

In the Boardroom

WHAT BOARDS MUST GET RIGHT

As the past several years have demonstrated, when a business today faces a crisis or erosion in performance, the board's action — or inaction — is in the spotlight as never before. Stakeholders and outside observers are looking for answers, or parties to blame, and often assume a deep level of board involvement in the company and knowledge of its inner workings that may be well beyond the board's actual capacity.

But it's not just outsiders who can lack a clear view about the precise role of the board. As the board's agenda has expanded and expectations on boards have grown, directors themselves have some fundamental questions about the board's role in far-reaching, complex areas like strategy, succession planning and risk, as well as emerging areas such as the environment and corporate social responsibility. Yet rarely do boards and management teams have a frank discussion about how expectations have changed and how the board's responsibilities have or should evolve.

Boards clearly can't do everything; but what must a board do and do well? What must a board get right? In this time of growing complexity for business — when companies are expanding globally, facing more regulation and scrutiny from investors, and adapting to evolving customer expectations and technological change — boards need to spend time on the right things, carefully defining their role in several critical areas of responsibility:

- Strategy
- Building and sustaining strong company leadership
- Risk

We asked experienced directors from companies in Europe and the U.S. to discuss how expectations have changed, how boards are defining their role in these critical areas, and what boards can do to make sure they are being effective in practice.

New expectations and familiar constraints

High-profile business failures and the crisis in the global financial system have heightened the attention on the role of boards, both in a company's response to a crisis and in the decisions leading up to it. "When things go wrong in a company, it's only natural for the media, shareholders or others to look to place blame somewhere, and that may include a board in certain instances," said Linda Cook, who serves on the boards of directors of The Boeing Company and Cargill.

While it is natural and to some degree appropriate to look to the board for answers, these expectations can be at odds with reality when stakeholders or the public overestimate a board's decision-making authority and knowledge of the day-to-day operations of the company. Supervisory boards have particular limits, said Klaus Peter Müller, supervisory board chair at Commerzbank and chairman of the Government Commission of the German Corporate Governance Code. "What these criticisms tend to overlook is that, for instance, a major project is prepared by the executive board members over months, sometimes with a hundred or more people involved, while the nonexecutive board members receive information packages just two or three weeks prior to the meeting," he said. "Therefore, the supervisory board can but question and challenge, can only comprehend premises, yet it is supposed to be fully responsible for such decisions."

Boards also are limited by practical constraints. Typically with just a half dozen or so in-person meetings a year, directors have limited exposure to the company's operations and management team and, given the complexity of any large, global business, not nearly enough time to delve into the raft of issues they might like to cover. Boards in many countries already have a long and growing list of responsibilities that they are required to address, not the least of which is oversight of effective financial reporting.

"Time is a very scarce resource for a board," said Robert Lumpkins, chairman of the Mosaic Company board. "It's important that boards do those things that matter well, and not try to do everything because there isn't time to do everything."

Strategy development

Oversight of the business strategy always has been a core responsibility of the board, but, for many companies, strategic discussions have become more urgent in the past few years as threats and opportunities have become increasingly dynamic. "The world is just changing faster than it used to," said Cook. "The emergence of new competitors in a globalizing world, the economic and political shift from West to East, the competitive and business threats and opportunities arising from advancements in information technology, all of these things are coming at companies faster and more frequently than in the past. Therefore, boards need to ensure that management teams are adequately responding to these developments in a strategic manner."

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The CEO and his or her team take the lead in developing the strategy, but the board must be fully involved. "Strategy is an area where the board can be a great help, but the initiative really must come from the executives," said Jan du

Plessis, chairman of the board of Rio Tinto and a nonexecutive director for Marks and Spencer Group. The executive team should initiate the strategy process, present strategic scenarios and their pros and cons to the board, and draw on the experience and judgment of the nonexecutive directors for their views about the strategy. “But the nonexecutives cannot and should not drive the process. The executives must drive the process, but at the same time be open-minded enough to respond to directional guidance from the nonexecutive directors,” he said.

While the board does not propose the strategy, it does have the right to challenge the assumptions on which management is basing its strategic plan and evaluate the soundness of the strategy. “The role of the board is to review and discuss the strategy proposed by the management and to check its validity and its strengths and then to either approve it, amend it or reject it. It is not the board’s role to propose the strategy, but it should be strong and competent enough to conduct a robust discussion on it and independently make its own judgment,” said Patricia Barbizet, vice chairman of PPR, chairman of Christie’s International and board member of Air France-KLM, Total and Bouygues.

Furthermore, while management should be taking the lead on strategy development, there may be times when a board needs to be more assertive. “When an organization is functioning well and is forward thinking, then it is the role of the board to approve management’s strategies, which management develops through a collaborative process with the board,” said Scott Carson, professor of strategy, Queen’s School of Business, and chair of the corporate governance and conduct review committee of The Economical Insurance Group. “However, not all companies are strategic and performing well. In some situations, the board must force management to do the planning. In a circumstance like that, the board becomes far more active in the strategic planning.”

CEO succession and talent management

CEO succession planning and selecting a new CEO are unquestionably board responsibilities, but how hands-on do directors need to be to make sure that the company is developing capable leaders with the skill-sets that will be needed in a future CEO? Beyond the CEO, what should the board be doing more broadly to ensure that the company is developing strong leaders?

The board should be deeply involved in succession planning for the CEO role. CEO selection is arguably the most fundamental board decision, and it is a responsibility that cannot be delegated. Directors argued in favor of a multi-tiered approach enabling the board to identify the skills that will be required in the next CEO, get to know potential candidates and evaluate their developmental needs and the plans to address them.

Boards like to see potential CEO candidates in action, both in formal settings, such as presenting to the board, and in more casual environments. “It’s important that we get to see them outside of the boardroom with their teams or with customers, to see how they interact and how other people react to them. Also, it is helpful to get to know them a bit personally by having dinner with them to begin to understand what’s driving them, what their passions are, and what their aspirations are,” said Cook.

In boards that function well, the CEO tends to take a back seat during succession planning discussions, said Cees van Lede, chairman of the supervisory board of Heineken, a member of the Philips Electronics supervisory board and a nonexecutive director for Air France-KLM, L’Air Liquide and Sara Lee Corporation. “If it’s really done well, the CEO makes his or her point of view known to the nonexecutive board members and then sort of withdraws and leaves it to the board, because in succession you may wish as a board really to change the nature of the job and have a completely different individual.”

While less agreement exists among directors about how involved the board should be in influencing talent decisions further down in the executive team, directors said the board should be sure that the CEO has a strong team and that the

organization has an effective succession planning process in place for other key roles. “The top priority needs to be the CEO, although enough time needs to be set aside for the four or five other key people involved in the leadership of the company,” said du Plessis. “In some ways, the nonexecutive directors are better equipped than any of the executives to judge the qualities of the rest of the leadership team because they have a healthy degree of detachment.”

Many boards monitor the succession planning for the top 10 or 12 positions in the company, making sure development plans are in place for these executives, that they are given challenging assignments or new roles, and that they gain exposure to the nonexecutive directors, for example, by presenting during strategy meetings. So important is the management team to the success of the company, Müller meets with each of the top 60 global executives in his capacity as supervisory board chairman, and provides for other board members to meet them as well by arranging for six or seven members of the top executive level to have dinner with the supervisory board prior to the board meeting.

“In this way, the supervisory board gradually meets all upper management members and can form an opinion,” Müller said.

Risk oversight

Risk management is an area where expectations on boards have changed dramatically, and boards’ approach has evolved to become more in-depth, broader in scope and influenced by real-life scenarios. In the past, boards, led by the audit committee, tended to focus on financial risk. Today, risk is defined more broadly, encompassing not just financial matters, but also areas such as health and safety, the environment, information technology and security, industrial relations and corporate reputation.

“Boards have seen really big risks materialize all over the world during the past few years. As a result, the discussion covers a broader set of risks, and the scenarios we use to test management’s assumptions are much wider in scope. Things have happened — the credit crisis or the oil spill in the Gulf of Mexico, for example — that boards never thought about in the past. That’s been helpful for boards because it has given them the credibility to ask ‘what if’ questions that might have been considered irrelevant previously,” said Cook.

Boards should determine whether they have the optimal structure for overseeing risk, including whether there is a clear delineation of risk management responsibilities between the board and the executive team and the extent to which the board will focus on the big themes or the processes that the management will execute. “At a minimum, the board has to exercise a marginal judgment as to whether the areas that the management has identified as high risk are indeed the right ones. That’s No. 1. Secondly, you have to make sure that once these risks are identified, there is a system within the company that follows these risks or reports on them, and that if areas need attention that attention is properly given,” said van Lede.

Boards should spend most of their limited time on the risks that could have a major impact on the company — the “bears and not the rodents,” but also monitor a wider range of potential risks to ensure risk-taking stays within the agreed-upon risk appetite for the company, said Lumpkins.

Again, though, it is up to management to execute risk management policies and procedures, said du Plessis. “The job of the board is to appraise the overall quality of risk management and the assumptions, set the terms and influence the culture. It is very much for the executives, at the end of the day, to monitor the actual risks,” he said. “It is the executives

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who have responsibility for individual risks. The nonexecutives need to set the framework and see that it is adhered to. Most boards in recent years have become much better at risk management. However, shareholders often do not realize that it is not appropriate for nonexecutives to be involved in the actual execution of risk management.”

Tools for a more effective board

With so many demands on them, how can boards make sure that they perform well in these three critical areas of board responsibility? Boards that contribute at a high level in shaping company strategy, developing and selecting strong leaders, and appropriately balancing the company’s risks tend to have the following characteristics.

Have the right people on the board. Boards can add value through the collective judgment of members — resulting from a robust discussion of issues — and from the deep expertise a single director has on a specific topic. Particularly in the areas of strategy and risk, this diversity of perspectives is valuable. No one director has all the skills and experience needed for the range of governance and strategic issues the board handles, but a well-represented board can be helpful in thoroughly examining the range of potential issues and obstacles.

Therefore, boards should consider whether they have the right representation of expertise in strategically important areas, or whether there are emerging issues where additional skills would be valuable to add. Boards should include directors with a range of different perspectives and skills, but also individuals with a deep understanding of the business, including the history, the marketplace, competitive landscape and the drivers of success. Where there are gaps, the board can use vacancies to add needed skills.

Beyond having the right expertise, boards need directors who are able to devote sufficient time to board activities, as serving on a board today takes much more time than in the past. That may mean that directors will have to re-evaluate their board commitments to ensure that they limit their board memberships only to those where they can actively contribute in the key areas of board responsibility. In fact, the regulatory bodies in some countries and some boards already have acknowledged the risk of overcommitted directors by restricting the number of boards on which nonexecutive directors may serve.

Manage the board’s time well. Boards are most effective when they are well prepared and structure directors’ limited time together to focus as much as possible on the most valuable board activities, including strategy, risk and succession planning. With so much on the board’s plate, board and committee chairs must be diligent about running meetings efficiently and focusing on priorities spelled out in their charters. Materials should be distributed well in advance and presented in the most useful format so directors have ample time for review and can use meeting time for unscripted discussion about critical issues. Board and committee chairs also should continually review whether meeting time is being used appropriately.

Conduct a regular board effectiveness assessment. Regular board assessments provide boards with an opportunity to identify and remove obstacles to better performance and to highlight what works well. They can cover a wide range of topics, including board composition and organization, board processes, roles and responsibilities, communication, boardroom dynamics, the relationship between the board and management, and the quality of boardroom discussion. Importantly, board assessments provide a platform for ensuring that the board and CEO are in agreement about their respective roles and responsibilities.

“A board review is extremely important. A critical analysis of the supervisory board’s efforts enables the supervisory board chair to recognize in time where action should be taken and to align the board concerning its activities or its members,” said Müller.

With so many disparate views about what boards can and should be doing, ensuring that there is alignment between the expectations of the CEO and board — and even among directors themselves — about the role that the board should play in strategic decision-making, succession planning and risk management is essential to improving board performance and focus.

Who we interviewed

Patricia Barbizet, vice chairman of PPR, chairman of Christie's International and board member of Air France-KLM, Total and Bouygues.

Scott Carson, professor of strategy, Queen's School of Business, and chair of the corporate governance and conduct review committee for The Economical Insurance Group

Linda Cook, board director for The Boeing Company and Cargill

Jan du Plessis, chairman of the board of Rio Tinto and a nonexecutive director of Marks and Spencer Group

Robert Lumpkins, chairman of the board of the Mosaic Company

Klaus Peter Müller, supervisory board chair at Commerzbank and chairman of the Government Commission of the German Corporate Governance Code

Cees van Lede, chairman of the supervisory board of Heineken, a member of the Philips Electronics supervisory board and a nonexecutive director for Air France-KLM, L'Air Liquide and Sara Lee Corporation

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