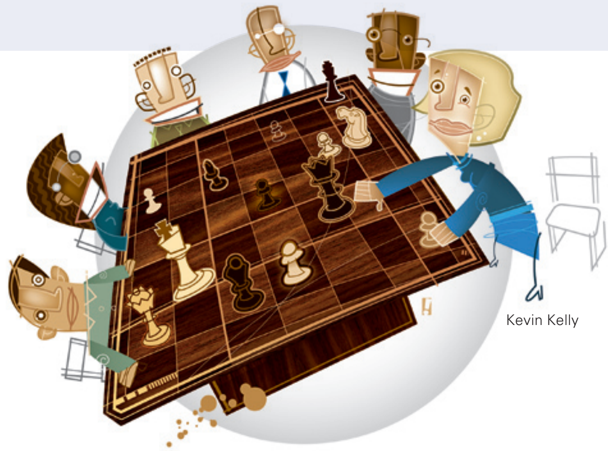
Closing Views



Kevin Kelly

Shaping strategy from the boardroom

As companies turn their attention from compliance to growth and innovation, boards must focus on strategy.

Dennis C. Carey
and Michael Patsalos-Fox

The case has never been stronger for US boards of directors to focus their attention where it belongs: on corporate strategy. When the storms of governance scandals began whipping across the corporate landscape, boards—good, bad, and ugly—turned inward to deal with their companies' problems and to digest the new accounting compliance rules of the landmark Sarbanes-Oxley Act. Now, by and large, boards have come to terms with the new governance rules, and it's time to move on.

Linking a board's human capital to the long-term strategy crafted by management to create more value for shareholders should be the next wave of governance reform. Boards may approve strategy, but, sadly, they have only minimal involvement in shaping and developing it. Now that innovation and growth increasingly drive the top executive's agenda and major business trends emerge in the blink of an eye, strategically minded boards that forge close partnerships with management will prove to be the crucial difference between companies that create superior shareholder value and those that don't.

Not that we envision boards setting corporate strategy independently. But they must find the energy, industry savvy, and ability to debate, test, and approve the strategy that management crafts. Directors say that they welcome this kind of involvement, and the fourfold increase we've recently observed in the number of board retreats devoted to strategy suggests that they do. Yet their efforts don't appear to be very effective. In a recent McKinsey survey, a mere 32 percent of senior executives credited directors with a complete understanding of the corporate strategy.[1]

Governance reforms have been extraordinarily effective in bringing more independence to boards and restoring investor confidence, which had been battered by the excesses of the 1990s. Yet in our work with boards we find that too many simply lack directors who have the industry expertise to participate effectively in shaping strategy—much less to reshape it on the fly as the business climate changes. And in the postscandal chill, even as the business landscape has become more complex, many boards have taken to playing defense. Too many have blandly populated themselves with less capable people and denied CEOs sufficient say in selecting directors who could offer crucial assistance in shaping long-term strategy.

Building a board's strategic mind-set isn't easy. The effort requires rethinking what makes a director fit to serve on a board, the tenor of its deliberations, and the way it interacts with management to help develop a strategic vision, although that must originate with the CEO. Progressive CEOs, for their part, need the ability to articulate a clear strategy and the personal confidence to build board teams that include experts who may be far more skilled in certain industry and operational areas than the CEOs themselves are.

No single approach will serve every company well. In our experience, however, several concrete steps can build a good foundation.

Raise strategy's profile in board work. Why is there no committee, no vehicle, that could put strategy on the agenda of every board meeting? We find many boards with committees for political affairs or technology but have yet to come across a single US company that has one devoted to the formulation and review of strategy. Today strategy isn't an entry in the job description of any director.

Within the hierarchy of board activities, strategy should be raised at least to the level of accounting compliance. One way to achieve this goal would be to make strategy a formal subset of the regular work of the nominations

[1] "What directors know about their companies: A McKinsey survey," *The McKinsey Quarterly*, Web exclusive, March 2006 (www.mckinseyquarterly.com/links/22434).

or governance committees, thereby ensuring that it gets discussed regularly at board level. Moreover, CEOs might use the establishment of such a strategy council to appoint more strategically minded directors to appropriate committee roles. No doubt some old-guard CEOs will fight the formalization of strategy within board functions; that resistance should in itself serve as a warning to investors looking for boards that create the most value.

Populate boards more boldly. Boards must become less politically correct and more strategically correct in populating their ranks. Sitting CEOs and board chairs often make the most capable directors, we find, particularly for providing strategic insights based on current market realities. Yet in the wake of stronger compliance regulations, investor groups have arbitrarily pressured companies to restrict the number of boards on which current CEOs and board chairs may sit—ostensibly, to keep directors from spreading their time on boards too thinly.

Our research shows the effectiveness of these pressures. Top executives now account for 32 percent of new board appointments, down from 53 percent five years ago.[2] At the same time, demand for academics, executives of nonprofit organizations, and retired executives has soared. Such people may offer time and good general-management experience, but unless board members (including even retired executives) are directly involved with competitive changes it's easy to fall behind on fast-moving trends such as the economic development of China and India. The net effect of recent tendencies is a move toward boards that are older and less market savvy.

We believe that on a board of, say, a dozen directors, a litmus test of strategic energy is the presence of at least three or four members who have deep industry expertise in the core business and market conditions the company faces. In the same way that boards brought on financial expertise in the wake of Sarbanes-Oxley, they should now ensure that their ranks include directors with the industry knowledge crucial to the primary business of their companies. Once that expertise is in place, other board members can be screened for deep functional or geographic expertise.

To achieve that level of specialization, some boards may have to risk seeking out executives without board experience. Forward-thinking

[2] *Spencer Stuart US Board Index 2005*, Spencer Stuart, November 2005.

companies could be well served by going deeper into their ranks to find younger, up-and-coming executives who are familiar with the industry trends and market forces that are essential to their global strategy. Private equity firms regularly demonstrate the benefits that can flow to investors when they use specialized, intense due-diligence work to support business strategy. Nothing prevents the directors of public companies from building such capabilities into their boards.

Restore power to CEOs in choosing directors. One of the more glaring affronts of the 1990s era of corporate excess was the way CEOs staffed their boards with golfing buddies and other cronies. Unfortunately, the inevitable backlash has meant that even value-minded CEOs are denied the chance to put together a board team that is truly aligned with management's strategic approach. Where CEOs once had a near-exclusive right to select their own boards, they now find themselves taking a backseat to the chairman of the board's nominating committee in deciding who becomes a director.

As a company's chief strategy architect, the CEO must provide the vision for a strategic course that a good board can enrich and support. And to be effective, directors must have an affinity for the CEO's approach. Better boards have to some extent swung the pendulum back, restoring the CEO's role in selecting directors together with the nominating committee. We believe that giving both the committee and the CEO a veto on any candidate can ensure that boards are populated not by puppets but by specialists who can work in a challenging partnership with the CEO. Progressive CEOs should welcome this kind of partnership.

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Reform board processes. There's nothing wrong with annual board retreats, but we see the best companies doing much more. Most retreats take the form of show-and-tell sessions where operating executives report on initiatives. They provide snapshots of a company's current status, not full-motion video, complete with dialogue, on its strategic direction.

To keep pace with change in the business world, CEOs should lead regular strategy updates at least every other board meeting. These updates might filter new information and assess its impact on various elements of the strategy. Should the company stay on its strategic course when two major competitors merge, for example? Do directors see new risks that might argue for a different approach?

With beefed-up industry expertise in place, three or four board members might serve as a sounding board for the CEO, since people who are close to the formulation of strategy can help make important judgments about it. Industry experts on the outside can serve to challenge conventional thinking.

None of these steps need undermine the role of the CEO. Rather, they should reinforce checks and balances and stimulate debate among directors capable of helping the CEO to evaluate all options. As compliance issues move backstage and attention turns to growth and innovation, a new source of shareholder value will flow from companies with boards that embrace this kind of strategic dynamism. Q

Dennis Carey is a partner at the executive search firm Spencer Stuart;
Michael Patsalos-Fox is a director in McKinsey's New York office.