arrangements. Good culture is demonstrated – rather than stated – and underpinned by everything the company does. As it is by nature intangible and variable, it is difficult to measure with a single indicator.

Understanding a company's culture firstly requires disclosure from the board, given its role in setting values. Investors need reassurance that the CEO and management drives the cultural message and sets the tone from the top, and that this is regularly discussed and challenged by the board, as well as monitoring how the cultural message filters down to the rest of the organisation.

When we combine open discussion with some key indicators, we begin to arrive at a clearer picture.

Culture indicators we look for

- A clearly defined **mission statement** which is understood by every employee to drive the whole organisation in its strategic direction.
- **Employee surveys** are a helpful way to ascertain how and to what degree culture is integrated within an organisation. Most questions can be standardised on a sector basis and some tailored to the company being surveyed. In evaluating surveys, it is important to measure feedback based on the quality as well as the number of responses. Company secretaries can help standardise these surveys for a particular sector and independent companies to verify the results. Be prepared to discuss the results with investors.
- **Employee turnover** may be an indicator of whether or not culture is successful. A standard measure would enable investors to compare companies within the same industry.
- **Workplace diversity** is an important indicator for how robust the company may be in the face of change. A healthy culture supports diversity and, in turn, high levels of diversity can generate a diverse and inclusive culture that enables challenge of the cultural status quo – one which is also more likely to handle change.
- The information gathered from **exit interviews** provides insight into whether or not the values and expectations illustrated by the leadership team are clearly translated into a company's culture.
- A standard measure for comparing investment in **staff training** helps investors establish the degree to which firms are valuing their human capital and fostering positive culture.
- **Values training**, including the rate of employee participation, yields insight into the company culture. Examples of how employees and divisions have demonstrated these values moreover provide stakeholders with reassurance that it is integrated into the culture.
- Shareholders can gain greater visibility of culture where values are included as a review item in **board effectiveness reviews**. It is important to also address whether the reviewer feels culture is adequately emphasised and is a recurring board meeting agenda item.
- The company **chair's statement** in the annual report indicates whether or not promoting good culture is driven from the top. The statement ideally explains what the board has done to drive values, what those values are, and a personal view from the chairman supporting the values with concrete examples of where they have been applied.

- It is important that company executives discuss what they have added to the company's values at **annual general meetings or in annual reports**. Many employees in big organisations do not even know who the non-executive directors are; for a culture to work, the executives need to set the direction and examples.
- **Whistleblowing** is becoming more common, but surveys show that workplace culture can be a hindrance to effective reporting of wrongdoing. For example, 55% of managers said that they would be deterred by both concerns that it would damage their career prospects and concerns that their reports would not remain anonymous.[5] Leaders should be clear that their culture both encourages and protects those who help the company avoid misconduct. Additionally, the standardisation of data will facilitate comparison in the company's approach to supporting whistleblowing.
- **Pay ratio** information provides transparency of pay distribution within a firm. This holds management to account for promoting pay equality and demonstrating the value put on human capital.
- Finally, investors will consider whether **values underpin pay and compensation**. Where remuneration is meaningfully linked to values, it is clear that the company prioritises good culture.

All of these indicators require companies to gather and analyse workplace metrics and data. Companies therefore need to consider how they report on culture to investors in annual disclosures and should devote sufficient resource to evaluating and monitoring its impact. Companies should also be prepared to discuss culture alongside strategy with their investors and to raise this in update meetings.

How is good culture incentivised?

When cultural issues are identified, the board is tasked with the need to take fast action. However, new cultural programmes take time to be embedded and therefore we should be considering culture a long-term endeavor rather than an issue that should be fixed quickly.

3 of the most-used strategies to improve culture are:

Communicatons

Leadership development

Embedding culture change in management objectives

There are a number of ways in which companies and stakeholders can encourage good culture:

- Link corporate values to personal objectives and financial compensation
- Ensure power dynamics are equitable, providing employees with the means to question and challenge management
- Provide employees with room to fail, as this fosters creativity and innovation
- Constantly 'health check' the leadership team and managers
- Where there is misalignment with company purpose and values, the board should hold management and leadership to account

5. Freshfields Bruckhaus Deringer, Whistleblowing is on the rise: Global survey, November 2017

What are some of the barriers to culture change?

Leadership teams of organisations are tasked with delivering strong financial results but when business performance becomes an all-consuming priority, culture can suffer. There can be a tendency for leaders to avoid 'rocking the boat', and if the organisation is performing well they may be less likely to implement the significant cultural change required. Additionally, for culture to shift, the current culture must be recognised.

Korn Ferry and Spencer Stuart, the management consultants, have assessed the various barriers to changing culture. Here are some things to think about:

- **Ownership at the top** – the CEO and management team should own culture, and the board should challenge it as they would any other strategic issue
- **Board visibility into the culture** – management needs to provide the board with information about corporate culture to enable the board to make accurate assessments and the ability to challenge where necessary
- **Define the board's role** – the board's role in cultural oversight should be clearly defined just as it is on areas such as executive compensation or risk oversight
- **Establish a shared vocabulary** – without a shared vocabulary or framework to discuss culture, independent board directors and executives won't know where to start or how to have a constructive conversation about it
- **Ownership of change initiatives** – any initiatives set out to change culture should be given clear ownership and accountability with timeframes to ensure it remains a key focus
- **Tackle resistance** – push back against cultural change must be tackled constructively to ensure change is not derailed

Cultural change checklist

Poor culture can be improved when a critical number of individuals at a company adopt new behaviours consistent with their organisation's strategic goals and direction. Additionally, the diversity of the board is a key input to culture change, as different viewpoints will bring a fresh perspective to this issue.

There are, however, a number of questions which we can pose to assess a company's culture and, where necessary, instigate change, assisted by research from executive search consulting firm Spencer Stuart:

What is the current culture of the organisation?

- What are the unwritten rules that everyone knows but cannot necessarily articulate?
- How can these be better articulated?

How aligned is corporate culture with strategy?

- What organisational behaviours are required to achieve the strategy?
- How well do employees and executives demonstrate those behaviours today? How are they measured?

What is the difference between current and ideal corporate culture?

- Do you face cultural impediments and, if so, how do you intend to overcome them?
- Where are the most influential people in your organisation, and are they being leveraged effectively?

How well do your organisational structure and practices support your ideal culture?

- How might different compensation structures help shape different types of organisational culture?
- During an organisational change that is not going to plan, could culture be getting in the way?

How do you consider culture in your succession plans?

- How does your talent development process advance your ideal culture?

How does the board contribute to the right tone at the top?

- Are there any changes needed in board composition or behaviour to set the right tone?

Where in the board agenda are questions about culture?

- What models or frameworks can the board adopt in order to discuss culture effectively?

Conclusion

We can conclude that culture, leadership and strategy are inextricably linked. Yet culture is an elusive mechanism as so much of it is implicit in unspoken behaviours, social patterns and mind-sets – making it difficult to assess, manage and measure. However, through clear communication and understanding of what is required, culture can be developed to help reinforce a company's overall strategy.

It is important to remember that developing a company's culture is not a one-time project. Corporate culture is a critical tool for creating long-term shareholder value, yet is often overlooked or side-lined too quickly. By prioritising culture on their agenda and creating the right language and framework around it in order to discuss it effectively, boards can help to ensure that culture and business strategy are mutually supportive.

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