



Environmental, Social & Corporate Governance

Good corporate governance is critical and protects from serious threats

MarketLine Case Study

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1. Overview

1.1. Catalyst

Corporate governance has come to the fore as directors and executives recognize that they are responsible not just to shareholders, as in the past, but to a wide range of stakeholders. Customers, partners, employees, and communities must be considered. Regulators and non-governmental organizations command attention. Few, if any, directors or executives would argue that they have no responsibility for the environment, especially as the effects of climate change grow more evident and more dire.

1.2. Summary

GlobalData has developed a framework to help companies understand and address their responsibilities across the three main areas – environmental, social, and governance (ESG) – once termed simply sustainability. Organizing the topic in these three areas makes it much easier for companies to assess where they stand. GlobalData's framework goes deeper and defines four key areas within each of the three main topics. Within corporate governance, these are corporate structure, risk management, corruption and bribery, and ethics. Then, within each area, the framework identifies several contributing factors and mitigating actions to help companies identify where progress is needed and create action plans

This report describes how corporate governance has shifted as disclosure requirements have given stakeholders greater access to information. Financial disclosure reveals whether executive pay structures are equitable, for example, while other types of reporting make it harder for companies to evade responsibility for pollution and unsafe or unjust workplace practices. The report also provides numerous positive and negative examples that illustrate how corporate governance is inextricably tied to results.

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2. Why companies must take governance seriously

Simply put, governance is what determines whether a company will deliver results to stakeholders, however it defines stakeholders, and however it defines results. Free-market advocate Milton Friedman once proselytized the view that corporations were responsible only to one stakeholder – its investors – and results were almost purely financial. Today that view seems almost quaint. Investors still hold significant sway, but few executives would publicly proclaim they are responsible only to investors. Instead, nearly all would acknowledge responsibility to a broader group of stakeholders. The best-run companies tend to be those that take the broadest and longest-term view of stakeholders, risks, and responsibilities. Even the Business Roundtable, the association of US CEOs founded in 1972 that long espoused Friedman's view, has come around. In 2019, the organization published a new Statement on the Purpose of a Corporation, signed by 181 CEOs who committed to "lead their companies for the benefit of all stakeholders – customers, employees, suppliers, communities, and shareholders." The statement acknowledged the importance of a healthy environment.

2.1. Shareholders first mentality is now highly risky

The "shareholders first" view of corporate management drives a short-term view of governance similar to short-term views of financial markets and performance. As Andrew Johnston, professor of corporate governance at the University of Sheffield, wrote in 2020, too great an emphasis on near-term financial results drives short-term behaviors. These include stock buybacks, excessive dividends, failure to invest in productive capabilities, and inattention to the corporation's long-term sustainability. The result, Johnston wrote, can be a "tragedy of the horizon" no less consequential than the "tragedy of the commons," a legal and economic concept in which individuals acting out of unregulated individual self-interest produce a result detrimental to all. In the "commons" example, shepherds lacking a shared social structure allow their sheep to eat all the grass. In Johnston's "horizon" example, companies may soar in the short term but fail in the long run.

With few exceptions, such as Russian state-owned companies like Gazprom and Rosneft, companies and their directors and executives are subject to much more oversight and scrutiny today than in the past. Legal requirements constantly evolve, as do penalties for monopolistic or anti-competitive behavior. Non-governmental organizations and activist investor groups are increasingly numerous, well organized, and aggressive on environmental and human rights issues. In times past, such groups had only limited access to information about, say, social and environmental impacts from mining in Africa, so mining companies were rarely held accountable. Now, when anyone can post a video to Facebook or Instagram, companies are under more pressure than ever. In many cases, this pressure on ESG issues has not been sufficient to drive thorough reform. But it is growing and unlikely to decrease.

2.2. Governance can go badly wrong

Companies that get into the greatest trouble are often those that forget how many ways they may be held accountable. Sometimes they even "out" themselves, whether inadvertently or because they view disclosure as unavoidable. Airbus triggered the largest corruption enforcement action in history in 2016 when it self-reported irregularities in payments to third-party consultants. The case took four years to resolve and resulted in fines of nearly €4bn.

Payments services company Wirecard went out of business following a fraud scandal in 2020 when, ahead of reporting its financial results, it had to acknowledge that €1.9bn (\$2.26bn) was missing from its balance sheet. Volkswagen's comeuppance came from an unusual direction. A clean-air advocacy group had tested Volkswagen diesel cars in hopes of showing diesel could be a clean fuel. Instead, the group revealed in 2015 that it had found massive fraud: Volkswagen had fitted cars with technology that reduced emissions during testing but permitted excessive emissions during regular driving. Volkswagen saw its share price fall by half and wound up paying nearly \$35bn in fines and settlements.

Activist shareholders, particularly those focused on combating climate change, are a growing factor in corporate governance. In June, a relatively tiny climate-focused hedge fund called Engine No. 1 forced three of its nominees onto the board of ExxonMobil, which had long sown misinformation about the planetary threat. On a larger scale, asset managers are becoming increasingly active in the climate fight. The world's largest, BlackRock, has been driving the message that climate risk is investment risk and demanding that its portfolio companies prepare long-term strategic plans. To drive action, BlackRock has increasingly been voting against companies whose climate strategies it finds insufficient.

Lax corporate governance often takes the form of weak cybersecurity oversight. Recently, ransomware attacks of Russian origin have received extensive media attention, but these are only one type of security breach. Companies are subject to espionage by foreign governments as well as other companies seeking access to trade secrets. Customer data, including credit card numbers and contact information, may be vulnerable to hackers because of poor corporate security practices.

2.3. How to improve corporate governance

The overarching lesson is that corporations face so much disclosure and must answer to so many different watchdogs that it is difficult to avoid accountability, and there are rapid and severe consequences for lax governance. Good governance alone may not ensure long-term success, but it is a necessary component. So how is it achieved?

- Develop and adopt vision, mission, and values statements that define your corporation and establish accountability at all levels.
- Define ESG success for your company and recognize that it is entwined with financial success. Commit to integrated assessment and disclosure of ESG and financial performance.
- Establish a team to drive ESG performance, headed by a C-level executive.
- Incentivize ESG performance by tying it to a portion of executive compensation.
- Appoint more independent board members to widen the board's vision and sense of responsibility.
- Increase board-level diversity to drive greater diversity throughout your organization.
- Embrace transparency, understanding that secrecy tends to grow like mold and cause internal rot.
- Take the long view, recognizing that stakeholder scrutiny will only increase.

2.4. Technology can play a role in effective corporate governance

Modern business would not survive without software – for accounting, customer relationship management (CRM), resource planning, and much more – that provides visibility and control over corporate operations. Governance is no different. Governance software can facilitate all of the points enumerated above.

No aspect of enterprise software is automatic, of course. Such solutions take time and effort to implement. Above all, they require buy-in, participation, and alignment across the business. Without these, they sit unused and join the category once known as shelfware. But companies that failed to implement enterprise software, or implemented it badly, found themselves at a competitive disadvantage, often for years. By contrast, those that implemented enterprise software properly gained a competitive advantage. Governance capabilities will become just as essential.

3. Corporate structure and good governance examples

Corporate structure is typically defined by a company's founders. This structure is unlikely to change much until a major event, such as a listing or a new tax structure, necessitates change. Poorly designed corporate structures can cause many problems. Executives can be paid too much and workers too little. The company's strategy can result in conflict with shareholders or other stakeholders. Regulators may be deceived or obstructed when investigating crimes. Employees may not be able to access the pensions they have been promised. Minority shareholders may be mistreated, and executives may be encouraged to value short-term profits above sustainable, long-term growth, to the detriment of other stakeholders and society as a whole.

3.1. Companies leading by example in corporate structure

3.1.1. BMW leading ethical AI use

According to ESG data aggregator Censible, BMW is a top performer in corporate integrity and corporate leadership diversity. The company has doubled its number of female managers since 2011. Its UK subsidiary annually discloses its gender pay gap, which in 2019–20 had a mean of 20.9% and a median of 16.1% across all levels. In the same report, the subsidiary outlines how it intends to close the gap. In 2020, the company changed its bonus structure, moving away from bonuses based on a percentage of base pay (which favors majority-male senior leadership) to an approach that aims for equal value for all employees. In addition, the executive board has committed to objectives aimed at increasing the number of women in senior roles, such as a diversity steering group.

In corporate governance, BMW in 2020 began to reform the transparency and oversight of its supervisory board (which appoints and removes senior executives and independently reviews strategy and results). This followed the company being implicated in 2019 in an anti-competition case on restricting clean emissions technology. BMW had initially set aside €1.4bn for potential fines from the European Commission, but it announced in May 2021 that it expected the penalty to be €1bn less. Nonetheless, the board faced significant pressure at the 2020 annual meeting. Investors representing a fifth of the company's capital refused to back the re-election of chairman Norbert Reithofer, arguing that he and two long-serving members had too much influence. Reithofer promised reforms, which were announced in March 2021. Of the 10 non-executive directors elected by shareholders, three directors agreed not to seek re-election; two had been on the board for more than a decade. This move has likely placated some investors, secured Reithofer's position, and rehabilitated his image.

BMW is a leader in the ethical use of artificial intelligence (AI). It began an ethical AI project in 2018 and, in October 2020, set out seven principles to promote it. They are human supervision; technical robustness and safety; privacy protection and data governance; explainability; diversity and non-discrimination; social and environmental well-being; and accountability. Both AI and ethical AI will grow in importance, so BMW's action will boost stakeholder confidence.

3.1.2. BlackRock uses publicity to press for change

BlackRock CEO Larry Fink used his annual "Letter to CEOs" in 2020 and 2021 to give guidance on ESG issues, including board-level diversity, environmental sustainability, and the need for companies to consider all stakeholders when making decisions. He called for portfolio companies to improve disclosure in areas such as workforce diversity, supply chain sustainability, and protection of consumer data. Fink argues that sustainable practices are essential to the long-term health and success of the business.

BlackRock, which has more than \$8.6tn under management, has significant power over its portfolio companies in how it manages its holdings and through support for activist board members to drive change within these companies. Fink is arguably the most important man in private finance; his words signal changing winds in the investor world toward sustainability.

3.1.3. Chipotle Mexican Grill working on emissions

Chipotle Mexican Grill's mission statement is to provide "food with integrity" with a vision to "cultivate a better world." These statements highlight the importance the company places on ESG, particularly sustainable sourcing.

Companies in many sectors have laudable mission statements which are not always matched in practice. Chipotle stands out as a governance leader because it has tied executive compensation to performance against ESG goals. An ESG metric will determine 10% of their annual incentive bonus, holding Chipotle's leadership responsible for making business decisions that prioritize corporate responsibility. The metric will include progress toward publishing Scope 3 greenhouse gas (GHG) emissions (emissions in the company's value chain), increasing the amount of organic, local, and/or regeneratively grown or raised food used in its restaurants, maintaining racial and gender pay equity, and promoting people from within the company.

A compensation structure that prioritizes ESG performance, not just profit, is evidence of true commitment. Measurable ESG targets also facilitate monitoring and evaluation by shareholders, customers, and investors, which improves accountability.

3.1.4. BP has put in significant effort after the Deepwater spill

While still repairing reputational damage from the disastrous 2010 Deepwater Horizon oil spill in the Gulf of Mexico, BP is seeking recognition as an industry leader for transparency in reporting. In 2020, it published comprehensive data on its ESG performance. For example, its Diversity, Equity & Inclusion Report contained detailed statistics on its employees' gender, ethnicity, and nationality. Separate data illustrating the same splits but stratified by seniority was also offered. (It is a common complaint that companies will show balance across the total employee base but conceal the dominance of privileged groups at the most senior levels.) Another notable disclosure was the company's remuneration weightings; safety and environmental factors each determine 15% of bonuses, with the remaining 70% determined by financial and operational performance.

BP's governance has been optimized to ensure alignment with the Paris Agreement climate goals. In 2020, new material investments were evaluated for Paris alignment, and those approved were judged to be consistent with the Paris goals. Climate issues were on the agenda of every board meeting. The board's safety and sustainability committee's remit was expanded to include overseeing the effectiveness and implementation of net-zero and social goals. For transparency, BP published its current and anticipated comparative spending in hydrocarbon reserves and low-carbon investments, with no backgrounding of the hydrocarbon investments. Regarding targets, BP has set intermediary targets to meet on the way to longer-term ESG targets to ensure quick progress; a goal of \$5bn low-carbon investment by 2030 is paired with an intermediary goal of between \$3bn and \$4bn by 2025. BP's emissions targets focus on absolute emissions rather than carbon intensity, which can be useful but also subject to misdirection.

3.2. Companies with room to improve in corporate structure

3.2.1. L'Oréal behind its competitors in gender pay equality

L'Oréal enjoys a relatively positive corporate image. However, GlobalData's analysis of gender pay equity within the UK subsidiaries of the top 20 FMCG (fast-moving consumer goods - goods with a lifespan shorter than a year) companies

revealed L'Oréal is significantly behind its competitors. Female employees at L'Oréal earn £0.66 for every £1 a male employee earns. The average woman at the top 20 FMCG companies with a UK subsidiary earned £0.93 for every £1 earned by a man.

The top FMCG companies (taken from GlobalData's thematic scorecards) were searched on the UK government's gender pay gap service. The data was taken from the most recent report each company had published, a requirement under UK law. Danone and Colgate-Palmolive were not included because they do not have a UK subsidiary, but every other company in the GlobalData consumer scorecard was included.

L'Oréal was the worst in gender pay equity, followed by Estée Lauder, where women earn £0.79 for every £1 a man earns. Unilever was one of the best companies in gender pay equity, with women earning £1.02 for every £1 a man earns. L'Oréal CEO Jean-Paul Agon earned a salary of €2.2m and total compensation of €9.5m in 2018, with contributions from other remuneration. This could contribute to the company's significant gender pay gap. However, regarding diversity and inclusion, L'Oréal won two awards at the Corporate Governance Grand Prix Awards in 2020 for "Corporate Social Responsibility" and "Diversity in management bodies." L'Oréal's board members represent seven different nationalities, with 58% female directors and 50% independent directors. However, L'Oréal's gender pay gap causes their diverse board to seem somewhat tokenistic. These positive measures should be transferred to the broader body of L'Oréal's workforce.

3.2.2. Heineken poor timing of layoffs and remuneration

Heineken gave former chief executive Jean-François van Boxmeer a €5.5m severance award when he left in 2020 after 15 years in the role. This was in addition to his salary, bonuses, and pension, bringing his total payout to €8m. Proxy adviser Glass Lewis urged Heineken investors to revolt at the brewer's annual general meeting in April 2021.

Heineken's move deviates from the Netherlands' corporate governance code (set by the Tabaksblat committee in 2003), which limits payouts to one year of an employee's salary. According to Heineken, the agreement with van Boxmeer predates the code. However, the company still set aside €7m to deal with any penalties from the Dutch authorities.

Heineken has been cutting costs because of COVID-19. The CEO's remuneration was announced around the same time as it cut 8,000 jobs, almost 10% of staff. Glass Lewis commented, "Given the cost-cutting measures undertaken by the company to save liquidity, and the poor operational and financial results posted in the past year, we believe a more modest approach to executive remuneration would have been more appropriate." The poor timing of the remuneration announcement, and COVID-19 making 2020 a difficult year for consumers, resulted in Heineken receiving bad press, which could damage its brand image.

3.2.3. Wirecard failed to address concerns of fraud

Wirecard was a global fintech that enabled payments, headquartered in Germany. In 2020 the firm was rocked by an accounting scandal that led to its CEO, Markus Braun, being placed under arrest. On June 18, 2020, the firm was supposed to report its results for 2019 and the first quarter of 2020. The firm was unable to present these results as it became apparent €1.9bn was missing from its balance sheet. The firm's supervisory board (which oversaw its management board, specifically to enhance governance under German law) had failed to intervene despite accusations of fraud dating back to 2019. The firm also aimed to suppress whistleblowers like Pav Gill, a former in-house lawyer, who managed to break the story to the Financial Times in 2019.

3.2.4. Volkswagen scandal continues to haunt it

The German automaker's biggest scandal came to a head in 2015, when it was revealed that it sold diesel vehicles fitted with a device that would detect when the car was being tested and activate equipment that reduced emissions. During regular driving, the software turned down the equipment, increasing emissions far above legal limits. Poor governance processes

allowed this deception to take place and cost Volkswagen shareholders dearly: between 18 September and 25 September 2015 – the week that US regulators discovered the deception software – Volkswagen’s share price fell 45%. Poor governance also cost it more than \$30bn in legal and regulatory penalties. Bosch, a major supplier manufacturing engine and fuel mixture control equipment, was also implicated in the proceedings. In 2017, Bosch agreed to pay a civil settlement in the US totaling \$327m, although it did not accept liability nor acknowledge facts presented by plaintiffs. Later, in 2019, Bosch was fined a further \$100m by German prosecutors for its role in supplying equipment that could be used to circumvent emissions standards.

Volkswagen changed its environmental strategy by announcing electrification plans in 2020. But its governance structure continues to face criticism. In October 2020, BlackRock, the fourth-largest Volkswagen shareholder, criticized Volkswagen’s management and supervisory boards, saying that the automaker had a dearth of independent governance five years after the emissions scandal. Volkswagen has a two-tier capital structure in which three shareholders hold more than 90% of voting rights (Porsche SE, the state of Lower Saxony, and Qatar). BlackRock voted against both boards at Volkswagen’s annual meeting. BlackRock also highlighted that executives who were present during the emissions scandal were still in post. Moreover, BlackRock disapproved of the convoluted voting process used at the annual meeting, in which shareholders are required to complete individual proxy forms to exercise voting rights. However, this is due to the Volkswagen Act that has governed the company since privatization in 1960. BlackRock was critical of the protocol since it limits the influence of minority shareholders, making it more difficult for concerns to be voiced.

Another significant structural restriction that stems from the Volkswagen Act is the state of Lower Saxony’s shareholding. It owns 11.8% but maintains a 20% blocking minority of voting rights despite several legal challenges. While this legislation was originally enacted to ensure fair representation of workers, the act may now hamstring Volkswagen’s ESG efforts as it is in the interest of the state and the government to maximize the company’s financial performance over longer-term sustainability. This situation also highlights inherent tension among different aspects of sustainability, in this case, legacy social concerns over contemporary environmental and governance concerns. What is clear is that, at a time when consumer expectations move so quickly, successful companies require the greatest possible degree of transparency between the upper echelons of company authority and common shareholders.

4. Appendix

4.1. Further reading

Corporate Social Responsibility: No longer an afterthought, now a necessity (2021) MarketLine Case Study

Sustainability: The big topic for 2020 as climate change becomes more severe (2021) MarketLine Case Study

City Possible: Mastercard's lesson in sustainable development and smart cities (2021) MarketLine Case Study

5. Ask the analyst

We hope that the data and analysis in this case study will help you make informed and imaginative business decisions. If you have any questions or further requirements, MarketLine's research team may be able to help you. The MarketLine Research team can be contacted at ReachUs@MarketLine.com.

6. About MarketLine

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