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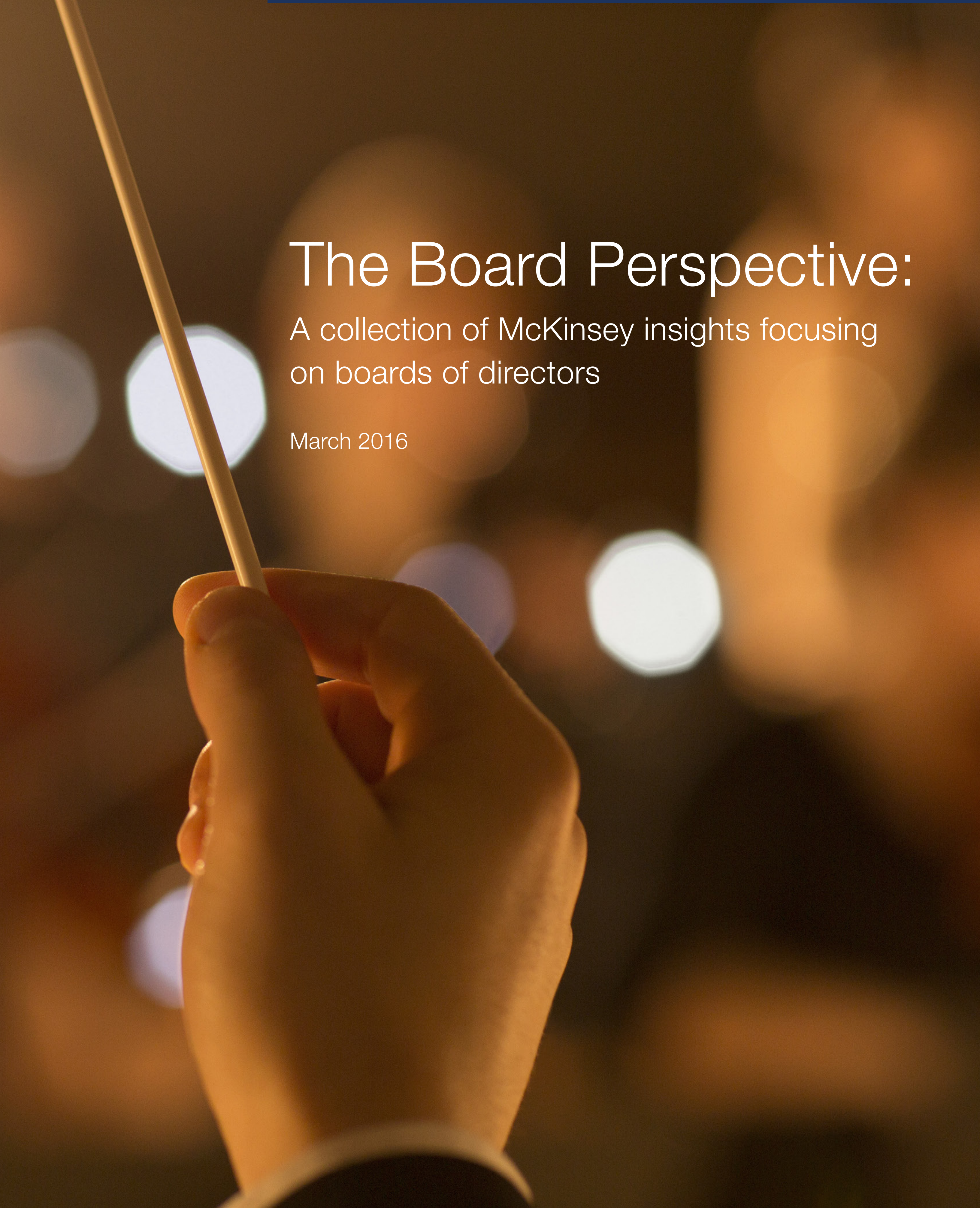

The Board Perspective:

A collection of McKinsey insights focusing on boards of directors

March 2016

McKinsey Board Services helps CEOs and boards of directors to improve board effectiveness and leave more time for value-enhancing activities. Our solutions are tailored, integrated, and supported by deep industry, functional, and board expertise.

The Board Perspective is a publication written by board experts and practitioners at McKinsey as well as McKinsey affiliates.

Editorial Contact:
Board_Services@McKinsey.com

Art Direction and Design: Cary Shoda

Cover:
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Introduction

Welcome to the first issue of *The Board Perspective: A collection of McKinsey insights focusing on boards of directors*.

Several corporate and system failures and an increasingly complex regulatory environment have sharpened the focus on good governance in recent years. In response, we have stepped up our research into what makes boards effective, how they are developed, and how their expectations and responsibilities have increased.

This compendium presents a selection of insights from McKinsey experts and board practitioners. The research draws on interviews with successful chairs from around the world, global board-member surveys, and the personal experience of subject-matter experts.

We have structured the compendium into three main sections:

- The role of the board. Which activities should the board engage in, and how?
- Board structure and foundations. What foundation do you need to deliver on increasing expectations?
- Board effectiveness. How can you increase the overall effectiveness and impact of your board?

It's worth noting that this is a selection of perspectives and is not intended to be a comprehensive analysis of what it takes to develop an effective board of directors. We would welcome a discussion on what this would require.

We hope that you enjoy this compendium and that it triggers interesting insights and ideas.

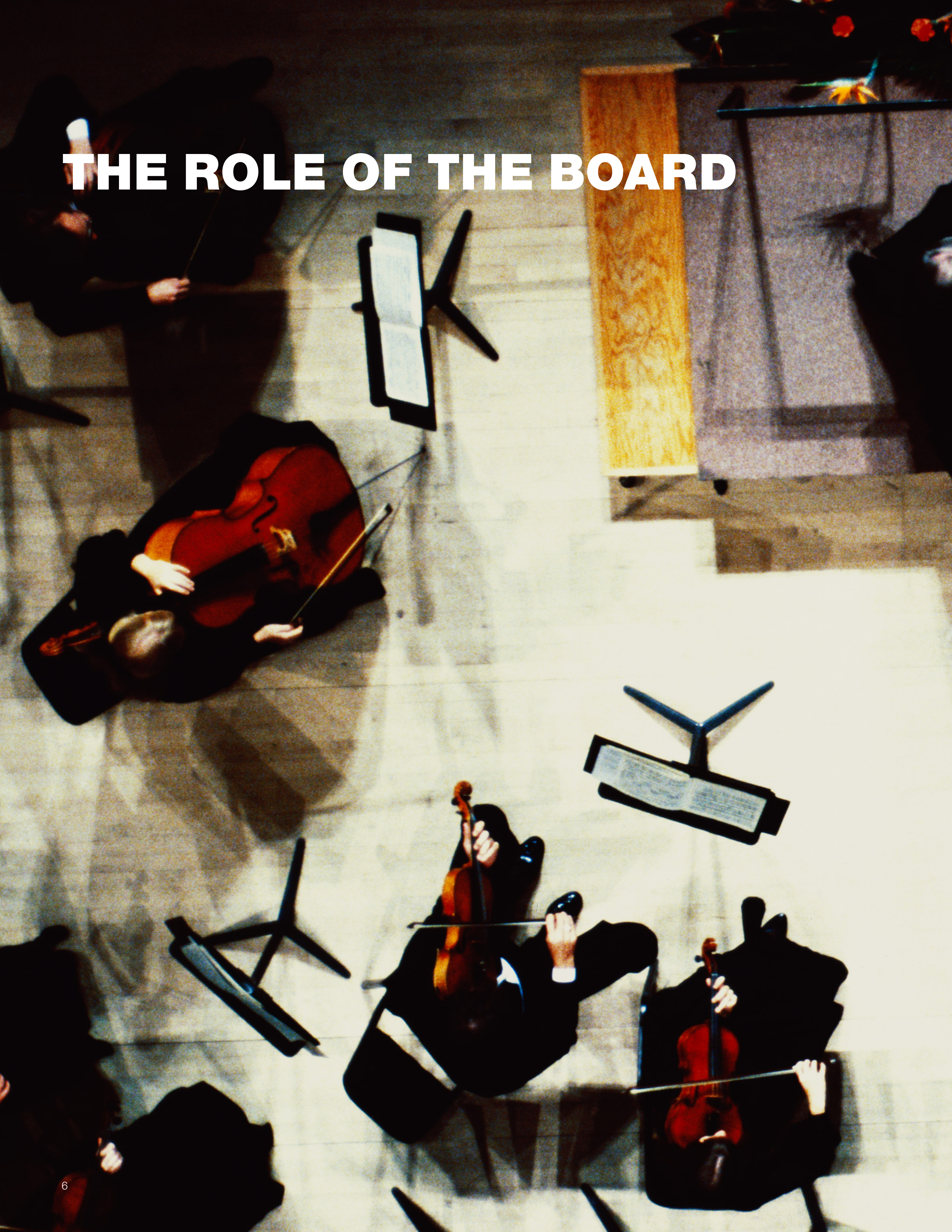
Please direct comments or questions to us or any of the authors at Board_Services@McKinsey.com.

Martin Hirt
Director, global convener of McKinsey's Strategy & Corporate Finance Practice, Greater China

Frithjof Norman Lund
Principal, global leader of McKinsey Board Services, Oslo

Nina Spielmann
Practice manager, McKinsey Board Services, Zurich

THE ROLE OF THE BOARD



Building a forward-looking board

Directors should spend a greater share of their time shaping an agenda for the future.

Christian Casal and Christian Caspar

Debate over the role of company boards invariably intensifies when things go wrong on a grand scale, as has happened in recent years. Many of the companies whose corpses litter the industrial and financial landscape were undermined by negligent, overoptimistic, or ill-informed boards prior to the financial crisis and the ensuing deep recession. Not surprisingly, there's been a renewed focus on improved corporate governance: better structures, more rigorous checks and balances, and greater independence by nonexecutives, for example.

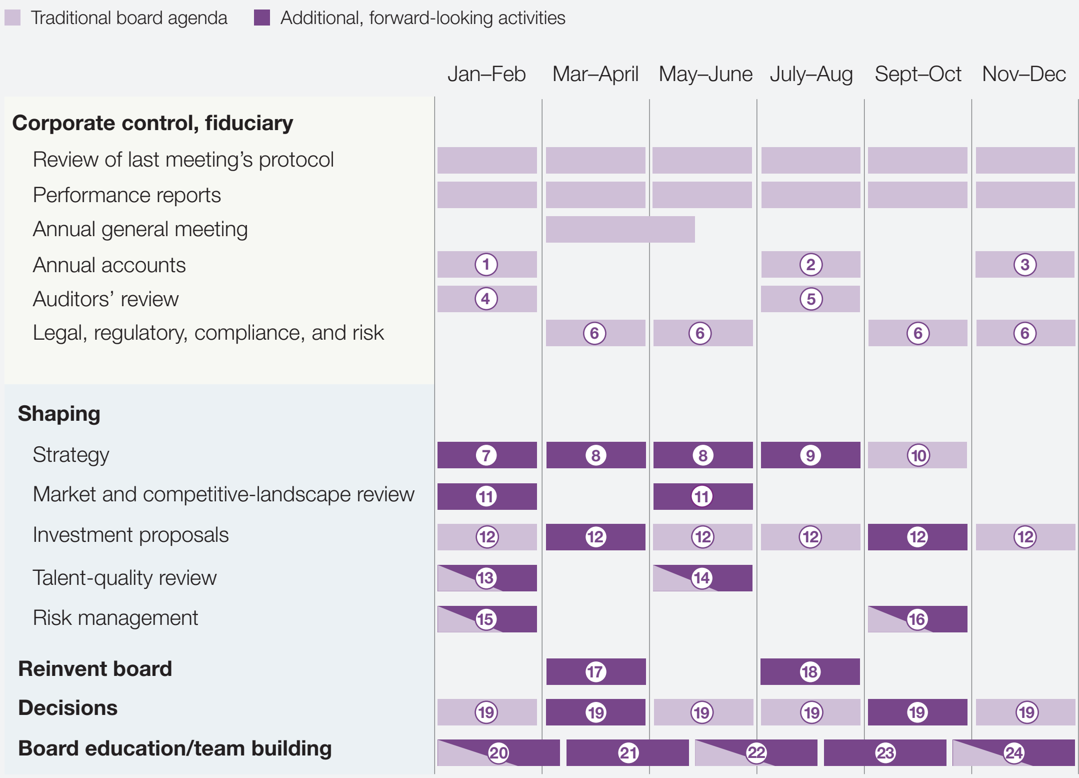
Governance arguably suffers most, though, when boards spend too much time looking in the rearview mirror and not enough scanning the road ahead. We have experienced this reality all too often in our work with companies over several decades. It has also come through loud and clear during recent conversations with 25 chairmen of large public and privately held companies in Europe and Asia. Today's board agendas, indeed, are surprisingly similar to those of a century ago, when the second Industrial Revolution was at its peak. Directors still spend the bulk of their time on quarterly reports, audit reviews, budgets, and compliance—70 percent is not atypical—instead of on matters crucial to the future prosperity and direction of the business.

The alternative is to develop a dynamic board agenda that explicitly highlights these forward-looking activities and ensures that they get sufficient time over a 12-month period. The exhibit illustrates how boards could devote more of their time to the strategic and forward-looking aspects of the agenda. This article discusses ways to achieve the right balance.

The case for change

Our conversations with successful chairmen showed a strong continuing bias toward fiduciary tasks but also a desire and willingness to shift focus. "Boards need to look further out than anyone else in the company," commented the chairman of a leading energy company. "There are times when CEOs are the last ones to see changes coming."

Exhibit **How forward-looking boards should spend their time.**



Details on selected activities (all others are self-explanatory, as labeled)

Fiduciary
1. Annual accounts
2. Annual budget directives
3. Next year’s budget
4. Auditors’ report
5. Audit-planning approach
6. Audit-committee reviews

Strategy
7. Set framework for the year
8. Define broad options
9. Outline/select options
10. Approve final strategy approach
11. Review strategic and competitive position, key performance indicators

Investment
12. Engage in ongoing review of investment proposals

Talent
13. Set talent-review objectives for the year
14. Review top 30–50 people

Risk
15. Determine risk-review objectives for the year
16. Conduct annual risk review, including mitigation approaches

Board reinvention
17. Conduct board 360° evaluation
18. Determine approach for board-process enhancement

Decisions
19. Engage in decision making—eg, on budgets, investments, M&A, and key nominations

Board education
20. Travel with sales staff, customer visits
21. Visit R&D facilities
22. Visit new geographies
23. Inspect production sites
24. Attend customer conference

This forward-looking imperative comes in part from the way long-term economic, technological, and demographic trends are radically reshaping the global economy, making it more complex to oversee a successful multinational business. As executive teams grapple with the immediate challenge of volatile and unpredictable markets, it's more vital than ever for directors to remain abreast of what's on (or coming over) the horizon.

Second, and compounding the short-term executive mind-set, the length of CEO tenures remains relatively low—just five to six years now. That inevitably encourages incumbents to focus unduly on the here and now in order to meet performance expectations. Many rational management groups will be tempted to adopt a short-term view; in a lot of cases, only the board can consistently take the longer-term perspective.

Distracted by the details of compliance and new regulations, however, many directors we meet simply don't know enough about the fundamentals and long-term strategies of their companies to add value and avoid trouble. It doesn't have to be this way. A select handful of banks and other multinational corporations with prudent, farsighted, and independent-minded boards not only survived the financial crisis largely intact but also continue to thrive.

Rather than seeing the job as supporting the CEO at all times, the directors of these companies engage in strategic discussions, form independent opinions, and work closely with the executive team to make sure long-term goals are well formulated and subsequently met. How can a board better focus on the long term and avoid becoming a prisoner of the past?

Foundations of a forward-looking board

Board chairmen and fellow directors will quickly grasp the point by studying the exhibit. The light-purple part of the annual schedule depicts how a board preoccupied with its fiduciary responsibilities typically spends its time. The dark-purple agenda items, by contrast, show what the calendar focus of a predominantly forward-looking board might look like. It's impossible to effect this change without a solid foundation: the right directors, knowledgeable about their roles and able to commit sufficient time.

Roll back the future to access top board members

Too often, vacancies on a board are filled under pressure, without an explicit review of its overall composition. An incoming chairman should try to imagine what his or her board might look like, ideally, three years from now. What kinds of skills and experience not currently in place will help fulfill the company's long-term strategy? What, in other words, is the winning team? A willingness to look ahead expands the number of candidates with appropriate skills and heightens the likelihood that they will sign up if and when they become available.

One of the world's leading food companies used this approach to introduce a range of expertise clearly reflecting its strategic direction and requirements. Of course, its board has high-profile (former) executives and top professionals with a profound finance, risk, or general-management background and diverse geographic experience. But now it also includes people with successful track records in health, nutrition, the public sector, and welfare. Other companies need specific kinds of expertise to help them adapt to cutting-edge technologies or market disruptions. Here, advisory boards without formal governance authority are especially useful.

Define the board's role clearly

The familiar roles of a well-functioning board—such as setting strategy, monitoring risks, planning the succession, and weighing in on the talent pipeline—are easy to list. But in practice, things are never simple. CEOs and their top teams, for example, are often touchy about what they see as board interference. Equally, weighty boards with years of experience and members used to getting their own way are frequently frustrated because they can't intervene more actively or their advice is ignored.

It's critical to defuse these tensions at the outset by clearly defining the board's role and establishing well-understood boundaries. Unless roles are clear, the relationship between the CEO and management, on the one hand, and the board, on the other, risks devolving into misunderstandings, loss of trust, and ineffectiveness. An annual discussion between the board and management, perhaps including a written letter of understanding setting out the roles of each party, is always a productive exercise. For instance, a large Nordic investment company creates work and role descriptions, for the board and management, that are reviewed and approved every year. This process always generates valuable discussions and makes roles more clear.

Get your board to work harder

Most board members we know are hard working. The old caricature of long lunches and big stipends is just that—a caricature.

Yet the 10 or 12 days a year many board members spend on the job isn't enough, given the importance of their responsibilities. Several well-performing boards prescribe a commitment of up to 25 days of engagement for nonexecutive board members.

Some of that extra time should be spent in the field. Boards seeking to play a constructive, forward-looking role must have real knowledge of their companies' operations, markets, and competitors. One big international industrial company we know requires all its board members to travel with salespeople on customer visits at some point each year. Other companies ask their directors to visit production and R&D facilities. The chairman of a manufacturing company we interviewed adds that "You can't fully understand the business, analyze the competition, review succession plans, visit a company's facilities, travel with salespeople, and set strategic goals by working a handful of days."

How can companies achieve the right degree of commitment? Higher pay will not be the answer, even if there were no governance watchdogs who would doubtless conclude that directors are already well paid or at least rarely need the extra money. The question of pay has never been an issue at a major oil company that requires its board members to set aside 30 days a year, for example. What does actually help (as in this case) is a board environment that encourages participation and allows board members to derive meaning, inspiration, and satisfaction from their work. The reward for individuals will be an opportunity to enhance their reputation for good boardroom oversight, to strengthen their personal networks, and to influence decisions.

Putting the board's best foot forward

The best boards act as effective coaches and sparring partners for the top team. The challenge is to build processes that help companies tap the accumulated expertise of the board as they chart the way ahead. Here are four ways to encourage a forward-looking mind-set.

Require the board to study the external landscape

As a starting point, says the chairman of a finance company, "We invite renowned experts and professionals in various fields—such as technology, regulatory matters, and economics—to board meetings, who talk about specific topics." Board meetings also may be held in overseas locations where directors can be exposed to new technologies and market developments relevant to a company's strategy.

To be able to challenge management with critical questions, a company's directors should regularly compare internal performance data with those of their competitors across a range of key indicators. The chairman of one telecommunications company says his board "regularly develops an outside-in view of the industry and business from public information. And from time to time, we seek outside advice to get an independent view on the firm's strategy and new potential development areas."

Make strategy part of the board's DNA

The central role of the board is to cocreate and ultimately agree on the company's strategy. In many corporations, however, CEOs present their strategic vision once a year, the directors discuss and tweak it at a single meeting, and the plan is then adopted. The board's input is minimal, and there's not enough time for debate or enough in-depth information to underpin proper consideration of the alternatives.

What's required is a much more fluid strategy-development process: management should prepare a menu of options that commit varying levels of resources and risks. In this way, board and management jointly define a broad strategic framework, and management defines options for board review. Finally, during a special strategy day, the board and management ought to debate, refine, and agree on a final plan. "At the beginning of the annual planning process, the board's role is to help management broaden the number of strategy options," says the chairman of a large transportation company. "At midyear, it is to discuss strategic alternatives and help select the preferred route, and at end of year, it is to make the final decision to implement."

Strategy should always provide the context for proposed acquisitions or stand-alone investments. "Without reference to long-term objectives, stand-alone investment proposals do not make much sense—but they are not unusual," says the chairman of a bank. Strategy and policy go hand in hand. Policy is not only among the most powerful tools a company can use to propel its culture and employee behavior in new directions but can also contribute significantly to the effective implementation of strategy. Yet most boards are aware of neither the full set of company policies nor their content.

Unleash the full power of your people

Forward-looking boards are powerfully positioned to focus on long-term talent-development efforts because they understand the strategy and can override some of the personal ties that cloud decision making over appointments. Divisional managers, say, might be tempted to hang on to high performers even if the company's interest would be to reallocate their skills and experience to a business with more potential. For example, a large media company, prompted by its board, recently reassigned its strategic-planning director to lead digital development projects on the US West Coast. The move was remarkably successful: working in close cooperation with some of the most accomplished digital giants in the United States, the business quickly got up to speed on the newest technological trends.

Many forward-looking boards hold annual reviews of the top 30 to 50 talents, always with an eye on those who might eventually be suitable for key executive roles. Here's how the process works in one manufacturing company. Each executive director selects, for presentation to the board, three to five promising managers. The board gets a photograph, information on their educational background, and performance reviews over the last three years. The presenter organizes the information on an evaluation grid showing categories such as performance, leadership, teamwork, and personal development. The directors then spend 10 to 30 minutes on each person, discussing key questions. How can the company coach and develop talented people? What personal and professional development opportunities, such as an international posting, might help broaden an individual's experience? What are the potential next career steps? In addition, during corporate projects, client gatherings, and trade shows, directors should take any opportunity to meet—and assess—upcoming executives and fast trackers informally.

The key is that the board must agree with management on a sensible approach to reviewing executive talent. Appointing a board member with a successful people-leadership track record to lead the effort is one way of boosting its impact.

Anticipate the existential risks

Every company has to take significant risks. But while it has long been understood that overall responsibility for risk management lies with boards, they often overlook existential risks. These are harder to grasp—all the more so for executives focused on the here and now—yet harm companies to a far greater extent than more readily identifiable business risks.

"Instead of only discussing competitive risks, boards should put in place a well-functioning crisis-management system" for cybercrime, insider trading, or corruption, says a consumer-goods company chairman conscious of the dangers of corporate secrets falling into the wrong hands. "We want to be ready for existential risks if they occur."

The best-managed companies in safety-sensitive sectors such as oil or autos—where a rig explosion or product recall could have significant consequences for large numbers of people or cost a year's profits—are already vigilant in this area. The board of one oil-exploration company we know regularly receives reports on the safety record of its on-platform activities. The reports trigger intense discussions about the root causes of problems and remedial action where there is any deviation from norms. The boards of other businesses should also demand that management supply quarterly reports (probably to the audit committee) on the observance of safety, quality, and ethical standards and hold management to account. Directors of a media company, for instance, could regularly ask its news executives to lead reviews of editorial standards.

Yet even the best systems will not identify all the risks, and boards and management must somehow try to grasp the unthinkable. The best way may be to tap into the concerns and observations of middle management, the group most likely to be aware of bad practices or rogue behavior in any company. Boards have a duty to ensure that management teams pursue bottom-up investigations (through confidential questionnaires, for instance), identify key risk areas, and act on the results.

■ ■ ■

Forward-looking boards must remain vigilant and energetic, always wary of bad habits. An objective 360-degree review, built on personal interviews, is generally a much better option than the box-ticking self-evaluation alternative. Winning boards will be those that work in the spirit of continuous improvement at every meeting, while always keeping long-term strategies top of mind. Only by creating more forward-looking boards can companies avoid the sort of failures witnessed during the last financial meltdown the next time one strikes. ■

Christian Casal is a director in McKinsey's Zurich office; **Christian Caspar** is a director emeritus in the Zurich office and serves on the boards of several large European companies.

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High-performing boards:
What's on their agenda?

Directors report that they have a greater impact as they move beyond the basics.

Chinta Bhagat and Conor Kehoe

Several years after the financial crisis, the pressure on boards and directors to raise their game remains acute. A recent survey of more than 770 directors from public and private companies across industries around the world and from nonprofit organizations suggests that some are responding more energetically than others.[1] The survey revealed dramatic differences in how directors allocated their time among boardroom activities and, most tellingly, in the respondents' view of the effectiveness of their boards. More than one in four of the directors assessed their impact as moderate or lower, while others reported having a high impact across board functions. So what marks the agenda of a high-performing board?

A hierarchy of practices

Our research suggests that the distinction between higher and lower impact turns on the breadth of the issues directors tackle and on the time dedicated to them. We drilled down to detailed board practices across the functions to which directors devote much of their attention: strategy, compliance, and M&A, as well as performance, risk, and talent management. It appears that boards progress through a hierarchy of practices that's analogous to Maslow's hierarchy of needs.[2] Directors who report having a low to moderate impact said that their boards undertake "the basics" of ensuring compliance, reviewing financial reports, and assessing portfolio diversification, depending on the function. Directors reporting that their boards have a higher impact undertake these activities, as well, but add a series of other practices in every function.

In the area of strategy, for example, this means becoming more forward looking. Boards with a moderate impact incorporate trends and respond to changing conditions. More involved boards analyze what drives value, debate alternative strategies, and evaluate the allocation of resources. At the highest level, boards look inward and aspire to more "meta" practices—deliberating about their own processes, for example—to remove biases from decisions (Exhibit 1).

We observed a similar hierarchy across other board functions. In performance management, for instance, many boards start with a basic review of financial metrics. More involved boards add regular performance discussions with the CEO, and boards at still higher levels of engagement analyze leading indicators and aspire to review robust nonfinancial metrics. In the areas of risk, M&A, and talent management boards follow comparable progressions. (For more, see “Building a forward-looking board,” on page 8.)

A greater time commitment

Working at a high level takes discipline—and time. Directors who believe that their activities have a greater impact report spending significantly more time on these activities, on average, than those who serve on lower-impact boards. We found that directors reporting that they had a very high impact worked for their boards about 40 days a year, while those who said that their impact was moderate or lower averaged only 19.[3] Higher- and lower-impact directors spend the same amount of time on compliance-related activities: about four days a year. By contrast, higher-impact board members invest an extra eight workdays a year on strategy. They also spend about three extra workdays on each of the following: performance management, M&A, organizational health, and risk management (Exhibit 2).

Exhibit 1

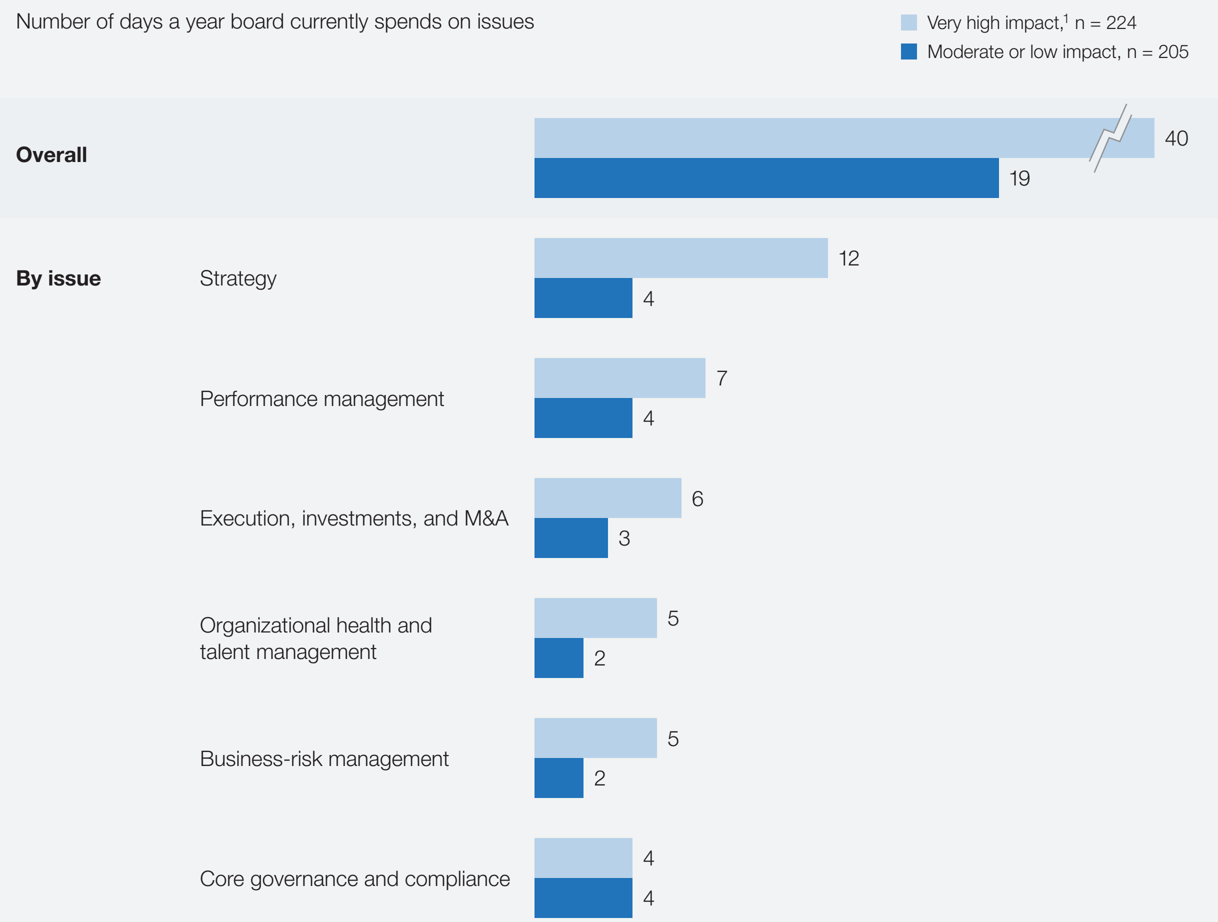
Boards appear to progress through a hierarchy of practices, with high-impact boards often employing more rigorous practices.

● Practiced by majority ○ Practiced by minority
▲ Biggest aspiration

	Example: strategy practices	Low-impact boards	Moderate-impact boards	High-impact boards
Rigorous	Reducing decision biases	▲	○	▲
	Evaluating resource reallocation	○	○	●
	Assessing value drivers	○	○	●
	Debating strategic alternatives	○	▲	●
	Assessing portfolio synergies	○	○	●
	Adjusting strategy, based on changing conditions	○	●	●
	Assessing whether strategy stays ahead of trends	○	●	●
	Engaging on innovation	●	●	●
Basic	Assessing portfolio diversification	●	●	●

Source: April 2013 McKinsey Global Survey of 772 directors on board practices

Exhibit 2 **Board members with very high impact invested eight extra workdays a year on strategy.**



[1] Figures do not sum to total, because of rounding.

Source: April 2013 McKinsey Global Survey of 772 directors on board practices

The data suggest that less engaged boards correctly identify the next step up in the hierarchy but underestimate the time it would take to meet this aspiration. When low- to moderate-impact directors are asked how much time they ideally should spend on their duties, they suggested increasing the number of days to 27, from 19. While spending more time can never assure a high impact (see sidebar, "What surveys can and can't tell us"), even very high-impact directors would increase their commitment to 45 days, from 40.

A final implication of our survey is that CEOs need not fear that a more engaged board may constrain their prerogative to set a company's direction. Highly committed boards are not spending the extra time supplanting management's role in developing strategic options. Rather, they are building a better understanding of their companies

What surveys can and can't tell us

Survey-based research can be an effective means of aggregating information from diverse respondents about fairly granular attitudes or activities, such as detailed governance practices. However, as Professor Phil Rosenzweig, of the International Institute for Management Development (IMD), and others have pointed out, there's also a danger that other factors will influence respondents, undermining the validity of the survey results.[1] For example, a "halo effect"—the tendency to make specific inferences on the basis of general impressions—might make board members more inclined to rate their efforts highly if their companies have been successful. We recognize this difficulty and did not seek to correlate the directors' self-reported evaluations with financial performance. But it is possible that directors who devote a large number of days to their boards come to believe that they are having a greater impact simply as a result of making that investment of time.

Some additional checks, however, showed that this isn't necessarily true. First, we split the number of days when directors worked into quartiles. Not surprisingly, this showed a wide range of time commitments. However, it also showed that those claiming to have a high impact were by no means all in the top quartile of directors by days worked. This suggests that a board member's view of his or her impact is influenced by matters other than just the amount of time spent on the job.

We also cut board practices by quartile of days worked. From this analysis, we saw that high-impact boards appear to have an even richer set of strategic priorities than the most time-intensive boards (those in the top quartile). In addition, we found much less differentiation among the practices of the second-, third-, and bottom-quartile board members when cut by days worked—which again suggests that when directors assessed the impact of their activities, they were doing more than just counting hours served.

Factors beyond days spent, of course, affect the richness of a board's agenda and how directors rate their impact. For example, a board locked in crisis or subject to new and complex regulation may need to work hard just to keep the business running. The size of a board and the skills of its members have also been shown to affect efficiency and effectiveness. And in all situations, a skilled chair can make boards significantly more efficient by setting high standards and taking action to help members improve their contribution.

[1] See Phil Rosenzweig, "The halo effect, and other managerial delusions," *McKinsey Quarterly*, February 2007, McKinsey.com.

and industries, while helping senior teams to stress-test strategies and then reallocate resources to support them. Some CEOs find that task to be lonely and difficult when they face internal "barons" who protect their fiefs. In short, engaged boards can still be supportive of management. And the directors serving on them, our research suggests, are not only more effective but also more satisfied with their work. ■

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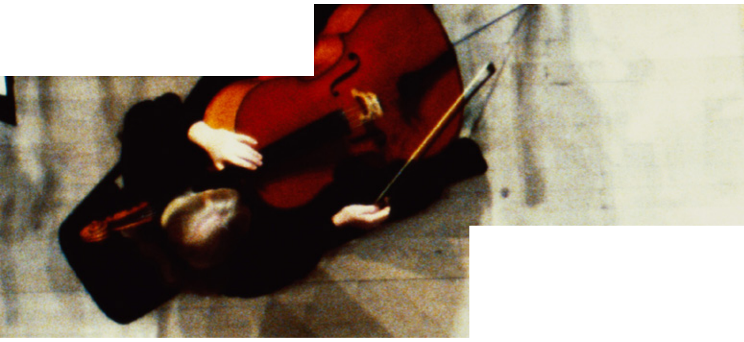
[1] The online survey, in the field from April 9 to April 19, 2013, garnered responses from 772 corporate directors, 34 percent of them chairs. We asked respondents to focus on the single board with which they are most familiar. Overall, 166 respondents represent publicly owned businesses and 606 privately owned ones, including the full range of regions, industries, and company sizes.

[2] Psychologist Abraham H. Maslow contended that human needs are structured in a hierarchy; as each level of needs is satisfied, the next higher level of unfulfilled needs becomes predominant. See Abraham H. Maslow, "A theory of human motivation," *Psychological Review*, 1943, Volume 50, Number 4, pp. 370–96; and Abraham H. Maslow, *Motivation and Personality*, first edition, New York, NY: Harper & Brothers, 1954.

[3] Directors who assessed their impact as high worked about 27 days a year.

Chinta Bhagat is an alumnus of McKinsey's Singapore office, and **Conor Kehoe** is a director in the London office.

The authors wish to thank Frithjof Lund and Eric Matson for their contributions to this article.



Tapping the strategic potential of boards

Too many boards just review and approve strategy. Three questions can help them—and executives—begin to do better.

Chinta Bhagat, Martin Hirt, and Conor Kehoe

It's late afternoon in the boardroom, and the head of a major global infrastructure company's construction business is in the hot seat. A director with a background in the industry is questioning an assumption underlying the executive's return-on-invested-capital (ROIC) forecast: that the industry's ratio of leased (versus owned) equipment will remain relatively constant. The business leader appears confident about the assumption of stability, which has implications for both the competitive environment and for financial results. But the director isn't convinced: "In my experience, the ratio changes continuously with the economic cycle," he says, "and I'd feel a whole lot better about these estimates if you had some facts to prove that this has changed."

An uneasy silence settles over the room: the board member's point appears quite relevant but requires a familiarity with the industry's behavior and economics, and the rest of the board doesn't have it. Finally, the chairman intervenes: "The question John is raising is critical and not just for our construction business but for our entire strategy. We're not going to resolve this today, but let's make sure it's covered thoroughly during our strategy off-site. And Paul," says the chairman to the CEO, "let's have some good staff work in place to inform the discussion."

If the preceding exchange sounds familiar, it should: in the wake of the financial crisis, we find that uncomfortable conversations such as this one[1] are increasingly common in boardrooms around the world as corporate directors and executives come to grips with a changed environment. Ensuring that a company has a great strategy is among a board's most important functions and the ultimate measure of its stewardship. Yet even as new governance responsibilities and faster competitive shifts require much more—and much better—board engagement on strategy, a great number of boards remain hamstrung by familiar challenges.

The strategy challenge for boards

For starters, there's the problem of time: most boards have about six to eight meetings a year and are often hard pressed to get beyond compliance-related topics to secure the breathing space needed for developing strategy. When we recently surveyed board members to learn where they'd most like to spend additional time, two out of three picked strategy. A related finding was that 44 percent of directors said their boards simply reviewed and approved management's proposed strategies.

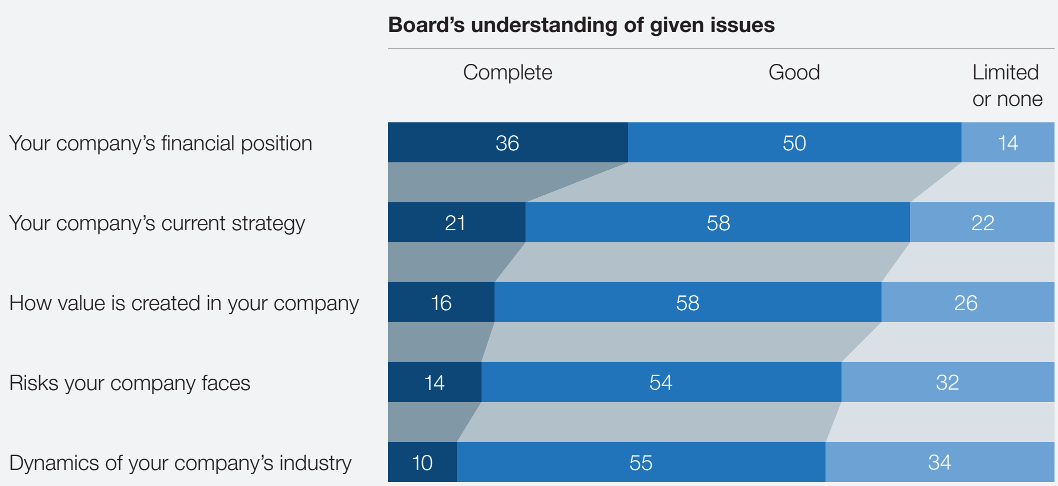
Why such limited engagement? One likely reason is an expertise gap: only 10 percent of the directors we surveyed felt that they fully understood the industry dynamics in which their companies operated. As a result, only 21 percent of them claimed to have a complete understanding of the current strategy (exhibit).

What's more, there's often a mismatch between the time horizons of board members (longer) and of top executives (shorter), and that lack of alignment can diminish a board's ability to engage in well-informed give-and-take about strategic trade-offs. "The chairman of my company has effectively been given a decade," says the CEO of a steelmaker in Asia, "and I have three years—tops—to make my mark. If I come up with a strategy that looks beyond the current cycle, I can never deliver the results expected from me. Yet I am supposed to work with him to create long-term shareholder value. How am I supposed to make this work?" It's a fair question, particularly since recent McKinsey research shows that major strategic moves involving active capital reallocation deliver higher shareholder returns than more passive approaches over the long haul, but lower returns over time frames of less than three years.[2]

Exhibit

Board members said they understand their company's financial position significantly better than its risks or industry dynamics.

% of respondents,[1] n = 1,597



[1] Respondents who answered "don't know" are not shown; figures may not sum to 100%, because of rounding.

Source: June 2011 McKinsey survey of 1,597 corporate directors on governance

Compounding these challenges is the increased economic volatility prompting many companies to rethink their strategic rhythm, so that it becomes less calendar driven and formulaic and more a journey involving frequent and regular dialogue among a broader group of executives.[3] To remain relevant, boards must join management on this journey, and management in turn must bring the board along—all while ensuring that strategic cocreation doesn't become confusion or, worse, shadow management.

Three questions to spur high-quality engagement

While no one-size-fits-all solution can guide companies as they set out, we suggest that board members and senior managers ask themselves three simple questions as they approach the development of strategy. Using them should raise the quality of engagement and help determine the practical steps each group must take to get there.

To illustrate what this looks like, we return to the infrastructure company we mentioned at the beginning of this article. The company had three key business units—construction, cement manufacturing, and the ownership and operation of infrastructure projects (primarily power plants)—as well as a fledgling real-estate business. It had expanded aggressively in emerging markets in the mid-to-late 1990s, until the Asian currency crisis forced it to sell off some of its more adventurous purchases and precipitated an equity investment by a large institutional investor with long-term interests in infrastructure. The investor appointed a new chairman, who in turn brought in a new CEO. After a few years of strong success and continued volatility (punctuated by the global financial crisis), the company's growth hit a plateau, triggering a thorough review of the strategy by the board.

When the chairman discussed the matter with the CEO, they agreed that the company had to take a different approach. Some of the board members were new and grappling with the problems of stewarding a complex multinational and multibusiness corporation. What's more, several fundamental questions were on the table that could conceivably lead to a full-blown restructuring and transformation involving the spin-off of divisions and the reallocation of capital to new areas.

The usual annual strategic refresh was unlikely to provide the board with an appreciation of the context it would need to address these questions fully, let alone to generate fresh insights in response. Such dissatisfaction with mechanistic annual board-level strategy processes is widespread, in our experience. The answer for this board (and several others we know) was to throw out the annual process and replace it with a much more intense but less frequent form of engagement—roughly every three years in this case—while still devoting some time at *every board meeting* to pressure-testing the strategy in light of its progress and changes in critical variables.

Pushing to answer the questions below, as the infrastructure company did, can help organizations enhance the quality of board engagement on strategy, both when that engagement must be deep and during the regular course of business.

1. Does the board understand the industry's dynamics well enough?

Most boards spend most of their strategic time reviewing plans, yet as we've noted, relatively few directors feel they have a complete understanding of the dynamics of the industries their companies operate in or even of how those companies create value. To remedy this problem and to avoid the superficiality it can engender, boards need time—some without management present—so they can more fully understand the structure and economics of the business, as well as how it creates value. They should use this time to get ahead of issues rather than always feeling a step behind during conversations on strategy or accepting management biases or ingrained habits of thought.

Board members at the infrastructure company began by studying its performance, focusing solely on ROIC across economic cycles. The board then studied all value drivers that affected ROIC. Revenue growth and earnings before interest and taxes, on which management spent most of its time, were two important but only partial explanations of the company's overall performance. Through a combination of independent sessions and two formal discussions with the CEO, the board established a much stronger foundation for a subsequent dialogue with management about strategy.

It turned out, for example, that the board member who had expressed concerns about the construction business's assumptions for leased-versus-owned equipment was right—not just for that unit, but also for most of the company's operations. One implication was that the forward-looking returns from the construction business were higher and more stable than those from the cement business, which, on the face of it, had higher margins and was better known and larger overall. This observation led the board to a closer look at both of these units and to a fuller appreciation of the construction business's strong project-management talent bench, which was well positioned to help counteract its "lumpier" risk profile.

2. Has there been enough board–management debate before a specific strategy is discussed?

Armed with a foundational view based on a clearer understanding of industry and company economics, boards are in a better position to have the kinds of informed dialogue with senior managers that ultimately help them prepare smarter and more refined strategic options for consideration. Board members should approach these discussions with an owner's mind-set and with the goal of helping management to broaden its thinking by considering new, even unexpected, perspectives.

> With a clearer understanding of industry and company economics, boards can have the kinds of informed dialogue with senior managers that ultimately help them prepare smarter options.

At the infrastructure company, such discussions were triggered by the chairman, who remarked, "I've found this process of assessing the industry and company economics very enlightening so far. It makes me wonder: if a private-equity firm were to take over this company right now, what would they do with it?" The question's disruptive nature changed the frame of the discussion from "What more can we do with this business?" to "Should we be in this business at all?" It led to the recognition that the cement unit required a level of scale and competitiveness the corporation didn't have and was unlikely to achieve organically. That realization ultimately led the infrastructure company to spin off the business.

During such debates, management's role is to introduce key pieces of content: a detailed review of competitors, key external trends likely to affect the business, and a view of the specific capabilities the company can use to differentiate itself. The goal of the dialogue is to develop a stronger, shared understanding of the skills and resources the company can use to produce strong returns, as opposed to merely moving with the tide.[4]

It's important, however, that this dialogue should stop short of deciding on a strategy, which comes next.

3. Have the board and management discussed all strategic options and wrestled them to the ground?

Very often, the energizing discussions between the board and management about the business, its economics, and the competition represent the end of the debate. Afterward, the CEO and top team go off to develop a plan that is then presented to the board for approval.

Instead, what's needed at this point is for management to take some time—mostly spent alone—to formulate a robust set of strategic options, each followed through to its logical end state, including the implications for the allocation of people, capital, and other resources. These strategic options can then be brought back to the board for discussion and decision making.

At the infrastructure company, the actual off-site strategy meeting, held during two days to ensure adequate time, focused entirely on debating and deciding between strategic options and then working through the resource-allocation implications of the decisions. Among the various debates, two stood out. One was whether to double down on the company's highest-potential business—construction services—by allocating additional talent and capital for an M&A-led consolidation initiative in two high-potential markets. The other was whether to exit the company's real-estate business. Forcing an explicit conversation about it proved to be a relief for both the board and the management team, who agreed that these issues had been an unstated source of unease for quite some time.

An important caveat: forcing meaningful, high-quality conversations like these is challenging, particularly when boards aren't used to having them, and places a premium on the board chair's ability to facilitate discussion. Creating a participative, collaborative dynamic while maintaining a healthy tension is critical. Also, the chair must neither monopolize the discussion nor fail to intervene strongly to shut down unproductive tangents.

In this case, the infrastructure company used some time on the last day of its off-site meeting to discuss how the board and management would monitor execution. This led to a healthy negotiation between the two on "what would get done by when." The company also created time for a final debate, on the allocation of resources, ensuring that no one was left behind in the decision making. The director with a background in the industry spent some time with the CEO providing input on path dependencies, allocations of capital and people, and high-level time lines.

Extending the discussion of strategic options all the way to monitoring execution was a powerful—and unusual—step. Normally, this isn't necessary. But boards sometimes overlook how difficult it is for executives to reconcile the sweeping changes they and the board have committed themselves to with day-to-day operational realities that consume the executives' time. Sometimes, this is an unintended consequence of the timing of off-site strategy meetings. When they are held near the end of the financial year, there isn't enough time to flesh out plans and create linkages to key performance indicators before the budget must be approved.

■ ■ ■

Developing strategy has always been complex—and becomes more so with a board's increased involvement, which introduces new voices and expertise to the debate and puts pressure on management teams and board members alike to find the best answers. Yet this form of strategy development, when done well, is invaluable. It not only leads to clearer strategies but also creates the alignment necessary to make bolder moves with more confidence and to follow through by committing resources to key decisions. ■

[1] This conversation is drawn from real events, though we have changed the names of those involved.

[2] See Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, March 2012, McKinsey.com.

[3] See Chris Bradley, Lowell Bryan, and Sven Smit, "Managing the strategy journey," *McKinsey Quarterly*, July 2012, McKinsey.com.

[4] Determining whether a strategy will beat the market is one of ten crucial tests that boards can apply to determine the quality and strength of business-unit strategies. For more, see Chris Bradley, Martin Hirt, and Sven Smit, "Have you tested your strategy lately?," *McKinsey Quarterly*, January 2011, McKinsey.com.

Chinta Bhagat is an alumnus of McKinsey's Singapore office, **Martin Hirt** is a director in the Taipei office, and **Conor Kehoe** is a director in the London office.

Modernizing the board's role in M&A

Active involvement can help companies capture more value—and develop a competitive advantage in deal making.

Chinta Bhagat and Bill Huyett

In many conversations with senior executives and corporate directors, we've heard variations on the theme that deep board involvement in M&A encroaches on the line that separates governance from management. That line is critical. Yet our experience suggests that when it comes to M&A, many boards and management teams are drawing it in the wrong place.

Consider the stakes: many large corporations depend on M&A[1] for growth, and by executing it well they can significantly boost the value those deals create. But poorly executed M&A can saddle investors with weak returns on capital for decades. What's more, the margin between success and failure is slim. In most transactions, the net value creation to the buyer is usually a small fraction of the deal's value and therefore easy to wipe out with indifferent execution or ill-informed economic assumptions.

Many boards, reluctant to cross the line between governance and management, miss opportunities to help senior executives win at M&A. Boards are well placed to take a long-term view of a deal's value: the CEO or the business-unit leader may have tenures shorter than the time needed to realize it fully. Boards are also well positioned to challenge the biases that often cloud M&A decision making and goal setting. Furthermore, the diverse experiences of board members with long leadership careers in different corporate settings can shed useful light on common organizational risks in deals. Finally, boards can embolden senior management to pursue promising deals that may seem unfashionable or likely to be unpopular with investors initially.

Of course, a board cannot substitute for an effective management team. Yet it can play roles that go beyond the legal, regulatory, and fiduciary obligations that virtually every board fulfills on M&A—thereby helping executive teams to pursue deals and manage the associated risks in ways that create more value. In this article, we describe three such roles: challenging value-creation possibilities, testing merger-integration plans, and helping managers to create a corporate competitive advantage in M&A.

This final role is crucial because M&A is central to the strategy of many value-creating companies. Active M&A programs offer a window on the external world—product innovations, talent, new business models—and a way to bring fresh skills and ideas to the development of new products and geographies. They also help leaders keep corporate portfolios vibrant by training resources on the most attractive businesses and avoiding inertia in the allocation of cash and talent. In short, the benefits of M&A often transcend those of individual deals, making boards that engage with it better able to fulfill their broader stewardship functions.

Challenging value-creation potential

To understand how boards can help to create value, consider the example of one we know that's created a subcommittee to challenge the thinking of executives on potential transactions. That subcommittee is in constant touch with the company's M&A strategy, the pipeline of potential targets, and emerging deals. Its involvement allows the full board to feel more confident about (and to move much faster than other possible buyers on) large-scale transactions—even company-shaping ones, with all their accompanying risks—because the board is always current on how specific deals create value. This approach isn't common, but it's the right idea.

Providing such a challenge lies at the heart of the value boards can offer in M&A: helping managers to exploit its impact on performance while avoiding its traps. Why the board? Because without its input, ways of working that serve corporations well for ongoing business operations can work against consistent value creation through M&A. The board's independence from daily operations and its long-term perspective enable it to challenge the tendency of management to emphasize income statements over balance sheets; to adhere, sometimes slavishly, to budget targets obscuring the potential of transactions; or to behave in risk-averse ways that inhibit the consideration of aggressive deals and prevent managers from discussing any but the most certain synergies. Specifically, boards can enhance decision making in M&A by closely challenging the following.

The strategic fit

While opportunistic transactions can succeed, recent analysis by our McKinsey colleagues has underscored the importance of strategic fit: deals driven by strategy succeed more often when they are part of a stream of similar transactions supporting that strategy.[2] Boards should push to clarify the relationship between a potential transaction and corporate strategy: how the deal will support organic-growth efforts in target markets and provide complementary sources of value creation, for example. Above all, why is the company a "better owner" than competing buyers?

The pro forma

In reviewing pro forma financial statements prepared for a transaction, a board should test the assumptions used to justify a deal, not just make decisions based on estimates of net present value or internal rates of return. Many boards place too much emphasis on, for example, whether a transaction is accretive or dilutive of the acquirer's earnings per share or on basing the outlay for deals on price-to-earnings multiples. Instead, they should demand clarity—using discounted-cash-flow methods—about the value created by various growth, asset, and cost synergies compared with the value-creation potential other bidders would bring to the deal. Are the forecast growth rates and return-on-invested-capital (ROIC) estimates consistent with industry norms and the long-run tendency of these metrics to converge? What business-model or product disruptions may lie on the horizon? Does the pro forma account for a competitive response? Are its price assumptions consistent with its assumptions about market-share capture? Is there enough new spending to support growth projections?

The risks and rewards

Frequently, best-case/worst-case risk analyses that a board sees reflect a heavily negotiated pro forma that barely meets the minimum financial threshold to secure approval for a deal. These analyses may fail to highlight important risks or upside opportunities. Boards must indicate clearly that it's OK to acknowledge uncertainties in pro formas; what matters is management's ability to assess both those risks and the upside realistically and to develop plans that address them. For example, boards should explore the correlation between different types of risks inherent in a transaction and understand the impact they might have on future growth or returns. Similarly, boards shouldn't miss a chance to push companies to capture cost or revenue synergies more quickly. Setting high expectations for management—and rewarding it accordingly—boost the odds of creating value.

Testing the merger-integration plan

Important as it is to scrutinize a deal's value-creation potential, one board we know has decided that postmerger-integration (PMI) oversight, not a challenge to a deal's pro forma, represents its primary opportunity. In that company's industry, acquirers must typically rationalize costs and accelerate growth in the new entity—a tricky combination—to create value through deals. The board pressure-tests the PMI plan's specifics against stretch-growth and cost goals before and after a deal's announcement.

Boards should examine a transaction's PMI plan in as much detail as they do pro forma statements. While this might seem to verge on meddling in management, our experience suggests otherwise. We see more variation in the quality of post-merger plans than in the financial analysis and pricing of transactions. We've also seen effective PMI plans boost net value creation for the buyer by as much as two to three times the net value created through ineffective PMI plans. Boards can help realize these opportunities without micromanaging, by asking questions such as the following:

- Is the PMI designed to capture maximum value? A surprising number of PMIs and associated management incentives are designed, implicitly, just to integrate transactions smoothly and to meet, not beat, the value-creation pro forma approved by boards. Unfortunately, PMIs are inherently messy; the priority should be finding and exploiting every source of value, not merely keeping things orderly. The PMI plan also must be adaptable enough to accommodate new value-creation opportunities and risks uncovered in the early weeks of integration.

- Is the PMI leader well equipped to realize the deal's value? Particularly for large transactions, it's often important to appoint fairly senior integration managers. In a world of scarce senior talent, a board should make sure that when a complex transaction is under consideration, PMI leadership is on the table. Is a senior leader available with the skill and independence to manage what is often a tricky and high-stakes role?

- Can we launch the PMI on the day the deal is announced and complete it rapidly? If the answer is no, value leakage is inevitable. Our experience suggests that lost value is difficult to recover—and is rarely captured at all if a board accepts a strategy of "we'll integrate the business later."

Creating a competitive advantage in M&A

The third arena of board involvement is unrelated to a transaction's deadline; it is the decision to create a competitive advantage through M&A skills—a corporate asset that can be difficult for competitors to copy. Boards can help management along three dimensions.

M&A strategy

As part of a board's corporate-strategy oversight, the board and management must agree on the role M&A plays in creating value for shareholders—how material is that role, which of course varies across companies, and what critical sources of value can M&A provide? The dialogue between management and the board about sources of value must be quite specific, and the board should know how those sources fit in with the prospective deal pipeline, whose size, flow, and quality help determine the performance of M&A. While active involvement in the pipeline by the full board is rarely feasible or desirable, the board should periodically review it.

M&A leadership

Even if a company doesn't appoint a single executive to oversee M&A, it must have clear organizational-structure and process linkages between the creation of a healthy pipeline, the closing of deals, and their integration. The board can help the CEO and CFO become more explicit about the roles of the corporate center and business units in M&A and a permanent M&A organization's ideal scale and scope. Moreover, the executives leading various elements of M&A can significantly affect the creation of value. It's often harder to provide mentorship for these roles and to develop in them. They deserve the same attention from the board as do, for example, business-unit leadership roles.

M&A processes

Directors should read and challenge their company's M&A playbook—its guide for the types of deals it pursues. The playbook typically covers topics ranging from capturing cost synergies to integrating IT to jump-starting growth, and translates M&A strategy into specifics for delivering value. With the playbook in mind, a board can also help make M&A decision making more effective. The board should ensure that the company structures each phase of decision making to counter risks ranging from risk aversion in the early stages to biases in financial analysis to deal advocacy in the final stages. Once a deal is complete, boards can ensure that its performance is transparent, with incentives tied to realizing its full value.

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This level of engagement will be outside the comfort zone for some executives and directors—but need not cause friction between them. In fact, it can align the board and management on the need for bolder transactions with more upside potential. The risks will be clearer all around, while management will be able to focus on capturing value instead of securing the board's approval. Above all, greater engagement can convert what is typically a sequence of discrete deals into a set of ongoing deal processes and dialogues to deliver value from M&A. ■

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[1] In this article, M&A refers to mergers, acquisitions, joint ventures, and divestitures; it does not include sales of companies, leveraged buyouts, or other recapitalization events.

[2] See Werner Rehm, Robert Uhlaner, and Andy West, "Taking a longer-term look at M&A value creation," January 2012, McKinsey.com.

Chinta Bhagat is an alumnus of McKinsey's Singapore office, and **Bill Huyett** is a director emeritus in the Boston office.

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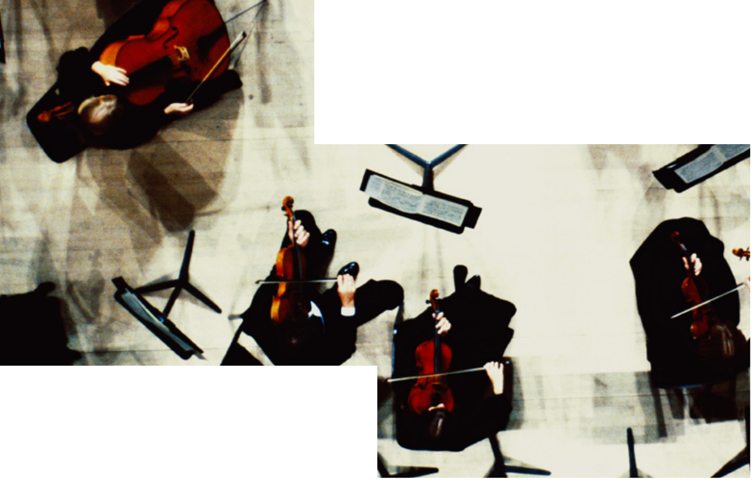


CEO succession starts with developing your leaders

Focusing on future priorities and debiasing decisions help, too.

Åsa Björnberg and Claudio Feser

Two-thirds of US public and private companies still admit that they have no formal CEO succession plan in place, according to a survey conducted by the National Association of Corporate Directors in 2014.[1] And only one-third of the executives who told headhunter Korn Ferry in 2015 that their companies do have such a program were satisfied with the outcome. These figures are alarming. CEO succession planning is a critical process that many companies either neglect or get wrong. While choosing a CEO is unambiguously the board's responsibility, the incumbent CEO has a critical leadership role to play in preparing and developing candidates—just as any manager worth his or her salt will worry about grooming a successor.

An ongoing process

Many companies treat the CEO succession as a one-off event triggered by the abrupt departure of the old CEO rather than a structured process. The succession is therefore often reactive, divorced from the wider system of leadership development and talent management. This approach has significant risks: potentially good candidates may not have sufficient time or encouragement to work on areas for improvement, unpolished talent could be overlooked, and companies may gain a damaging reputation for not developing their management ranks.

Ideally, succession planning should be a multiyear *structured* process tied to leadership development. The CEO succession then becomes the result of initiatives that actively develop potential candidates. For instance, the chairman of one Asian company appointed three potential CEOs to the position of co-chief operating officer, rotating them over a two-year period through key leadership roles in sales, operations, and R&D. One of the three subsequently dropped out, leaving two in competition for the top post.

Rotation is a great way to create stretch moments exposing candidates to exceptional learning opportunities. However, rotation is not enough in itself. A leadership-succession process should be a tailored combination of on-the-job stretch assignments along with coaching, mentoring, and other regular leadership-development initiatives. Companies that take this approach draw up a development plan for each candidate and feed it into the annual talent-management review, providing opportunities for supportive and constructive feedback. In effect, the selection of the new chief executive is the final step in a carefully constructed and individually tailored leadership-development plan for CEO candidates.

Looking to the future

Too often, companies forget to shape their candidate-selection criteria in the light of their future strategic direction or the organizational context. Many focus on selecting a supposedly ideal CEO rather than asking themselves what may be the right CEO profile given their priorities in the years ahead. The succession-planning process should therefore focus on the market and competitive context the new CEO will confront after appointment. One Latin American construction company, for example, began by conducting a strategy review of each business in its portfolio. Only when that had been completed did it create a CEO job profile, using the output of the review to determine who was best suited to deliver the strategy.

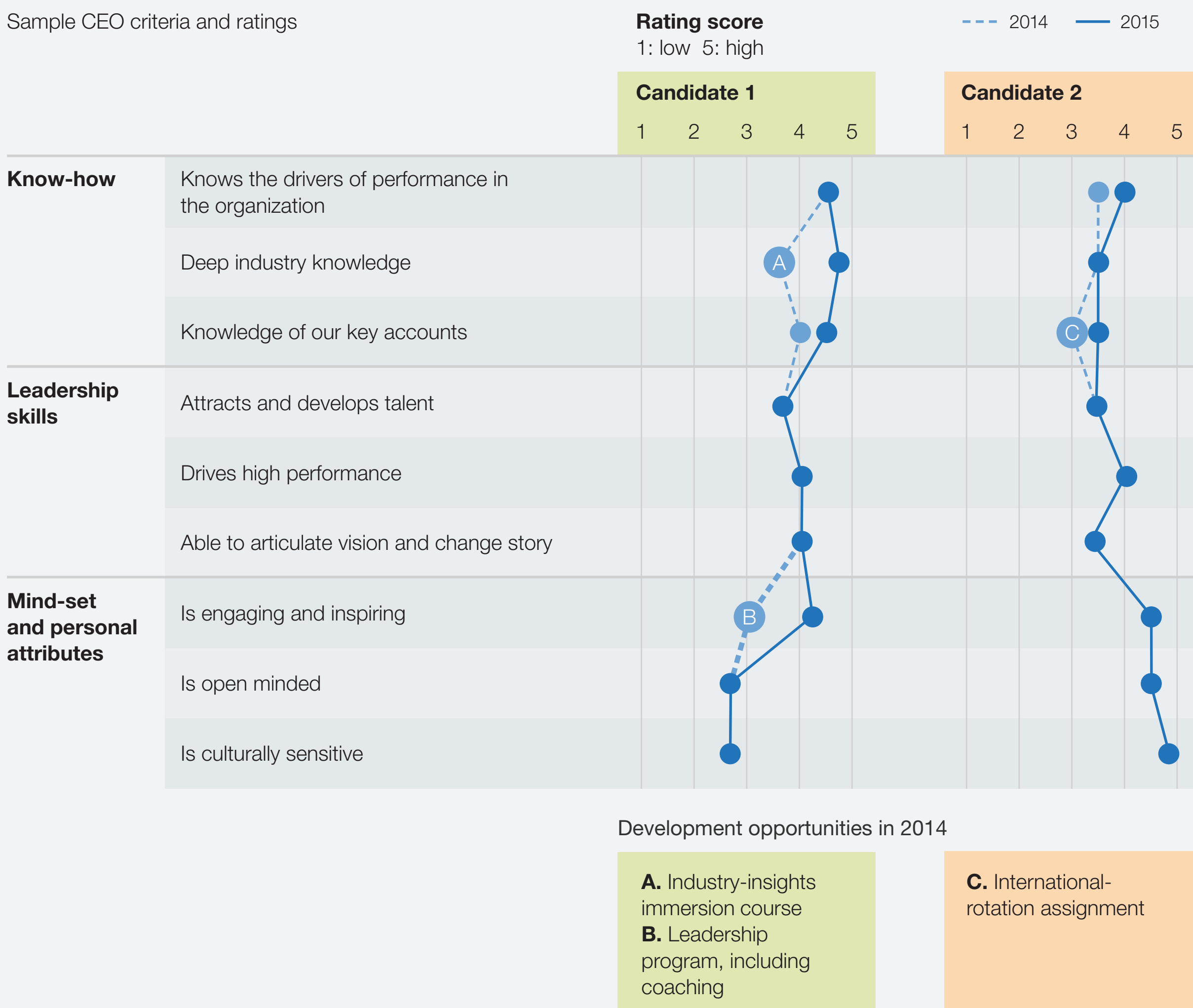
More broadly, three clusters of criteria can help companies evaluate potential candidates: know-how, such as technical knowledge and industry experience; leadership skills, such as the ability to execute strategies, manage change, or inspire others; and personal attributes, such as personality traits and values. These criteria should be tailored to the strategic, industry, and organizational requirements of the business on, say, a five- to eight-year view. Mandates for CEOs change with the times and the teams they work with. The evaluation criteria should change, as well. For example, the leadership style of a CEO in a media business emphasized a robust approach to cost cutting and firefighting through the economic crisis. His successor faced a significantly different situation requiring very different skills, since profitability was up and a changed economic context demanded a compelling vision for sustained growth. When industries and organizations are in flux and a fresh perspective seems like it could be valuable, it's often important to complement the internal-candidate pipeline with external candidates.

Much as the needs of a business change over time, so do the qualities required of internal candidates as a company's development programs take effect. It's therefore vital to update, compare, and contrast the profiles of candidates against the relevant criteria regularly. This isn't a hard science, of course, but without rigor and tracking it is easy to overlook. For example, the picture painted by the exhibit might stimulate a rich discussion about the importance to the evolving business of these candidates' natural strengths and weaknesses, as well as the progress they are making to improve them. Other candidates may be evolving different profiles. Regularly reviewing these changes helps companies ensure that the succession process is sufficiently forward looking.

Debiasing succession

Many biases routinely creep into CEO succession planning, and their outcome is the appointment of a specific individual. As we well know, decision making is biased. Three biases seem most prevalent in the context of CEO succession. CEOs afflicted by the MOM ("more of me") bias look for or try to develop a copy of themselves. Incumbents under the influence of the sabotage bias consciously or unconsciously undermine the process by promoting a candidate who may not be ready for the top job (or is otherwise weak) and therefore seems likely to prolong the current CEO's reign.[2] The herding bias comes into play when the members of the committee in charge of the process consciously or unconsciously adjust their views to those of the incumbent CEO or the chairman of the board.

Exhibit **CEO candidates will respond to development opportunities.**



Contrary to what you might conclude from all this, the lead in developing (though not selecting) the next leader should be taken by the current CEO, not by the board, the remuneration committee, or external experts. The incumbent's powerful understanding of the company's strategy and its implications for the mandate of the successor (what stakeholder expectations to manage, as well as what to deliver, when, and to what standard) creates a unique role for him or her in developing that successor. This approach encourages the CEO to think about the longer term and to "reverse engineer" a plan to create a legacy by acting as a steward for the next generation.

That said, companies must work hard to filter out bias and depersonalize the process by institutionalizing it. A task force (comprising, perhaps, the CEO, the head of HR, and selected board members) should regularly review the criteria for selecting internal candidates, assess or reassess short-listed ones, provide feedback to them, and develop and implement a plan for their development needs. The task force should identify the right evaluation criteria in advance rather than fit them to the pool of available candidates and should ensure that its members rate candidates anonymously and independently. The resulting assessment ought to be the sum of these individual assessments. Relatively few companies use such a task force, according to a 2012 Conference Board survey on CEO succession.

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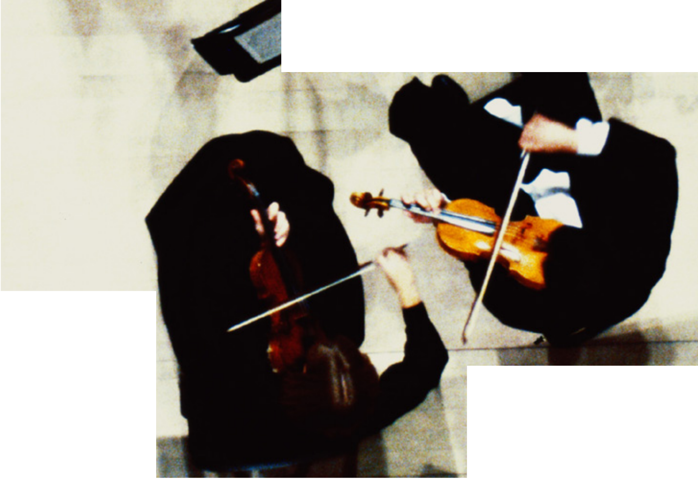
One in three CEO successions fails. A forward-looking, multiyear planning process that involves the incumbent CEO would increase the odds of success. ■

[1] In 2007 a similar study found 60 percent of large US companies had no meaningful CEO succession plan. See Joseph L. Bower, "Solve the succession crisis by growing inside-outside leaders," *Harvard Business Review*, November 2007, Volume 85, Number 11, pp. 90–6, hbr.org.

[2] See Manfried F. R. Kets de Vries, "The dark side of CEO succession," *Harvard Business Review*, January–February 1988, Volume 66, Number 1, pp. 56–60, hbr.org.

Åsa Björnberg is an alumna of McKinsey's London office, and **Claudio Feser** is a director in the Zurich office.



Engaging boards on the future of marketing

At many companies, the whole organization is becoming more responsible for customer engagement. A few are extending this thinking to the boardroom.

Jean-Baptiste Coumau, Ben Fletcher, and Tom French

As trends such as social media, the mobile web, and proliferating data streams rapidly redefine what it means to be on the cutting edge of marketing, the organization as a whole is becoming more responsible for customer engagement. In previous articles, we've described how an organization-wide commitment helps companies ensure access to the steady diet of wide-ranging inputs they need to stay ahead of the curve.[1] Some companies are extending this thinking to the boardroom. While it's still early days, and the dynamics will of course differ by industry and company, a closer look at what a handful of organizations are doing provides food for thought about the benefits of having boards engage with the fast-paced evolution of marketing.

Bringing the board into marketing

When a new CEO took the directors on a tour to visit innovators and peer companies in the United States and (later) Europe, one Asian technology-services company began to discover the value a board can bring to marketing. The CEO's intent was to instill among board members a shared sense of the need for fundamental changes in the company's growth goals and to build enthusiasm for a major efficiency drive.

In addition to accomplishing those goals, the visits created a new sense of urgency about the company's need to diversify both the range of channels it used to interact with customers and the points in the customer relationship where it would emphasize deep engagement. The board's commitment helped overcome internal opposition, and the company embarked on a dual program of restructuring its channels and acquiring or partnering with third-party providers whose services could help enrich its offerings at various points in the customer life cycle.

The results thus far have been impressive—customer satisfaction has increased by 20 percentage points, market share in core services by nearly 10, and profitability has increased correspondingly.

Meanwhile, the company has continued sending its corporate directors on fact-finding trips in a variety of geographies, with the intention of shaking up the directors' thinking and encouraging them to spot overlooked opportunities.

Such board missions can deliver unexpected insights thanks in no small part to the diversity of experiences and perspectives that well-chosen boards can bring to bear. When a large distribution business concluded that it needed to change its way of engaging with customers, it enlisted the board in the problem-solving process. The company paired off board members and senior managers with complementary skills and flew them to different locations, where they visited company sales offices and customers before later reconvening at an off-site strategy meeting. When the full group debriefed, its members' collective experiences yielded new insights about customer needs and the value proposition the company was (and wasn't) offering, all of which had implications for its sales and distribution approach.

The changing marketing environment also elevates to board agendas items that previously might not have made it there. One example is corporate brand management, long the domain of chief marketing officers and public-relations departments. Yet against a backdrop of social media, viral video, and the reputational threats posed by "citizen bloggers," the CEO of one North American manufacturer recently placed the potential for brand-changing events on the board's agenda. This move led to a good discussion about ways to cope. The conversation transcended traditional marketing communcations and touched on the company's overall strategy, as well as its approach to crisis response.

Boards can also serve a valuable role in helping management to identify and initiate beneficial marketing-strategy or organizational changes that would have been difficult for managers to envision on their own, given their focus on day-to-day concerns. At a global luxury group, for example, a board member helped management to see the importance of dramatically increasing a key brand's online presence. The additional focus highlighted the need for big changes—including new functional skills, organizational capabilities, and processes—that culminated in the creation of an internal "brand studio" tasked with "insourcing" a wide range of the brand's digital activities.

Three tips for improving engagement

As these examples suggest, it's too early to draw a definitive road map for board involvement in marketing, just as it's not yet possible to draw a universal blueprint for creating superior customer engagement. Still, our experience suggests a few ideas worth considering.

First, much as most boards now include a strategy day in their calendar of meetings, we think it's worth considering a customer-engagement day to take stock of the broadest strategic implications of changes in the marketing environment and of the company's position with customers. On such a day, the directors of another Asia-based services company took decisive action to rethink its premium-pricing strategy after coming to grips with big changes under way in the customer base.

Second, it's important to be mindful of the board's composition, given the fast-changing nature of marketing. For example, including more board members with public-sector experience—including political-campaign skills—can provide valuable counsel to today's ever-more-exposed CEOs.

Third, it's important to keep board involvement strategic in nature and clearly aimed at governance issues and not the day-to-day management of marketing activities. To be sure, it can be valuable for board members with specialized expertise to provide it fairly regularly; we know of one company that's asked an innovation guru on the board to work closely, between meetings, with the head of R&D. Yet any such involvement must ultimately connect back to the board; otherwise, there's a risk of creating a cadre of shadow managers. In this case, the R&D director and board member jointly update the board on innovation efforts to ensure that it remains plugged in.

This last example shows how CEOs are finding value in individual board members. In this case, the value was in R&D, the lifeblood of that company. In others, it might be in understanding new technologies shaking up consumer behavior or new geographies emerging as priority markets. As the digital-marketing revolution continues to unfold, senior leaders will need all the help they can get to keep their companies on the leading edge. ■

[1] See Tom French, Laura LaBerge, and Paul Magill, "We're all marketers now," *McKinsey Quarterly*, July 2011, McKinsey.com; and "Five 'no regrets' moves for superior customer engagement," *McKinsey Quarterly*, July 2012, McKinsey.com.

Jean-Baptiste Coumau is a principal in McKinsey's Tokyo office, **Ben Fletcher** is a principal in the Sydney office, and **Tom French** is a director in the Boston office.

BOARD STRUCTURE AND FOUNDATIONS

How to choose the right nonexecutive board leader

It's time to use a structured process for selecting the nonexecutive leader of the board. Defining the role is a good start.

Dennis Carey, John J. Keller, and Michael Patsalos-Fox

Ever since stock-listing requirements prompted many US companies to name an independent director to serve as the chairman, lead director, or presiding director of the board, these companies have been grappling with what, exactly, this board leader should do and how to find the right person for the job.

The change in governance followed corporate scandals (in the early part of the decade) that led to investor pressures to strengthen corporate governance by separating the roles of CEO and chairman. This separation represented a step into the unknown, because the CEO traditionally served as chairman in most US companies and was the board's undisputed leader. The combined role of CEO and chairman is still very common, but the governance structure at most Fortune 100 companies[1] has now been complemented by a presiding or lead director, who plays a substantial role in leading the board's work.

To examine how the new board-leader role has evolved, and the best practices for appointing one, we invited 11 current and former board leaders of large US companies to share their views and experiences (see sidebar, "Who's who"). One of their insights was that there is little difference in how their companies utilize the board leader whether the organization refers to that person as a presiding or lead director or as a nonexecutive chairman, although a few interviewees saw the latter title as having more importance symbolically. These board leaders spoke of a role that has grown beyond mandated process requirements, to carry a more substantive meaning for the creation of corporate value. At many leading companies today, the board leader is a real partner of the CEO on strategy issues and has taken over or partnered with the CEO on some functions the chief executive has historically led, such as setting board agendas, recruiting new directors, and more aggressively assessing risk.

Our panel also noted how the process of selecting a board leader has been evolving from an unstructured and haphazard approach toward one that should ideally resemble the best practices for CEO succession. The board leaders we interviewed agreed, without exception, that good board succession planning starts with producing a formal document that specifies the duties and the personal characteristics the board leader should have, even though they may change over time. This document could also be used for evaluating the board leader from time to time.

Based on our interviews and experience of serving on corporate boards, we believe that the leader's duties should ideally include chairing executive sessions, board meetings in the absence of the chairman (when the CEO has that role too), and meetings of the independent directors when necessary, as well as presiding over the board evaluation process to ensure that the board functions effectively. The duties should also involve frequent cooperation with the CEO in communicating with shareholders and external stakeholders, working with board-committee chairmen (for

Who's who

Name	Title[1]	Company
James G. ("Jim") Cullen	Nonexecutive chairman Lead director	Agilent Technologies Johnson & Johnson
David W. Dorman	Nonexecutive chairman	Motorola
Bruce S. Gordon	Lead director	Tyco International
James F. Hardymon	Lead director	WABCO Holdings
Bonnie G. Hill	Lead director	Home Depot
Irvine O. Hockaday Jr.	Lead director	Ford Motor
Constance J. Horner	Lead director	Pfizer
John A. ("Jack") Krol	Nonexecutive chairman Former lead director	Delphi Tyco International
Linda Fayne Levinson	Lead director	NCR
Harold A. ("Hap") Wagner	Former lead director	United Technologies
Tony L. White	Former lead director	Ingersoll-Rand

[1] As of May 2010.

example, on the CEO's evaluation and compensation), and acting as a liaison between the board and management. What's more, the board leader should ensure that a succession plan is in place for the CEO and the board leader, as well as work in partnership with the CEO on strategy issues.

Every one of the interviewees emphasized the need for close collaboration and trusted communication with the CEO and fellow directors to help the board navigate the challenges of a complex business environment and to focus boardroom discussions on strategy and overall value creation. Some interviewees discussed the need for the board leader to facilitate the evaluation of the board's performance and, if needed, to deal with problem directors. Most interviewees believed that "firing a director" should be a process led by the board leader, based on peer or self-assessments.

Given the focus on meetings and conversations, many directors in our panel stressed that the board leader must be a superb facilitator. "A skilled board leader can wring a lot out of these discussions," said Jim Cullen, the lead director of Johnson & Johnson and nonexecutive chairman of Agilent Technologies. And this function "lies at the heart of what a board leader can bring to the governance process and to the successful strategic momentum of the business." Doing one's homework on the business is also key. "You have to stay current [and] understand the priorities of the business, the strategy, and the direction of the business, especially if you are going to have candid one-on-one discussions with the CEO," Cullen said.

When Jack Krol became the lead director at Tyco International, in 2003, he developed, in conjunction with CEO Edward Breen, a document specifying his own role. With input from the board, the governance committee then developed some general characteristics of the role for whoever would succeed Krol in the future. Krol said three competencies or characteristics were deemed most critical.

First, Krol said, "the ideal candidate has to have stature with the other directors and be seen as a leader in the boardroom." Krol also noted that "the ideal board leader is an engaged and thoughtful director. This candidate adds value during board deliberations, with significant comments when compared to others who may talk more but, over time, indicate a lack of substance"—adding that "you just know it when you see it." Second, "the candidate must have compatibility with the CEO as well as good chemistry, and the person should not be adversarial." Third, "the candidate must express interest and have the time to do the job." Krol added, "at Tyco I was involved nearly every day for a year during the crisis, either at a company location or on the phone." (Krol was referring to Tyco's 2002 financial woes, which were compounded by accounting scandals involving its former CEO L. Dennis Kozlowski.) Indeed, many of the directors we interviewed underlined that boards should select leaders with the assumption that at some stage during their tenure, the company would be under some form of stress or in a crisis.

Advance planning and a well-vetted description of the role were essential when Krol recently handed over the reins as lead director to fellow Tyco International director Bruce Gordon. Krol, now nonexecutive chairman of Delphi, knew the stakes were high. If he and Tyco International's board hadn't found a successor capable of carrying on the dynamic created by the board and CEO Edward Breen, that failure might have unraveled years of progress in transforming the company's governance in the eyes of shareholders and employees alike. The process was conducted over several months. The governance committee developed a list of three Tyco directors who best met the selection criteria and then conducted discussions, led by Krol, with each candidate and the CEO. Ultimately, an executive session of the board made the selection, based on the committee's recommendation. The process, not unlike one that should be used to evaluate inside candidates for the job of CEO, enabled the board to engage in a thoughtful, well-paced process to arrive at the right answer.

The smooth succession at Tyco exemplifies best rather than common practice. Few of the companies in our sample had a formal specification for the board-leader position when the time came to pass the baton, but all believed that such a specification should be created for the next "baton pass." We find there is an increasing number of companies whose board leader says his or her board intends to develop a better profile of the ideal leader and then goes after the right candidate based on the formal specification rather than requiring candidates to compete with only nebulous criteria as their guide.

The old method of picking a successor wouldn't stand up in today's governance environment, noted Harold A. ("Hap") Wagner, who was lead director at United Technologies for five years. Wagner recalls that when it was time for him to step down, in 2008, there was no document specifying the criteria for the selection of his successor. "Today, the position of lead director has been much more magnified," he said. "I suspect that there is a specification now for lead director at UTC, and, if not, there should be."

■ ■ ■

The board-leader role has come a long way and is still evolving. What works best for one company may not necessarily fit another, because of varying degrees of business success, different cultures, and unique personal chemistry on the board. However, the common themes and recommendations uncovered by our research might help to shape the outlook of all boards when the time comes to pick a new board leader. ■

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[1] According to Agenda's 2009 board-leadership guide, of the 96 Fortune 100 public companies included in the research, 43.8 percent had a presiding director and 37.5 percent a lead director. The most common governance structure in the largest US companies combined the positions of chairman and CEO and complemented this with a presiding director. For more, see agendaweek.com.

Dennis Carey is vice chairman and **John J. Keller** is an alumnus of Korn Ferry. **Michael Patsalos-Fox** is a director emeritus in McKinsey's New Jersey office.

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Board directors and experience: A lesson from private equity

Independent directors contribute an outside perspective to governance, but analysis of private-equity firms suggests they need relevant managerial expertise, too.

Viral V. Acharya and Conor Kehoe

Independent directors are very much in fashion. Many companies, particularly in Europe, are looking to fill openings on their boards with professionals they hope will bring close oversight, renewed enthusiasm, and broader perspectives on strategy.

Similar attributes—such as independence and deep engagement in setting strategy and managing performance—are often cited as the primary reasons for the success of the better private-equity firms. Indeed, our own past analyses have found that these firms persistently outperform the S&P 500 because their partners are active directors of the businesses in their funds. They are more engaged with setting strategy and managing performance as their own interests are tied to the success of a business.[1]

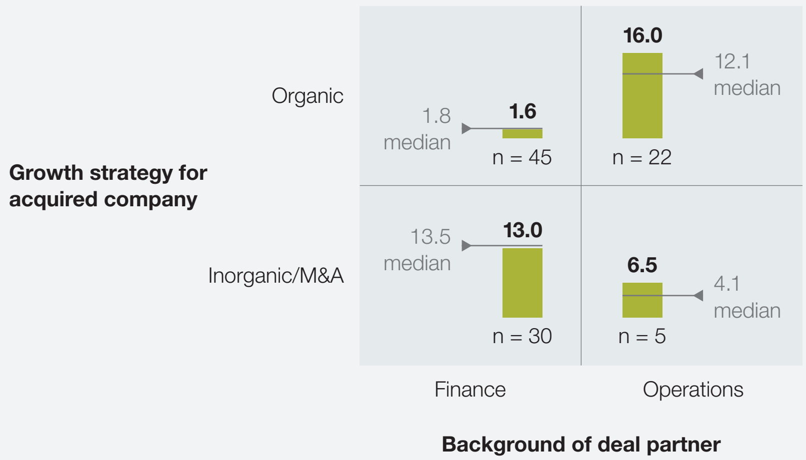
Yet greater involvement is apparently not the whole story. Our new research on private-equity firms shows that deals generate the greatest value when the skills of the lead partner are directly relevant to the business strategy of the portfolio companies to which they are assigned.[2] Partners with a finance background, for example, do best when acquisitions are central to a value-creation strategy, and partners with managerial backgrounds do better with companies whose chosen route to value is organic development (exhibit). And both strategies led to outperformance: companies that developed organically grew sales in line with their public-company peers but improved their margins more rapidly through faster improvements in productivity. Companies that grew through acquisitions improved their value by increasing expected future profits[3] more than quoted peers did—for example, because of higher expected margins once acquisitions are properly integrated.[4]

For public companies, these findings raise interesting questions about the expertise and experience

Exhibit

Matching the skills and experience of the deal partner with the growth strategy for the acquired company enhances the deal's performance.

Outperformance[1] for 110 of the largest European deals from 1996 to 2005, simple average, %



[1] Rate of return on equity (ROE) of a deal minus that of quoted peers and excluding the effect of debt.

they should be seeking even from independent directors—and their ability to match the strengths of a board to their overall strategies. The challenge goes beyond finding directors who will dedicate enough time to the company and who understand it (perhaps as the result of experience in its industry). The findings suggest that directors might also be chosen for their experience in having executed similar strategies elsewhere—perhaps in industries that have evolved further.

For private-equity firms, our findings raise questions about how they assign partners to deals. Do these firms consider the way value will be added to an acquired company? Should they deploy small teams of partners with different backgrounds for deals requiring more complex strategies? Are the firms doing enough to develop and expand the skills of partners beyond what they learned before entering private equity? ■

[1] See Andreas Beroutsos, Andrew Freeman, and Conor F. Kehoe, "What public companies can learn from private equity," January 2007, McKinsey.com; and Viral Acharya, Conor Kehoe, and Michael Reyner, "The voice of experience: Public versus private equity," December 2008, McKinsey.com.
[2] We looked at 110 of the largest European deals in the decade from 1996 to 2005.
[3] Expressed as the multiple of current profits at which they were valued.
[4] The companies in our sample typically started out with average margins—so they were not turnarounds.

Viral Acharya is a professor of finance at NYU's Stern School of Business; **Conor Kehoe** is a director in McKinsey's London office.

Boards: When best practice isn't enough

Many boards have improved their structures and processes. But to become truly effective stewards of their companies, they must also instill the right mind-set and boardroom dynamics.

Simon C. Y. Wong

Why is it that despite all the corporate-governance reforms undertaken over the past two decades, many boards failed the test of the financial crisis so badly? In North America and Europe, for example, boards of financial institutions that failed to check management's aggressive forays into US subprime mortgages saw their firms decimated during the 2008–09 economic meltdown. Indeed, the European Commission, the US Congress, and others found serious deficiencies in the way boards, particularly at financial institutions, guided strategy, oversaw risk management, structured executive pay, managed succession planning, and carried out other essential tasks.[1] But it's a sure bet that most of these boards would argue—and demonstrate—that they had best-practice structures and processes in place.

The answer, I believe, after years of examining and advising scores of boards, is that such best practice isn't good enough, even if your board is stacked with highly qualified members. Without the right human dynamics—a collaborative CEO and directors who think like owners and guard their authority—there will be little constructive challenge between independent directors and management, no matter how good a board's processes are. As a result, the board's contribution to the company's fortunes is likely to fall short of what it could and should be. Deficiencies in boardroom dynamics are a concern also for executives who are not directors but report to them, because it makes it harder for those executives to develop healthy and productive relationships with their boards. What's more, for executives who aspire to serve on boards one day, it's essential to learn the importance of the right human dynamics and what it means to be a good corporate director.

Identifying the contours of such a fluid interpersonal exchange isn't easy. But executive and non-executive directors can apply three tests to assess the human dynamics of their own boards.

1. Do our directors think and act like owners?

Boards are vital stewards, responsible for ensuring the long-term viability and health of companies under their charge for the benefit of current and future owners. It is therefore not unreasonable to expect boards to adopt an ownership mind-set. Yet while boards have improved as a result of reforms, many outside directors continue to be passive participants who do not believe that it is their role to challenge management beyond asking a few questions at board meetings. At one financial institution, the lead director mentioned privately to a colleague that "I didn't sign up for this" when it became clear that shareholders expected this director to step up his involvement after an activist investor started questioning the company's strategy and leadership structure.

Contrast this with how the chairman of a large and successful family-owned construction firm describes the role of board directors in well-governed family enterprises: "Directors with an ownership mind-set—whether from the family or outside—have passion for the company, look long term, and take personal (as distinguished from legal) responsibility for the firm. They will spend time to understand things they don't know and not pass the buck to others. They will stand their ground when it is called for. Ultimately, the success of the company over the long term matters to them at a deep, personal level."

To embed an ownership mind-set in the boardroom, companies should look for energy, a "can do" attitude, and an independent mind when they recruit directors. It is useful to ask candidates the following questions:

- How should nonexecutive directors be involved in the development of strategy?
- What type of information would you need to discharge your responsibilities effectively and how would you obtain it?
- In your previous board roles, in which areas did you have the greatest impact?
- In a group setting, when have you taken a stance against the prevailing majority view and what was the outcome?

It's a clear warning sign when a candidate cannot mention an occasion when she or he disagreed with management. Indeed, boards that operate to their potential are characterized by constant tensions, coupled with mutual esteem between management and outside directors. Rather than leading to endless bickering, this virtuous combination helps to facilitate healthy and constructive debate and improves decision making. As former UK Financial Reporting Council chairman Sir Christopher Hogg has noted, "Good boards are pretty uncomfortable places and that's where they should be."

Boards should also gauge a candidate's inherent interest in their companies and the amount of time the candidate can devote to the job. Why? Because a shortage of either will hinder a director's ability to think and act as an owner. Finally, although the role of financial incentives should not be overestimated, becoming an owner can help a director think like one. When directors are paid with shares in their companies or use their own funds to buy a sizable amount of those shares, they may carry out their responsibilities more robustly—provided that the stock acquired can be sold only after retirement from the board.

Thinking like an owner means, in practice, that directors should get deeply involved in developing strategy and monitoring risk. On a few issues, particularly CEO succession planning and executive remuneration, the board must absolutely take charge; in other words, board members need to roll up their sleeves and drive the work. That said, the near-universal norm that listed-company boards should probe and offer guidance—but let management handle execution and other

> A board should look for collaborative traits when selecting a new CEO. . . . Collaboration with the board should be built into a CEO's job description and feedback provided regularly.

details—is sound advice for most matters that come before a board.

An owner's mind-set also requires outside directors to possess a strong understanding of the industry, so that they can challenge management effectively. Often, they don't have that kind of knowledge. In some financial institutions that collapsed during the recent crisis, it appears the nonexecutive directors largely failed to appreciate the risks these firms were taking and were genuinely surprised when their condition deteriorated rapidly. To ensure that board members can make meaningful contributions, efforts to develop their knowledge should focus on experiential activities, such as visits to facilities, suppliers, and customers. These will yield a deeper understanding of the business and industry dynamics than the passive absorption of written reports and lectures.

However, there are limits to how much deep knowledge outside directors can build solely through service on a board. Some companies have therefore steered toward having more non-executives with sector expertise. The British bank Barclays, for instance, requires 50 percent of outside board members to have a financial-services background.

2. Does our CEO have a collaborative mind-set?

At some companies, senior executives fear that if boards are empowered, management will inevitably be weakened. In recent years, there have been high-profile incidents of CEOs failing to inform or involve their boards on critical developments—for instance, merger discussions. Such breaches of trust often have ended up costing these CEOs their jobs.

Although executives are increasingly conscious of the importance of keeping their boards fully informed, directors remain vulnerable to manipulation by management. Therefore they need to assure themselves that a collaborative CEO is in place. Some new CEOs may not realize, for example, that they are not sharing the right type of information with the board. In these cases, it is possible to solve the problem by giving feedback. However, where a seasoned CEO deliberately keeps the board in the dark, it is hard to change the status quo short of firing the chief executive. One company tried to coach a CEO who didn't tell the board about the true state of the company's affairs but ultimately fired him because trust could not be restored.

A board should look for collaborative traits when selecting a new CEO. For instance, it should spend time understanding how a candidate who is a sitting CEO at another company interacts with its board. And a board should avoid, at all costs, candidates who give the impression that they see it as an entity to be "managed" rather than a body to which they are accountable.

Collaboration with the board should be built into a CEO's job description and feedback provided regularly. In the annual board-evaluation survey, one UK chairman includes questions about the sufficiency of the information the CEO provided and how well the CEO got along with the other directors. The purpose is to signal to the chief executive that these issues are important to the board and to address any problems at an early stage.

Trust, of course, is built over time through repeated encounters. CEOs must be equally forthcoming about successes and failures and willing to ask for help. At many companies, discussions about the challenges facing the CEO take place in one-on-one meetings between the chairman and the CEO or in executive sessions where only the nonexecutive directors are present.

Boards can influence management's willingness to cooperate through their own behavior. For instance, they must gain the CEO's trust and confidence by demonstrating an ability to add value and not micromanaging the executive team. On the latter point, the chairman of an FTSE 100 company remarked that "the test is whether executives consider board counsel on matters within management's areas of responsibility as advice which they can accept or ignore. If they feel that they must follow it, the line has been crossed."

3. Does our board guard its authority and independence?

Boards must be ever-vigilant about protecting their standing and independence. Although few board directors like to say so, an increasingly successful CEO is one of the biggest threats to the board's authority, regardless of whether she or he is rewarded with the chairman's title too, as is common in the United States. In many industries, from financial services to entertainment to retailing, boards have seen their authority slowly chipped away as their CEOs experience ever-greater success. Tell-tale signs include less robust questioning of management's proposals and a readiness by the board to agree to unreasonable demands—for example, on executive remuneration. Some boards realize the extent to which they

have relinquished their authority only when the CEO changes or something goes wrong, such as a crisis or scandal.

Boards can take a number of steps to protect their authority and independence. First, they should ensure that different individuals occupy the positions of chairman and of CEO. From a principled standpoint, it is problematic for a board, whose job is to oversee management, to be led by the CEO. Appointing a lead independent director in lieu of a nonexecutive chairman—the preferred option in the United States—is not enough, because most US lead directors do not have primary responsibility for developing agendas for board meetings, interviewing candidates for directorships, and other activities that safeguard a board's authority and independence.[2]

Additionally, boards need to be on top of succession planning and leadership development, so that the CEO can't hold the board hostage with unreasonable demands, whether on pay or additional authority. At a European retailer, the failure of the board to identify a successor to the CEO enabled him to extract from it the chairman's seat as well.

Since a successful CEO's clout will grow, boards should also pay attention to the relative status of people in the boardroom. Discussions with chairmen and direct observations of boardroom dynamics have revealed that CEOs are not always attentive to the views of nonexecutive directors whom they perceive to be less qualified than they are. Outside directors who are in awe of, or intimidated by, a chief executive can also be overly deferential to management.

As a principle, boards should ensure that the stature of nonexecutive members is roughly comparable, and equal to or greater than the CEO's. At one UK company, the chairman has deliberately recruited to the board people who are chairmen at other listed firms. That way, the board is more likely to have the respect of the highly successful CEO, and nonexecutive directors will also treat each other with regard. At another company, a candidate will be nominated to the board only if all of the current nonexecutive directors support his or her appointment. The chairman reasoned that "the board's time is so precious that you cannot have a situation where one director is not respected by all others."

The relative stature of the chairman and the CEO is particularly important. According to a senior independent director of a UK company, "you need a person who can tell a CEO that he is acting like an idiot, when necessary." In the United Kingdom, chairmen are usually a decade or so older than their CEOs, which enhances the chairman's ability to serve as mentor to the chief executive.

Last, boards should put in place term limits for directors and CEOs, with some flexibility on the exact timing of exit, to ensure that new perspectives come into the boardroom and that boards remain sufficiently detached from management. At a food-services company, the board—many of whose members had served for years—became too close to the CEO and did not challenge him on his undisciplined growth strategy. The strategy subsequently unraveled, forcing the company to undertake a costly and embarrassing restructuring and leading to the ouster of the CEO and all of the long-tenured directors.

One Canadian bank normally allows nonexecutive directors to serve for ten years. At a UK company that has no formal policy on term limits, the chairman usually seeks to rotate directors off the board after six to seven years of service. Correspondingly, limiting the CEO's tenure may help the board preserve its authority and force it to devote more attention to succession planning and leadership development. This approach may also inject a sense of urgency into the CEO's work. One American CEO who imposed a ten-year limit on his own tenure felt that it helped him become a better leader. He also devoted a great deal of time to thinking about the long-term health of the company and the steps he should take to sustain its success after his departure.

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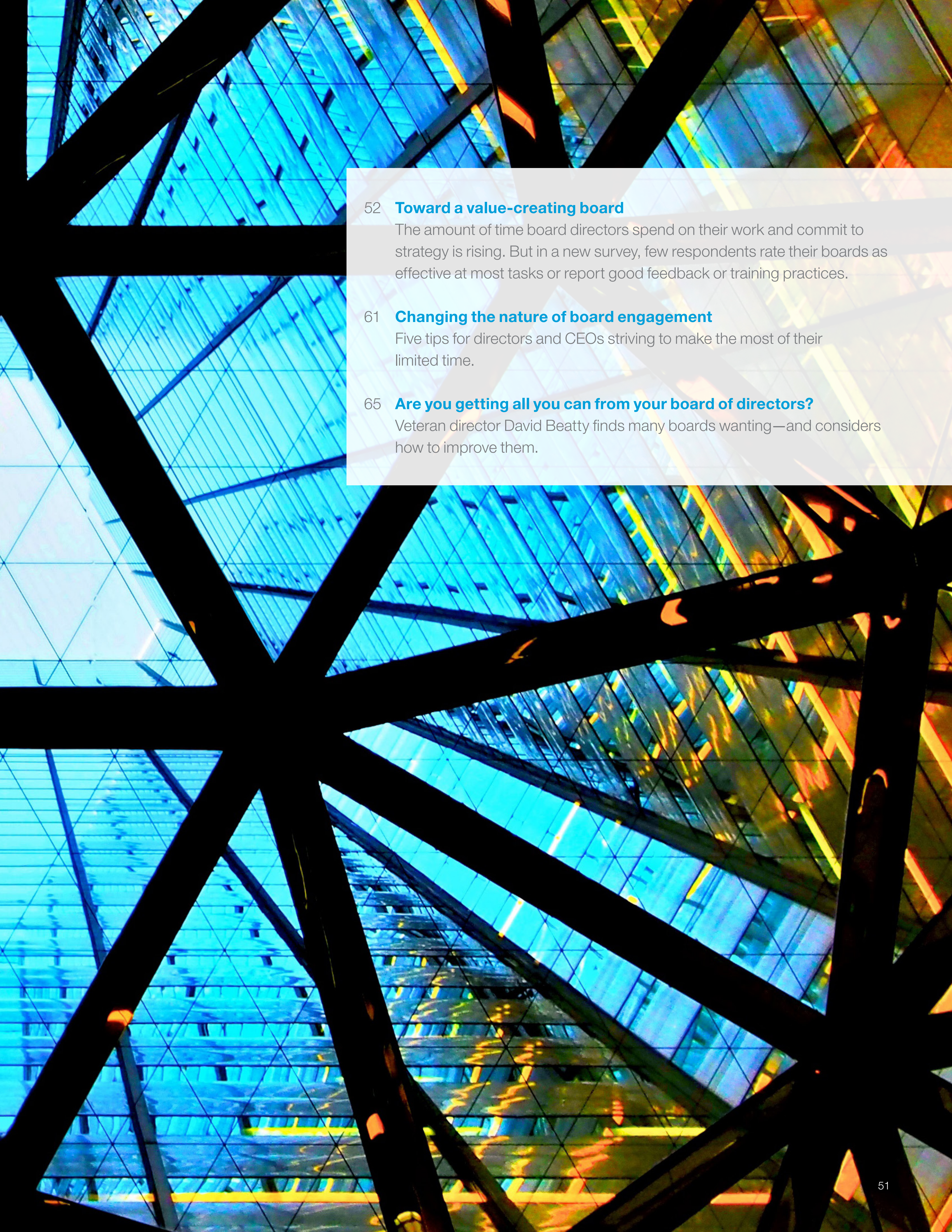
When it comes to well-functioning boards, best-practice structures aren't enough. Without the right mind-sets and human dynamics between directors and management, boards will not be able to fulfill their potential. ■

[1] See, for example, "Corporate governance and the financial crisis," Organisation for Economic Co-operation and Development, February 2010; "Corporate governance in financial institutions: Lessons to be drawn from the current financial crisis, best practices," European Commission working paper, June 2010; David Walker, "A review of corporate governance in UK banks and other financial industry entities," HM Treasury, July 2009; and "The financial crisis: Inquiry report," US Financial Crisis Inquiry Commission, January 2011.

[2] For further information, see *2010 Spencer Stuart Board Index*, Spencer Stuart, 2010, p. 23.

Simon C. Y. Wong, an alumnus of McKinsey's London office, is a partner at London-based investment firm Governance for Owners; an adjunct professor of law at Northwestern University School of Law, in Chicago; and a visiting fellow at the London School of Economics and Political Science. This article has been adapted from his working paper "Elevating board performance: The significance of director mind-set, operating context, and other behavioral and functional considerations," June 2011.

BOARD EFFECTIVENESS



Toward a value-creating board

The amount of time board directors spend on their work and commit to strategy is rising. But in a new survey, few respondents rate their boards as effective at most tasks or report good feedback or training practices.

Conor Kehoe, Frithjof Lund, and Nina Spielmann

Directors say they dedicate more time now to their board duties than ever before and that, since 2011, they've cut in half the gap between the actual and ideal amount of time they spend on board work. In the newest McKinsey Global Survey on corporate boards,[1] the results confirm that strategy is, on average, the main focus of many boards. Yet directors still want more time for strategy—more than any other area of their board work—when they consider its relative value to their companies.

We asked directors about the effect their boards have on company value and found that, in general, respondents believe their impact is high or very high—which was also true in our previous survey on the topic.[2] To gain a deeper understanding of how boards create value, we took a close look at larger commercial companies and identified patterns between directors' assessments of the board's overall impact, effectiveness at executing specific tasks, and the way the board works. From our analysis emerged three types, or profiles, of boards, which we call ineffective, complacent, and striving. Interestingly, some directors' initial views on their overall impact diverge from how effective they say their boards are at individual tasks. To be successful, then, the results from our three profiles suggest that boards must be effective at individual tasks, maintain a trust-based but challenging board culture that embraces feedback, and aim to improve continuously.

Time spent—and commitment to strategy—are on the rise

On average, the amount of time directors spend on board work has increased notably in recent years. Compared with 2011, respondents now say they spend five more days per year on board work, cutting in half the ten-day gap between the actual days spent and the number of days directors want to spend to get it right (Exhibit 1).

As the number of days has grown, so has the amount of time spent on strategy, where board members tend to say they make their biggest contributions (Exhibit 2). Indeed, directors are almost twice as likely to say their boards are more effective at strategy than any other area of their work; they report the least effectiveness at organizational health and talent management.[3] Strategy is also where directors spend nine days per year, the greatest amount of time across the seven areas of board work we tested.

But for all of their focus on strategy, most directors would like to dedicate even more time to strategic issues. Fifty-two percent of directors say they want to increase the time they spend on strategy in the next few years, based on its relative value to their companies (Exhibit 3). An equal share say the same for organizational health and talent management, an area where boards spend only three days per year.

A board's actions, dynamics, and self-perception all matter

To gain a more comprehensive understanding of how boards can be successful, beyond the time directors spend on their work, we looked closely at three factors of board performance: directors' assessments of what impact their boards have overall, how their boards perform specific board tasks, and how their boards operate.[4] After considering responses at both the global and the task level (where some interesting differences emerged), our analysis resulted in three types of boards: those that are ineffective, those that are complacent, and those that are striving.[5]

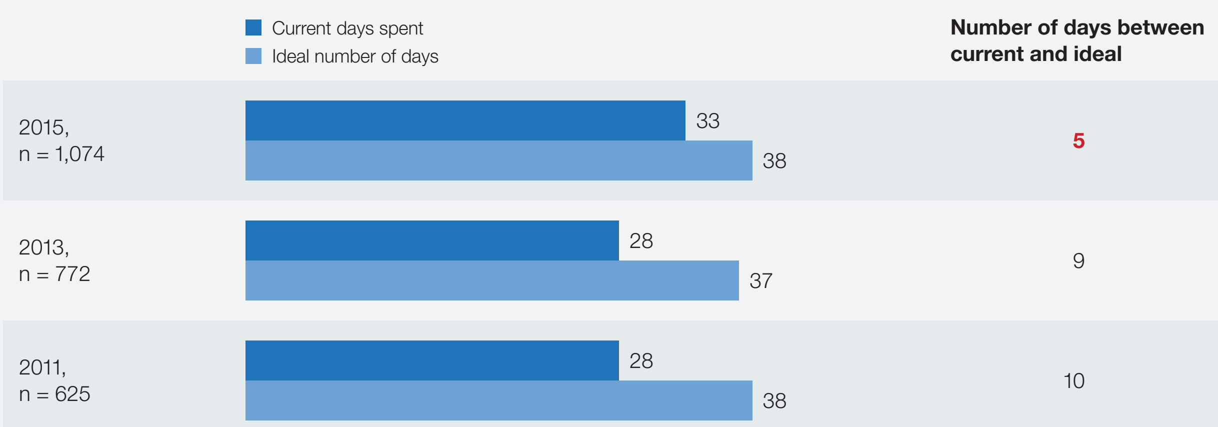
The ineffective boards

Compared with their peers, the directors on ineffective boards report the lowest overall impact on long-term value creation and the least effectiveness at the 37 tasks we asked about. Notable shares say their boards don't execute some of these tasks at all: 70 percent, for example, say their boards don't align with the executive team on how to manage company risk. Of the tasks they do perform, only minorities of these directors say their boards are effective at any one. Ineffective boards do best at securing and assessing their

Exhibit 1

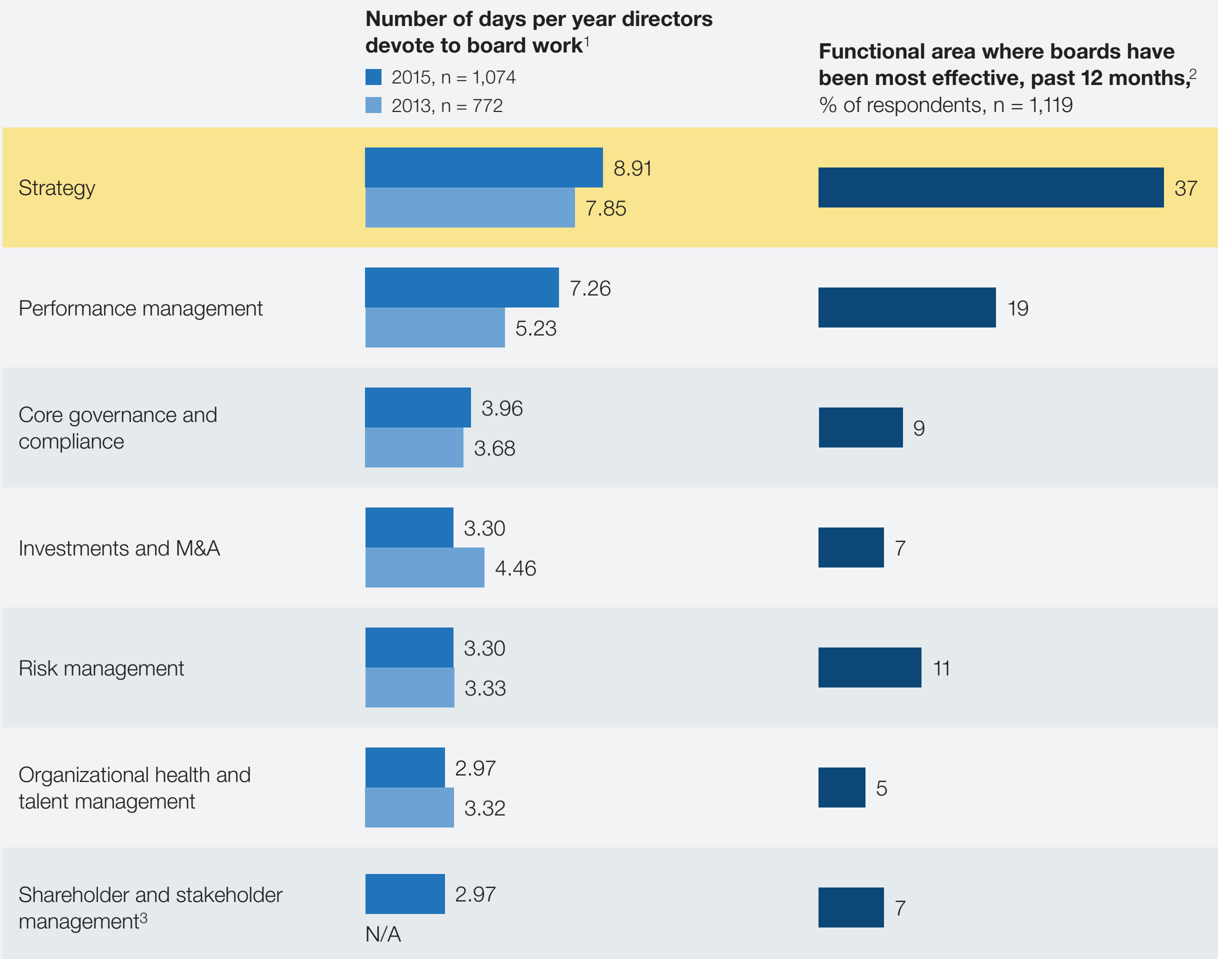
Since 2011, directors have halved the ten-day gap between actual days spent on board work and their ideal number of days.

Number of days per year directors devote to board work (including meetings, preparation, and informal contact with company)[1]



[1] Respondents who answered "don't know" are not shown.

Exhibit 2 **Directors spend more time on strategy now than in 2013—and tend to say it's where their boards make their biggest contributions.**



[1] Respondents who answered "don't know" are not shown.
[2] Respondents who answered "none" or "don't know" are not shown.
[3] Not offered as an answer choice in 2013.

management teams: 44 percent say their boards are effective at discussing top-team performance with the management team, and 42 percent say they're effective at regularly reviewing the top-talent pipeline. When it comes to how boards operate, less than half of ineffective-board directors report a culture of trust and respect in the boardroom or that directors seek out information on their own. Only 1 percent say their directors received sufficient induction training.

The complacent boards

By contrast, directors on the complacent boards have a much more favorable view of their overall contributions. Close to half say their boards have a very high impact on long-term value creation—

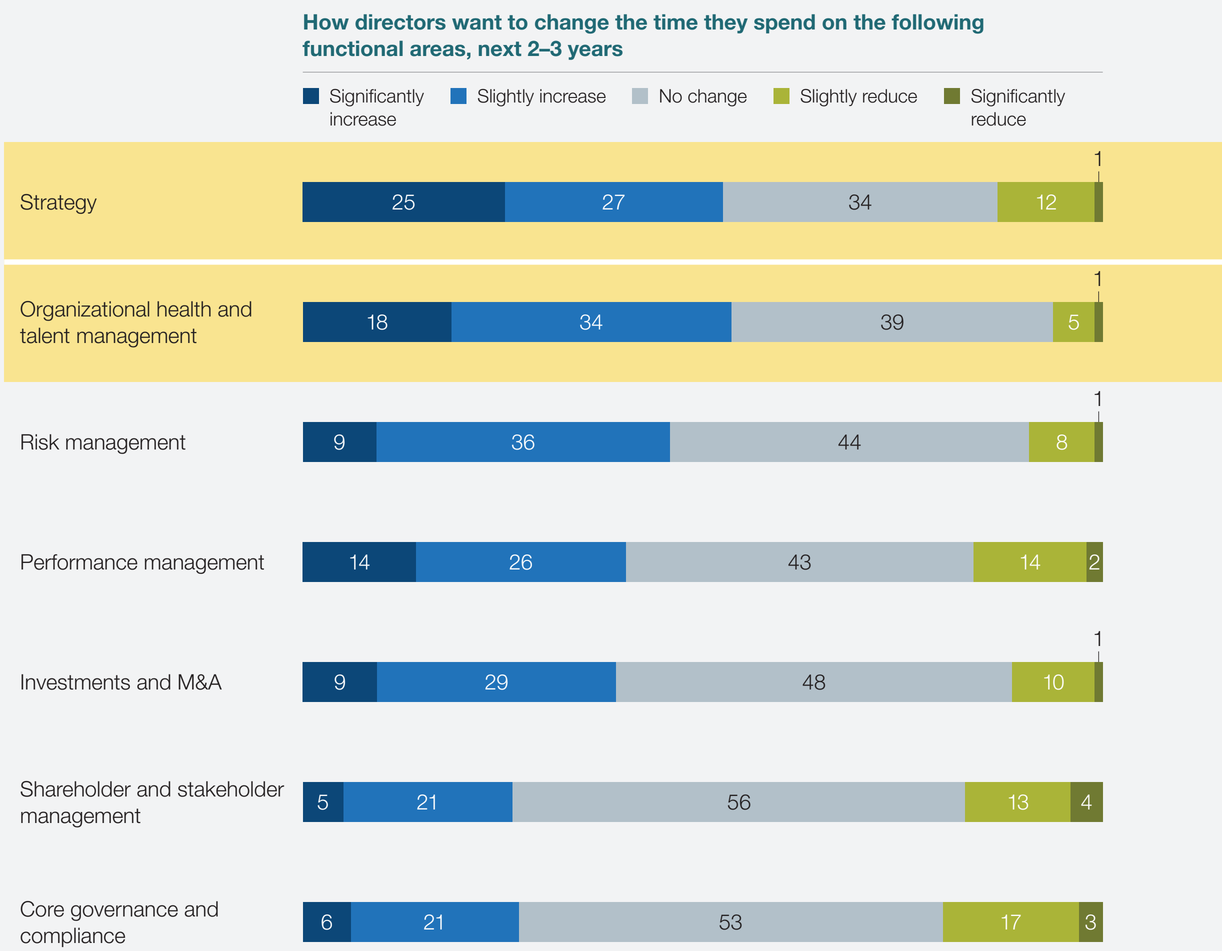
the largest share among the three types of boards. But when asked to consider their boards' execution of 37 specific tasks, there are only 3 for which a majority of respondents report effectiveness: ensuring that management reviews financial performance, setting the company's overall strategic framework, and formally approving the management team's strategy.

Organizational health and talent management is a particular weakness: just 9 percent of directors on complacent boards, for example, rate their boards as effective at ensuring the company has a viable CEO successor who can step in at any time (Exhibit 4). Compared with ineffective boards, though, these boards have a stronger sense of trust and teamwork. Two-thirds of complacent-

Exhibit 3

Over half of directors say they would like to dedicate more time to strategy and to organizational health and talent.

% of respondents,[1] n = 1,119



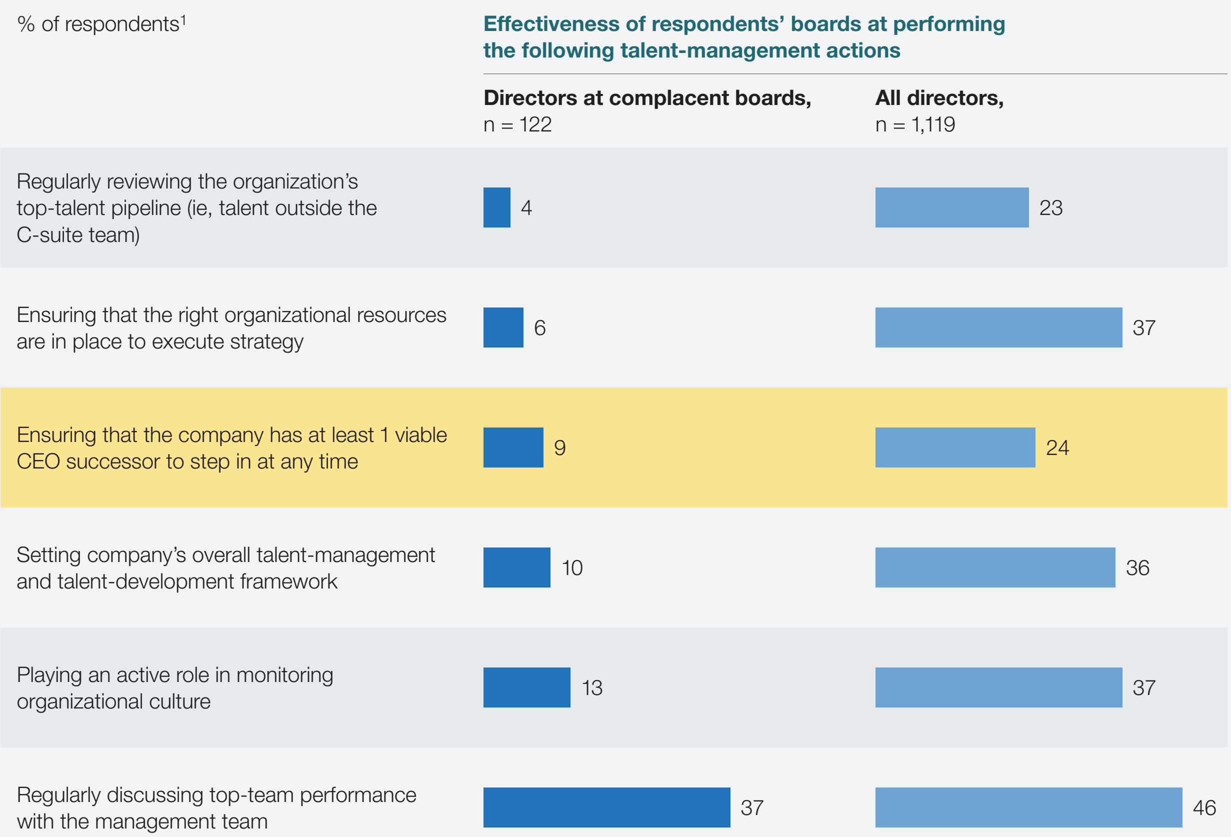
[1] Respondents who answered "don't know/not applicable" are not shown, so figures may not sum to 100%.

board directors report a culture of trust and respect, and about half say their boards spend enough time on team building. At the same time, they struggle to embrace feedback. Less than one in five say their boards regularly engage in formal evaluations, either individually or as a board, or that their chairs ask other directors for input after meetings.

The striving boards

The striving boards, then, are the most well-rounded of the bunch. Just 26 percent of these directors rate their boards' overall impact as very high, compared with 44 percent at the complacent boards. But on specific tasks, they report much greater effectiveness than their peers on every single one—and at least half of striving-board respondents say they're effective at 30 of the 37 tasks. These directors rate their boards as particularly good at strategy and performance management (Exhibit 5). For example, 69 percent of respondents on striving boards say they effectively adjust strategy on a continuous basis; only 35 percent on complacent boards and 2 percent on ineffective boards say the same.

Exhibit 4 **According to respondents, complacent boards neglect succession planning—and several other tasks to manage organizational health and talent.**



[1] Includes respondents who answered "effective" or "very effective." Those who answered "neutral," "ineffective," "very ineffective," or "not applicable; this is not an action we take" are not shown.

Exhibit 5

Across six areas of board work, the striving boards are particularly good at strategic and performance-management tasks.

[1] Includes respondents who answered "effective" or "very effective." Those who answered "neutral," "ineffective," "very ineffective," or "not applicable; this is not an action we take" are not shown.

[2] Out of 37 board actions tested in the survey, covering 6 areas of board work: strategy, performance management, investments and M&A, risk management, talent management, and shareholder and stakeholder management. Responses are arranged in descending order based on the biggest percentage-point differences between respondents at striving boards and respondents at ineffective boards.

Striving boards stand out, too, in the ways they operate (Exhibit 6). These directors report an exceptionally strong culture of trust and respect, that board members and the management team constructively challenge each other (76 percent say so, compared with 53 percent of complacent-board directors), and that chairs run meetings well. Feedback is another area that distinguishes these boards. Striving-board directors are more than twice as likely as complacent-board directors to say their boards conduct regular evaluations, and more than three times likelier to say their chairs ask for input after each meeting. That said, there's significant potential for even the striving boards to improve: only one-third of these directors say their boards regularly evaluate themselves.

Finally, directors on striving boards commit much more time to their work than others do: on average, they spend 41 days per year on board duties. The complacent-board members spend only 28 days per year—even less time than directors on ineffective boards, who report spending 32 days on board work.

Looking ahead

Spend even more time. These results indicate across-the-board increases in the time that directors spend on board work, compared with previous surveys. While directors at striving boards already spend 41 days per year and have no ambitions to spend more time, the average board member spends 33 days and says he or she would, ideally, spend 5 days more. In our experience, though, many board members are spending 50 days or more per year on board work, either due to regulatory pressure or simply owing to the fact that the time required to do a good job is usually more than directors initially expect.

Balance trust with challenging discourse. According to the results, the boards that are most effective and well rounded also have the strongest board dynamics. In a healthy boardroom, a culture of trust and respect is vital. But so is an environment where directors and company leaders challenge one another. It's no coincidence, then, that directors at striving boards report these characteristics most often. But all boards could be better at other elements of how their boards work: improving induction training, for example, and conducting regular evaluations, which only a minority of respondents report—even at the striving boards.

Appoint an ambitious chair. Another important ingredient of improved board dynamics—and an improved board—is an effective chairperson, who runs meetings well, establishes a culture

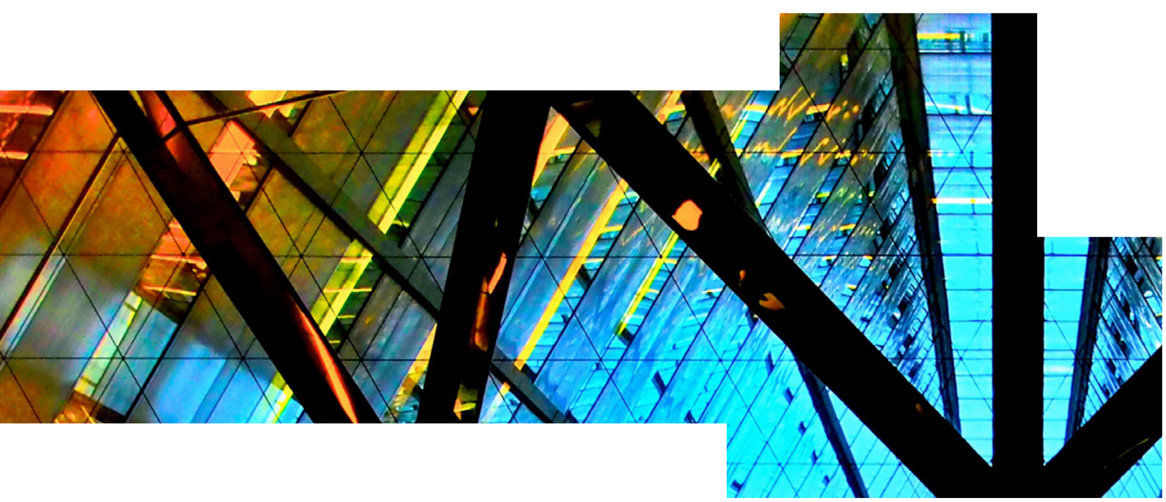
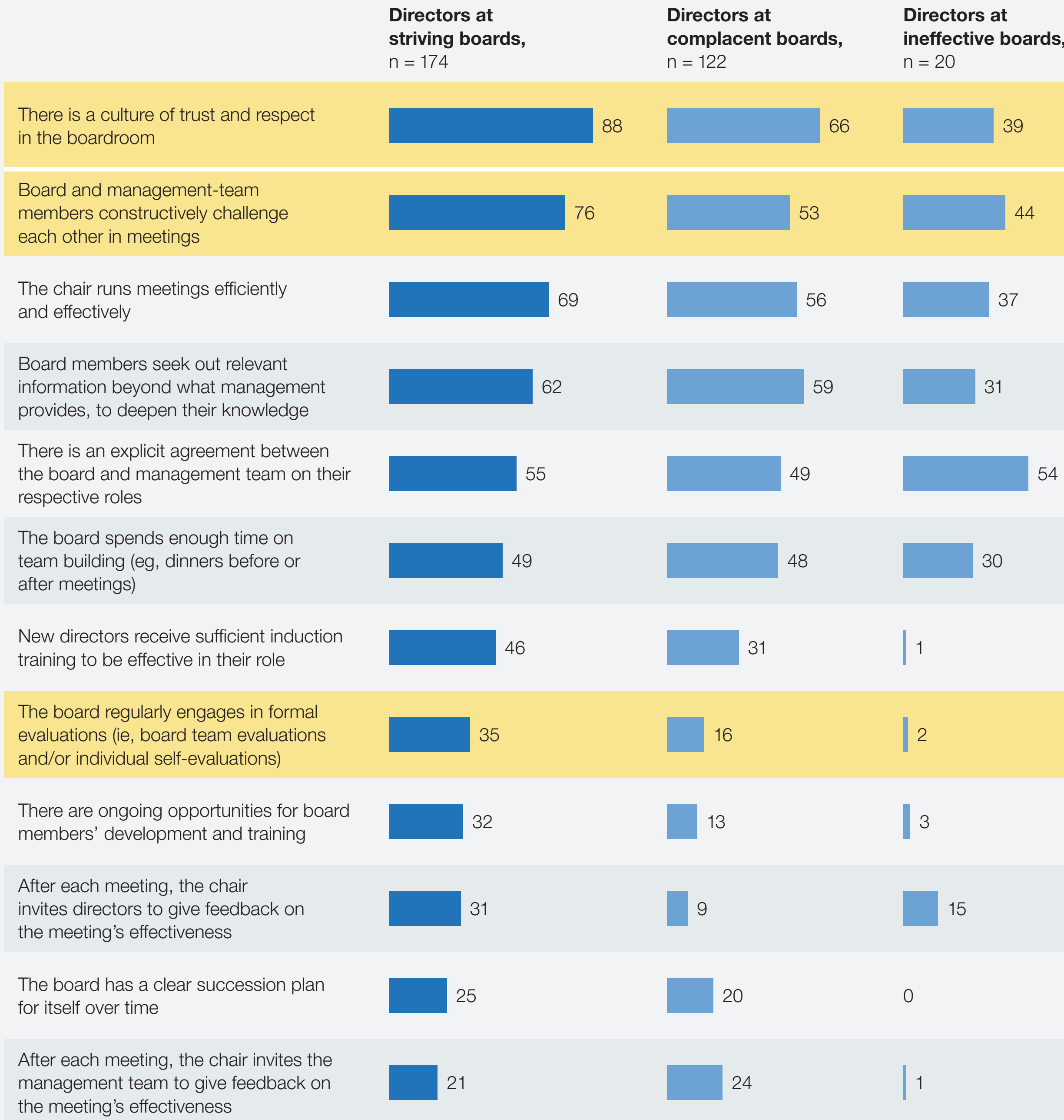


Exhibit 6 **Compared with others, the striving boards have an especially strong culture and mechanism for feedback.**

% of respondents who agree with the following statements, by type of board[1]



[1] Respondents who answered "none of the above" or "don't know" are not shown.

of trust and constructive discourse, and invests in training, development, and feedback. Good leadership sets the tone for the board as a whole and can set the stage for a more effective, value-enhancing board. ■

[1] The online survey was in the field from April 14 to April 24, 2015, and garnered responses from 1,119 board directors representing the full range of regions, industries, company sizes, and board roles; 23 percent of respondents are chairs. We asked respondents to answer all questions with respect to the single board with which they are most familiar. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

[2] This year, we asked respondents how much impact their boards' decisions and activities have had on their companies' long-term value creation; 36 percent report a very high impact. In 2013, we asked about the impact their boards had on their companies' overall financial success, and 30 percent said their impact was very high.

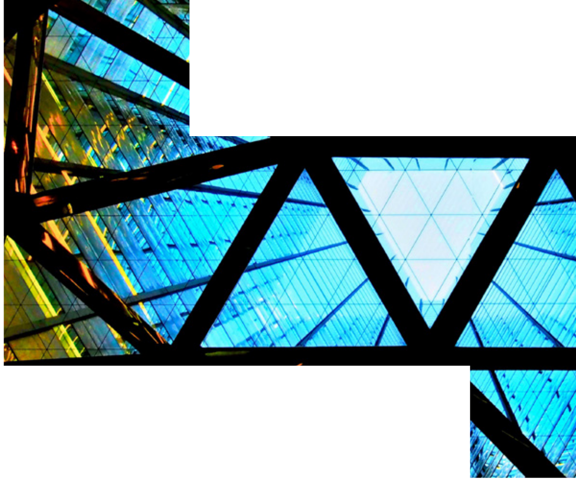
[3] We define "organizational health" as the ability to align around a clear vision, strategy, and culture; to execute with excellence; and to renew the organization's focus over time by responding to market trends. For more information on organizational health, see Scott Keller and Colin Price, "Organizational health: The ultimate competitive advantage," *McKinsey Quarterly*, June 2011, McKinsey.com; and Aaron De Smet, Bill Schaninger, and Matthew Smith, "The hidden value of organizational health—and how to capture it," *McKinsey Quarterly*, April 2014, McKinsey.com.

[4] First, we asked respondents to rate their boards' overall impact on the company's long-term value creation. Second, we asked them to rate their effectiveness on 37 board activities related to strategy, performance management, investments and M&A, risk management, organizational health and talent management, and stakeholder and shareholder management. Third, we asked which 12 aspects of board culture, information management, training, and evaluation are true of their own boards.

[5] The cluster analysis included only the responses from directors who sit on boards of private-sector companies with annual revenues of more than $100 million. Of the 316 respondents included in this analysis, 6.3 percent of respondents are directors at ineffective boards, 38.6 percent are directors at complacent boards, and 55.1 percent are directors at striving boards.

Contributors to the development and analysis of this survey include **Conor Kehoe**, a director in McKinsey's London office; **Frithjof Lund**, a principal in the Oslo office; and **Nina Spielmann**, a specialist in the Zurich office.

They would like to thank Chinta Bhagat and Martin Hirt for their contributions to this work



Changing the nature of board engagement

Five tips for directors and CEOs striving to make the most of their limited time.

Bill Huyett and Rodney Zemmel

"Ask me for anything," Napoleon Bonaparte once remarked, "but time."[1] Board members today also don't have that luxury. Directors remain under pressure from activist investors and other constituents, regulation is becoming more demanding, and businesses are growing more complex. McKinsey research suggests that the most effective directors are meeting these challenges by spending twice as many days a year on board activities as other directors do.[2]

As directors and management teams adapt, they're bumping into limits—both on the amount of time directors can be asked to spend before the role is no longer attractive and on the scope of the activities they can undertake before creating organizational noise or concerns among top executives about micromanagement. We recently discussed some of these tensions with board members and executives at Prium, a New York–based forum for CEOs.[3] The ideas that emerged, while far from definitive, provide constructive lessons for boardrooms (exhibit). If there's one overriding theme, it's that boosting effectiveness isn't just about spending more time; it's also about changing the nature of the engagement between directors and the executive teams they work with.

Engaging between meetings. Maggie Wilderotter, chairman and CEO of Frontier Communications (and a member of the boards of P&G and Xerox) stresses that "it's not just about the meetings. It's about being able to touch base in between meetings and staying current." Such impromptu discussions strengthen a board's hand on the company's pulse. Keeping board members informed also minimizes the background time that slows up regular board meetings. And the communication works both ways. "I also want board members to elevate issues that they're seeing on the horizon that we should be thinking about," explains Wilderotter. "To me, it's really more of a two-way street." Directors and executive teams will need to work out what rhythm and frequency are right for them. Denise Ramos, president and CEO of ITT, notes that "conversations with board members every week or every two weeks may be too much." For boards seeking to boost their level of engagement between meetings, experimentation and course correction when things get out of balance are likely to be necessary.

Engaging with strategy as it's forming. Strategy, especially corporate strategy, is an area where the diverse experiences and pattern-recognition skills of experienced directors enable them to add significant value. But that's only possible if they're participating early in the formation of strategy and stress-testing it along the way, as opposed to reviewing a strategy that's fully baked by executives.[4] In the description of Wilderotter, strategy needs to become "a collaborative process where different opinions can be put on the table" and "different options can be reviewed and discarded." This shifts the board's attitude from reactive to proactive and can infuse a degree of radicalism into the boardroom. Effective directors don't shy away from bold strategic questions, such as "what businesses should this company own?" and "what businesses should this company not own?" We were impressed by one board that even dared ask, "should this company continue to exist?" In fact, that board concluded that the company should not continue to exist, and effected a highly successful reorganization separating the firm into several freestanding enterprises.

Engaging on talent. Directors have long assumed responsibility for selecting and replacing CEOs, both in the normal course of business and in "hit by a bus" scenarios. Many also find it useful to track

Exhibit **Steps toward changing the nature of board engagement.**

> "Every board member does not necessarily need to have industry experience. But they must have the courage in the boardroom to ask difficult questions."

succession and promotion—for example, by holding annual reviews of a company's top 30 to 50 key executives. But to raise the bar, some boards are moving from simply observing talent to actively cultivating it. Case in point: directors who tap their networks to source new hires. Donald Gogel, the chairman and CEO of Clayton, Dubilier & Rice, explains that "our board members can operate like a highly effective search firm. There's nothing like recruiting an executive who worked for you for a long time, particularly in some functional areas where you know that he or she is both capable and a great fit." Other boards actively mentor high-performing executives, which allows those executives to draw upon the directors' experience and enables the board to evaluate in-house successors more fully.

Engaging the field. Another way to enhance board engagement is to assign directors specific operational areas to engage on. Board members can assume roles in specific company initiatives, such as cybersecurity, clean technologies, or risk—becoming not only "the board's eyes and ears," notes Eduardo Mestre, senior adviser for Evercore Partners and a board director of Comcast and Avis Budget, "but really being a very active participant in the process." Jack Krol, chairman of Delphi Automotive and former chairman and CEO of DuPont, requires board members to visit at least one business site every 12 months. At the same time, directors should be mindful not to interfere with operational teams or to supplant managers. The goal is to target specific projects that are particularly appropriate for individual directors and to encourage participating board members to be, as one director says, "collaborative, not intrusive."

Engaging on the tough questions. We noted above the value of probing difficult strategic issues, but the importance of asking uncomfortable questions extends beyond strategy sessions, to a wide range of issues. "You should have some directors—perhaps 20 percent of the board—who know the industry and can challenge any operating executive in that company on industry content," says Dennis Carey, a Korn Ferry vice chairman who has served on several boards. "But the problem is not too few people on boards who know their industries. The problem is too many people who know the industries, who are looking in the rearview mirror and assuming that what made money over the past 20 years will make money again." Michael Campbell, a former chairman, CEO, and president of Arch Chemicals, builds on this theme by adding that "every board member does not necessarily need to have industry experience. But they must have the courage in the boardroom to ask difficult questions."

Our McKinsey colleagues have noted in past articles that understanding how a company creates (and destroys) value makes it much easier to identify critical issues promptly.[5] In fact, it is worth asking whether everyone in the boardroom does indeed understand how the company and each of its divisions make money. Gogel even suggests that "boards should have at least one person who has the responsibility to think like an activist investor. Many boards are caught unaware because no director is playing that role."

As boards raise and grapple with uncomfortable questions, it's important to connect the dots between issues—perhaps by tasking one director with serving in an "integrator" role. "We get into a boardroom," Wilderotter remarked, "and everybody's a peer. But having a specific capacity to bring disparate points together is critical to keeping a board functional versus having it be dysfunctional."

■ ■ ■

Ultimately, there are no shortcuts to building and maintaining well-attuned board and executive mechanics. Each of the measures requires hard work from the board members—and, sometimes, a CEO with thick skin. But a good director will provide the extra effort, and an effective CEO will make the most of an engaged board's limited time. ■

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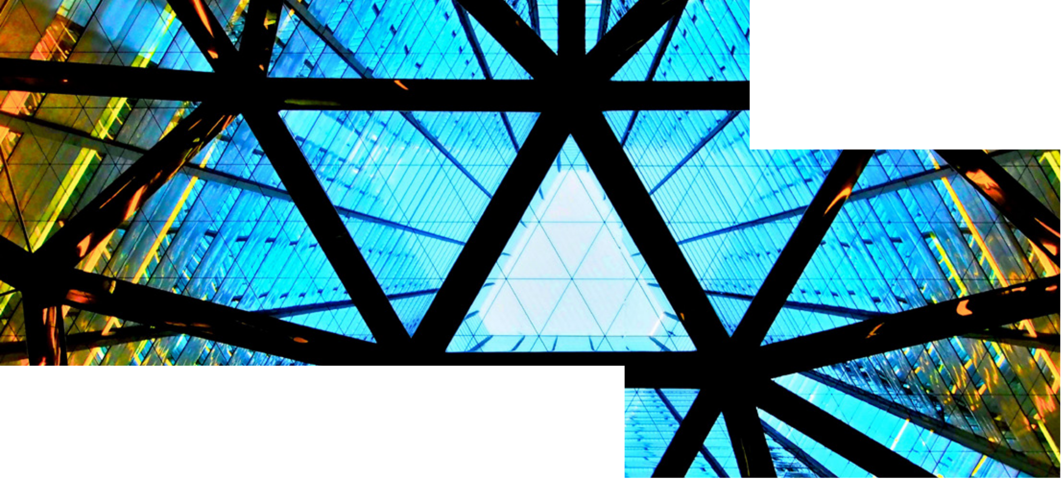
[1] See John Strawson, *If by Chance: Military Turning Points that Changed History*, London: Macmillan, 2003.
[2] See Christian Casal and Christian Caspar, "Building a forward-looking board," on page 8; Chinta Bhagat and Conor Kehoe, "High-performing boards: What's on their agenda?," on page 14; and "Improving board governance: McKinsey Global Survey results," August 2013, McKinsey.com.
[3] McKinsey is a knowledge partner with Prium.
[4] See Casal and Caspar, "Building a forward-looking board."
[5] See Chinta Bhagat, Martin Hirt, and Conor Kehoe, "Tapping the strategic potential of boards," on page 19.

Bill Huyett is a director emeritus in McKinsey's Boston office, and **Rodney Zemmel** is a director in the New York office.



Are you getting all you can from your board of directors?

Veteran director David Beatty finds many boards wanting—and considers how to improve them.

Jonathan Bailey and Tim Koller

Boards of directors have always, in all cultures, represented the shareholders in publicly traded companies—validating financial results, protecting their assets, and counseling the CEO on strategy and on finding, then nurturing, the next generation of leaders. It's a tough and demanding responsibility, requiring individual directors to learn as much as they can about a company and its operations so that their insights and advice can stand up alongside those of executives. That, at least, is the ideal.

One litmus test of whether or not the ideal is coming anywhere close to being the reality these days is the growth and involvement of activist investors. If boards were doing their jobs, there would be no activist opportunities. That's according to David Beatty, Conway Chair of the Clarkson Centre for Business Ethics and Board Effectiveness at the University of Toronto's Rotman School of Management. Apparently, they're doing "badly enough that there's been huge growth in activist firms," says Beatty, who interprets that growth "as a direct comment on boards of directors and their past performance."

He ought to know. In addition to his academic position, Beatty has served on more than 35 boards in five different jurisdictions and has been board chair at eight publicly traded companies. At the time of this interview, he served on three boards—one as chair—and was the leader of the Directors Education Program offered by the Institute of Corporate Directors. In this conversation with McKinsey's Jonathan Bailey and Tim Koller, Beatty discussed the role of corporate boards in guiding and overseeing public companies, offered recommendations for directors, and shared his thoughts on the CFO's role in working with boards.

McKinsey: *What do you see as the most important change in the way corporate boards function?*

David Beatty: Frankly, we used to be pretty lazy about boards. They were largely seen as being rewards for past service. There was an assumption that talented CEOs could move easily from their executive posts into a board setting. The boards were large and often perfunctory in the performance of their duties. I have been on the board of a large financial institution in a developing economy that had more than 50 directors, and the main event was always the lunch that followed the three-hour board meeting.

But a seat on a board is no longer a sinecure—and the day of a board comprising solely gifted amateurs is over. Partly because of external circumstances, collapses, and stock-market failures, there's a growing sense that boards have to be smaller, harder working, and more expert. And they have to be able to commit the time to do their work.

David Beatty

Vital statistics

Lives in Toronto, Canada

Married, with 4 children and 5 grandchildren

Education

Holds a master's degree in economics from Queens' College, Cambridge, United Kingdom

Has a bachelor's degree in political science in economics from Trinity College, Toronto, Canada

Career highlights

University of Toronto
(1997–present)
Professor of strategic management, Rotman School of Management

Director of the Clarkson Centre for Business Ethics and Board Effectiveness

Founded the Directors Education Program in 2004 and led the joint initiative with the Institute of Corporate Directors

Canadian Coalition for Good Governance
(2004–09)
Founding managing director of this group of more than 50 institutional investors dedicated to improving board effectiveness

Peter F. Drucker Foundation for Nonprofit Management
(1992–2000)
Vice chairman

Old Canada Investment Corporation
(1990–99)
Chairman and CEO

Weston Foods
(1985–94)
President

Fast facts

Has served as a director on the boards of 35 companies in Australia, Canada, Mexico, the United Kingdom, and the United States, and has been chairman of 8

In 2013, was awarded a Queen's Diamond Jubilee Medal for his contributions to the mining industry and received the Order of Canada Medal for his work in corporate governance

Has rowed competitively with his wife in the Fédération Internationale des Sociétés d'Aviron World Championships for many years

The last study I saw reported that directors were spending an average of around 240 hours per year across the S&P 500. That includes time spent at home studying, committee time, and board time. Today that number should be at least 50 percent greater—and if a potential director can't put in 300 to 350 hours a year, she shouldn't take the job. But even 300 hours per year has to be compared with the 3,000 hours a year that each member of a management team devotes to his or her work. And most managers these days have spent a lifetime working in their industry. Even a gifted amateur director who works hard is not likely to be able to add much value to an experienced management team about the day-to-day business.

The only place outside directors can really add value—aside from policing and oversight functions—is in offering a different perspective on the competitive environment and the changes in that environment. That's where their general business judgment comes in, helping management think through strategy and specific objectives for three to five years down the line. That's where directors have their best chance of making a difference.

McKinsey: *On average, how well are the boards of directors doing at most large public companies?*

David Beatty: Not well. Think of a long list of disgraceful performances at the beginning of this century—from Enron to WorldCom to HealthSouth to Adelphia Communications—and the recent collapse of the financial sector, which destroyed an aggregate of $1.2 trillion in shareholder value across the entire Organisation for Economic Co-operation and Development, and even of the more recent collapse of the mining sector, which has obliterated over $600 billion in shareholder value. You have to ask, "Where were the directors?"

Boards of public companies have apparently been doing badly enough that there's been huge growth in activist firms—which are in the business of studying companies deeply, putting their own money in, and then publicly advocating a better way—to the advantage of shareholders. I take that as a direct comment on the poor performance of boards of directors in publicly traded companies.

Part of the reason for this poor performance is that the boards of many companies still don't know the businesses in which they compete. Board directors are impoverished when it comes to the competitive insights they can bring that might make a difference. They're also 80 to 90 percent dependent upon management for the information they get about the business, its competitors, and alternative strategies. As a direct result, it's not uncommon for the CEO to assume control of the agenda, arrange fairly anodyne planning sessions, and be fairly closed minded about the potential value the board can add.

CFOs have a unique capability to unlock the potential of the board. The CFO knows the numbers, understands the businesses, and lives with the top-management team but does not "own" the business or businesses the way the operating managers do. The CFO is therefore in a unique position to work with and help the other members of the C-suite understand the needs of the board and to work toward making it effective.

McKinsey: *How do you see the role of the board chair?*

David Beatty: Benjamin Zander once observed that he suddenly discovered at age 45 that as conductor of the Boston Philharmonic Orchestra he was the only person on the stage who didn't make a sound. His job, he realized, was to create great things out of the individual talents that were in front of him.

That's also a really good description of the job of a board chair: to bring out the very best in the talent that is around the board table, both the directors and the managers. A board chair is responsible for bringing individuals with the right mix of talent together, utilizing their time to the greatest possible effect, and ensuring that the tone around the boardroom is open, transparent, and productive.

Talent and time are relatively easy components of a chair's task—the tough one is sensing and managing the tone of the board. Tone breaks down into two components: trust and tension. There has to be trust around the board table among the directors themselves, and there has to be trust between the board and management. At the same time, there has to be a certain tension between the board and the CEO and the CEO and his or her team, since they have different jobs to do. So the job of the chair is to make sure everyone comes together to make beautiful music.

McKinsey: *Speaking of that tension,do you think the chair and CEO should be separate roles?*

David Beatty: Yes, definitely. I can't see any excuse for the US practice. The fundamental difficulty is that the same person can't do both jobs; it's difficult for the fox to look over the henhouse. And that kind of problem can spread much deeper if a CEO fills other board positions with friends and colleagues who always agree with her or, for example, appoints her personal accountant to chair the audit committee.

The practice isn't likely to change in the United States, but there are work-arounds. A strong lead director, for example, can take control of the situation and ensure, over time, that a board is independent of management. But it's an even tougher job than normal given the dual role of the CEO and the chair.

If the lead director can't establish an effective, open, transparent, problem-solving, creative interface between the board and management and has done pretty much everything she could, then she should resign. That's what I've done in those circumstances.

McKinsey: *Short of waiting for a crisis, what should a director do if the CEO isn't up to the job?*

David Beatty: If the company is in difficulty or if doubt begins to creep in about the CEO's effectiveness, a director needs to go into a different mode—because if you've got the wrong CEO, you're out of business for three to five years. You have to begin by talking to your colleagues to see if others are also concerned. And study analyst reports carefully to see how the company is doing relative to its competition.

And talk to your chair. This is where the chair's responsibility for in-camera meetings after board sessions can be hugely important. When I was chair of the board at Inmet Mining, at the time a $6 billion company, we'd invite the CEO to stay after every board meeting—so we could ask questions without other managers around. Once the CEO left, I would canvass the board, one by one, on what

"Talent and time are relatively easy components of a chair's task—the tough one is sensing and managing the tone of the board."

worked or didn't work about the meeting, what each would like to see improved, and whether views on the CEO, if any, had changed.

McKinsey: *How long should individual directors expect to serve on a board?*

David Beatty: It's very hard to get rid of directors, so I am definitely in favor of term limits, whatever the cost. The United Kingdom has decided that in publicly traded corporations, 9 years is enough; they can extend that to 12, but from 9 years on, a director can't sit on the audit committee, the nominating committee, or the compensation committee, so her functional utility drops by about 60 percent, and typically she just leaves.

That also brings up a question of board evaluations. This is a practice that's grown up over the past decade, where boards formally sit down and appraise themselves. That can be a paper-driven appraisal, and it could be done in-house or by third-party experts.

When I'm the chair of a company, I tend to alternate between paper and personal. Every year, I sit down with each director and run through an extensive agenda of questions about the board's talent, use of time, and tone. Every second year, I supplement that with a six-page questionnaire that inquires in more detail about the functioning of the board. I then use a third party to collate those results and report to the governance committee so that any critique of the chair can be included in the results.

Peer evaluations are not very common and can often be problematic. The basic purpose is an open and honest appraisal of colleagues against certain performance standards. The peer evaluation is designed to be helpful, not harmful, to individuals. If somebody's clearly underperforming, it's the chair's job to figure that out, seek out the advice of other senior directors, and then act.

As chairman, I've asked two directors to leave major boards, and it's a miserable job. But in both instances, I felt that the benefits of having that person continue were greatly overwhelmed by the potential costs. As a chair, I no longer use peer evaluations but rely instead on continual contact with my fellow directors.

McKinsey: *Is there anything that can be done to mitigate the social stigma of being asked to leave?*

David Beatty: Next to determining that your CEO is significantly underperforming and needs to go, asking a director to step down is the toughest job there is. So, all too frequently, nothing is done.

Here, too, we may learn from activist investors. Often, one of their first demands when they get involved with underperforming companies is to replace specific members of the board. It's also not unheard of for board members to resign on their own after a testy proxy fight for control. That's kind of a disciplinary function that ought to give spine and courage to chairs of boards who are wondering about their board's performance, wondering about the performance of individual directors, and trying to find that courage to say, "On balance, we're going to be better off without this director or that, adding some new talent that we don't now have, and asking him to move along." It's not easy. But again, maybe the activists are teaching us that while it isn't easy, it might be necessary. And if you, as chair, don't do something, there's a good chance someone else will.

McKinsey: *Some companies are extremely complex. How does a board develop enough knowledge to add value in such cases?*

David Beatty: The job gets asymptotically harder the bigger the company gets. The skill sets are so demanding, the level of understanding so deep, and the diversity of the company so profound that it gets ever harder even to conceive of the board adding value through strategic insight as opposed to general business judgment.

A company such as GE, for example, is a talent machine. The board's contribution to the future lies less in the arena of business strategy and more in talent development and managerial succession. Directors see GE as an incredible university of capable people whose talents they develop. The oversight of that function, with respect to the future of the company, is intense and highly value added, versus the ability to say we should get out of credit, we should be doubling turbines, or we've got to move more deeply into China.

McKinsey: *How can a board decide whether a company is making the right trade-offs between its short-term performance and its long-term health and ability to grow?*

David Beatty: This is another topic that I would raise with the chair during in-camera meetings. Say you're coming out of a one-and-a-half-day strategy session leading to decisions on capital expenditures and a competitive way forward, and you have anxiety about the timing. So, ask in the in-camera meeting, "Did anybody else feel that these investment decisions were being shaped more from a share-price perspective over the next six months than what's in the longer- or medium-term interests of the company?" Just putting it out there as a topic for discussion can be a powerful tool.

Interestingly, family-controlled companies in Canada that are publicly owned have significantly outperformed the rest of the market. It's kind of intuitive that they would have a longer investment horizon—you don't invest in your kids' education for the next quarter. By their nature, CEOs of family-controlled businesses think longer term than the hired gun you bring in from outside to be the CEO and pay with a lot of options. The average tenure of an external CEO in the United States is around five years, and of course he or she is thinking shorter term. You get what you pay for.

Happily, most other markets in the world are family controlled, so short-termism may be an endemic disease only in the United States, the United Kingdom, and some parts of Canada. It's structured into our system, and we've fallen into the trap of measuring and compensating CEOs against "the market." Fortunately, we're now also hiring more from inside than outside—by a ratio of about 70 to 30 for the S&P. That's a huge plus because it means you don't have to go into the market to attract, retain, and motivate these gifted potential CEOs. But we're probably not going to get away from short-termism as long as we have options.

McKinsey: *What should the CFO's role be with respect to the board?*

David Beatty: I have a radical proposition: I'm a fan of the English system, where there are more executives on the board than just the CEO. And the first executive I would add to any North American board would be the CFO. That would give the CFO certain specific responsibilities with respect to his or her relationships with the audit committee, as well as with the board chair and other directors. It would also significantly enhance the quality of decision making around the board table over the medium term and empower the CFO to have an independent point of view—not necessarily in conflict with the CEO, but simply to have an honestly transmitted perspective on the company.

Where that doesn't happen, I'd encourage CFOs to think about their relationship with directors from the director's point of view—and how they can help directors do their job better. Certainly, a CFO should let the CEO know she was planning to do this, but she could reach out to directors independently and ask them what they feel about the quality of the material coming from her department. Are the numbers just too intense? Do they want more synthesis of what's going on? Would they like more in-depth analysis? The CFO has the numbers and the intelligence and understands the business without emotionally owning the business.

McKinsey: *What do you feel makes the best CFOs stand out?*

David Beatty: As a director, I like strong, independent CFOs, not those who are deferential to the CEO. I want a CFO who understands the numbers, understands what's behind them, and stands up independently. I've served on boards of companies with a CEO who had no trouble with me asking the CFO for more insight about this number or that, and the CFO himself would have no difficulty interrupting management meetings to clarify a point if it wasn't quite what he'd understood during audit-committee meetings. So I really regard a strong, independent CFO, in the handling of board matters, as offering a great deal of value. ■

Jonathan Bailey is an associate principal in McKinsey's New York office, where **Tim Koller** is a principal.

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