INTRABOND CAPITAL

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Engaging the Board of Directors on Strategy

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Sir Adrian Cadbury provided a succinct description of the forces in play at the top levels of an enterprise: "The basic governance issues are those of power and accountability." [i] Nowhere are the issues of power and accountability more clearly in evidence than in the working out of a strategy for an organization. A firm's strategy determines the course it will try to pursue over several years; strategy guides the allocation of resources... financial, physical, and human. And strategy often determines how well or poorly a company fares and what its return to shareholders will be. Clearly, strategy must be a subject that engages the interests of all the members of a firm's strategic apex—top management and the board of directors and, of course, the pivot point between the board and management, the Chief Executive Officer.

Over the last several years, many boards sought a more substantial role for directors in the strategy-setting process. This quest has been enhanced by Great Britain's Committee on the Financial Aspects of Corporate Governance, the Conference Board in the United States, and notably or notoriously since 2002, the US Sarbanes-Oxley legislation. The implications and repercussions of this trend will likely endure for years to come. How then can boards, Chairmen, CEOs, and top managers forge an effective way to engage directors on strategy?

During our years in industry and recently in our consulting endeavors, we have worked with top managers, CEOs, Chairmen, and boards on a wide range of governance issues. In particular, our work has focused on helping organizations build more effective boards. During this work, we've been asked over and over (in one way or another) how the board of directors can *effectively* engage its members on strategy. Often the question came as the serious counterpoint to a humorous incident or anecdote. One Silicon Valley CEO told me, "Left to their own devices, my directors will try to design new products on a napkin. How can I get them to focus on strategy?" The Chairman of a large Midwestern firm said, "We're always straying off into the weeds. How can we keep our discussions strategic?" Another CEO at a $1 billion technology firm groaned that "these guys want me to make a major acquisition; how can I get them to see that it doesn't fit the strategy we mapped out and agreed on eight months ago?" These are just three recent quotes from clients, all deeply experienced business leaders with years of work as Chairmen or CEOs. From working with our clients on this problem, we've developed a five point process for effectively engaging a board of directors on strategy.

One...Map Out a Strategy Agenda with the Board

Boards of Directors are at best episodic teams. Most directors have a myriad of other responsibilities as do Chairmen, CEOs, and the top corporate managers engaged in strategy work. A key beginning point is for the CEO to work out, in collaboration with the Chairman and other directors, a year-long agenda of strategy topics for board meetings. Everyone agrees that strategy work is an iterative process, not a big bang event. Yet, often we treat it as though it were an event by scheduling the board's strategy meeting or making strategy the key agenda item at the annual board retreat. Absent a rich context, directors are hard pressed to contribute effectively. Not infrequently, their contributions are destructive. That's why it is important to have a year-long agenda of strategy topics with the board. It might look something like this:

1st Meeting of the Year	Changing Competitive Environment
2nd Meeting of the Year	Strategic Investments: People, Plant, Equipment
3rd Meeting of the Year	Review Achievements against Strategic Plan
4th Meeting of the Year	Corporate Development... M&A Activities to Support the Strategy
5th Meeting of the Year	Annual Board Retreat & Strategic Planning Workshop
6th Meeting of the Year	Actions Individual Directors Can Take to Support the Strategy

In developing the board's strategic agenda, the Chairman and CEO will want to collaborate closely. One or both of them should speak one-on-one with each of the other directors soliciting their views and concerns. (Whenever a CEO, Chairman, or director is new to their role, these one-on-one conversations provide an opportunity to discover the expertise of each other.) Often in the course of such conversations, business leaders discover that many difficulties in strategy deliberations stem from the lack of a common vocabulary.

Mapping out the strategy process the board will follow removes the mystery ("Who came up with that idea?"), provides time for thought, reflection, dialogue, and iteration ("After the last meeting it occurred to me that Bob Smith is a real expert on that market you want to enter. I'd be happy to provide an introduction if you want to speak with him."), and allows management to make meaningful use of directors' expertise and knowledge ("John, you were involved in China manufacturing at XYZ; what are the downsides you see in our strategy for entering the Chinese market?").

The board's strategy work will clearly need to be tailored to the firm's maturity and development. In early stage companies, the board will need to be deeply involved in strategy formulation and provide frequent detailed guidance and support. Early stage companies rely on board members for knowledge, skills and abilities that a newly formed (and frequently inexperienced) management team does not yet possess. Crisis situations can also thrust the board into detailed strategy formulation (or reformulation). The unexpected departure of a CEO or a disruptive technological change are just two of the events that can trigger actual board leadership of the strategy setting process. Company successes will from time to time also present junctures at which the board will need to be more hands-on in strategy formulation. When a firm moves from single product or single market to a broader array of offerings or involvement in multiple markets, board members often need to bring their experiences to bear to guide a management team new to the increased complexity. Conversely, as companies succeed and become more complex, the board may need to recruit directors who have experience with this complexity. Companies with a portfolio of businesses (e.g., General Electric) must of necessity view strategy in a fairly abstract way at the board level. Directors at a more focused enterprise (even a giant one like ExxonMobil) may be familiar with and contribute to a much more granular view of strategy. The constant challenge for CEOs and directors remains…to align the needs of the business with the strategy formulation and development processes...to map out the best possible strategy agenda for the board given the specific circumstances of the firm.

Two...Describe Your Strategic-Planning Process

Not infrequently, organizations run two separate strategy processes. One involves management; the second the board of directors. The intersection of these separate processes is often a presentation to the board of the results of management's work. One Dallas-based organization, after three years of increasingly contentious debate between the CEO and the board, opened a board meeting with a detailed explanation of how management performed its strategic-planning work. The talk covered the *how*, not *what*. The CEO and the Vice President responsible for Strategic Planning laid out all of the work streams that were brought together to make the strategy. As the Strategy VP (who possessed deep technical expertise in planning but was new to the organization) described the process, the CEO added anecdotes about changes made over the years to improve the process and the reasons for those changes. This exposition gave the directors the *how* and *why* of management's work on strategy. Once the directors saw that management's process was, indeed, robust, their questions shifted markedly from challenging management's conclusions to dialogue that extended management's thinking. And, in a surprise to both management and the board, the directors' involvement led to a more aggressive and slightly more leveraged strategy. Accustomed to pushback, management had become too conservative.

During another CEO's description of management's strategy-setting process, the Chairman asked questions of the board to encourage dialogue as well as gauge the board's level of concurrence. At the end of the presentation, he asked the directors individually to describe their reaction to the strategy. All understood, most agreed, almost all raised questions. By the end of the discussion, the board and the CEO shared an understanding of the work the CEO and his team were doing to develop strategy. The Chairman's questions ensured that everyone spoke up on their views regarding the process management was following. A few suggestions were incorporated into the process. Most importantly, though, the board gained confidence that management was in fact diligent in its strategy-setting work.

A number of CEOs supplement these board-meeting presentations with phone calls to individual directors based on each director's interests and expertise. L. J. Seven, the famed founder of Seven Rosen and CEO of Mostek, regularly drew out individual directors with his understated request, “Tell me that again; I don’t get it.” It was his way of seeking both understanding and agreement through dialogue with the director. Other CEOs use monthly letters to their board members providing the CEO’s perspective on a number of issues – some strategic, some tactical. Michael Ullman, CEO of J. C. Penney Company, composes a weekly, Sunday morning e-mail to keep his directors in the loop on strategy and execution. Whatever the method, CEOs with strong, positive board relationships keep their directors engaged in dialogue about strategy. It’s a process, not an event.

Three...Emphasize the External Environment & Competitive Pressures

Author William Miller hits on a CEO’s dilemma when deciding how much information to provide the board of directors about strategy: “God forbid one of them should start thinking deeply about this stuff and expose the limits of my knowledge.”[ii] At the heart of strategy for any reasonably complex business is our often unvoiced fear that we really don’t know as much as we let others believe we do. In presenting strategy to the board, CEOs often rely on the internal view: our products, revenues, growth, plans, etc. Less is heard of the marketplace, competition, technology, etc. The danger of this approach is subtle. Given nothing but the inwardly focused view, directors’ questions tend strongly toward the inward looking plans and assumptions. From management’s perspective, such questions then seem more like intrusions into the realm of management or attacks on management’s conclusions. Either way, it makes for uncomfortable discussions.

Chairmen and CEOs who have forged an effective and collaborative path with their boards of directors focus considerable attention and board time on looking outward. The CEO of a highly successful Silicon Valley company moved his board's perspective considerably over a period of several years. When he first joined the firm, he described the board by saying, "They are each brilliant when it comes to technology but they don't know a thing about what general managers do. I really don't need their help with this." Realizing this was a risky approach for a new CEO, he began changing the board's role in corporate strategy by focusing on the company's markets. Over the course of a few board meetings, the CEO and a handful of key executives briefed the board on markets, customers, distribution channels, etc. He followed with briefings on key competitors and invitations to directors to visit key customers and suppliers along with members of his senior team. Then and only then did he bring the agenda around to technology again. As a next step, he scheduled an hour with the board to lay out the options and alternatives management had considered during its strategic-planning work. After more than a year of careful work, the CEO noted that board discussions of strategy were moving from challenge and skepticism to collaboration and contribution.

Four...Be Clear About the Required Resources

Typically, directors deal pretty well with financial matters. Unfortunately, CEOs and their key executives fail to take advantage of the board's financial acumen in strategy discussions. Clarity around the resources required to execute a strategy helps the board have confidence in management and helps management develop the discipline to actually execute its strategy. Clayton Christensen of the Harvard Business School has written persuasively about the extent to which corporate resources are allocated more by the demands of current customers than by the official strategy.[iii] Henry Mintzberg has also described how *emergent* strategies, what companies actually do, differ from their *intended* strategies, what they presented to the board of directors.[iv] Specifying the resources required for a strategy and where and how management plans to come by these resources provides an opportunity for real collaboration between the board and top management.

Resource-requirement discussions should include three areas:

- financial resources
- leadership and organizational resources
- technological competency

Outlining the financial resources required to implement strategic initiatives, when done well, provides the board with convincing evidence that management has not confused strategy with hope, that management's plans are realistic and achievable in ways that enhance shareholder wealth. Detailed financial and analytical plans provide a foundation for, or first level of, board confidence.

The second level of board confidence can be built by outlining the organizational and leadership capabilities required to implement strategies. Writing in *McKinsey Quarterly*, Tsun-yan Hsieh and Sara Yik noted that "Few companies recognize the leadership capacity that new strategies will require. This oversight condemns many such endeavors to disappointment."[v] Historically, CEOs have stayed away from discussing organization and people issues with their boards, preferring the hard stuff of finance, marketing, and operations to the soft stuff of organizational development and leadership. Directors often agreed with the strategic thrust outlined by management but their intuition, built up through years of experience, told them the company lacked the organizational resources to successfully execute their plans. Frequently, the directors would not articulate their real skepticism, preferring instead to focus on picking at financial or marketing aspects of the strategy. When the board's involvement in the strategic process includes discussion of leadership and organizational resources, their concerns and insights can be put on the table clearly and objectively.

Recently, as senior leaders and directors have learned the hard way, organizational and leadership issues must be faced. Hseih and Yik state it succinctly, "When it comes time to implement a strategy, many companies find themselves stymied at the point of execution."[vi] Boards begin to devote time to succession planning with a generally narrow focus on CEO succession. Next, CEOs and boards look carefully at the top-management team. Now, boards are beginning to link organizational and leadership capabilities with strategy. A two-stage approach works best here.

First, brief the board on your current organizational resources and capabilities.

- Be candid about how your people stack up in the marketplace.
- Describe how your structure fits your strategy.

- Demonstrate how the company’s culture and *esprit de corps* make the achievement of your strategic goals possible.
- Show how your human-resource systems (goal-setting and performance management, recognition, compensation, etc.) support your strategy.

Many strategies have stalled or failed because of undetected weaknesses in the organization. New products fall flat in the hands of a second rate sales force. Other strategies for growth and expansion fail to meet profit targets because Operations couldn’t bring the new factory on line within the timeframe of market opportunity. Other strategic initiatives fail because the executive responsible for them was overstretched to handle his existing portfolio and the new initiative as well. Many CEOs have been bushwhacked when morale in the field and factories was far lower than in the headquarters planning staff.

Secondly, think through and present to the board the changes the organization will need to undergo as your strategy is implemented. What talent must be recruited? What training will be needed? What reward systems will be altered? How will you produce the leaders needed for new products, markets, geographical regions? Presenting the board with well developed plans for meeting the organizational, leadership, and talent requirements of the strategy will often stretch a management team in new ways. As the CEO and his strategy team assess the structure and systems requirements of a strategy, they develop not only a fuller appreciation for the challenges ahead, but also new ways in which to involve the board. The realistic assessment of current leadership and talent can lead to productive changes in recruiting and training. New strategies often benefit as well from a thorough review of the company's performance management, recognition, and reward systems. Culture and employee satisfaction may need to find their way into the board's deliberations on strategy. When directors know that managers have realistically assessed their human capital, they feel more confident in the firm's ability to execute what it has planned.

Five...Know the Warning Signs of Trouble & Tell the Board

The third leg of the stool in assessing the resources required to implement a strategy falls into the area of risk assessment. What would the impact of failure be? Are we betting the business? Or, would failure mean only a year with little or no profit? Military leaders are schooled from the beginning of their careers to plan for every contingency they can think of. When Eisenhower was asked after World War II for the secret of his success, he replied, "Because I planned right up to the very last minute as though defeat were possible."

Part of contingency planning is knowing the early warning signs that a strategic initiative is falling short. Perhaps sales are below expectations. Regulatory approvals may be behind schedule. Hiring plans may not be met. When management thinks through the right warning signs and presents them to the board with the assurance that they will be measured, the board can feel a greater degree of comfort in backing management even on risky ventures.

Another critical aspect of risk management is carefully assessing whether the strategic thrusts are within the firm's technological capabilities and know-how. Can manufacturing build what engineering designs? Does the product roadmap push the company to the bleeding edge of a technology and is management prepared to live on the bleeding edge? Can information systems be implemented and integrated so that products or services can be ordered and delivered? The CEO needs to insure that his management team provides the board with the evidence behind management's confidence in the organization's capability to execute the planned strategies.

Warning Signs for the Board Itself

Most boards of directors follow some form of self assessment and evaluation. An excellent way to insure that the board's strategy deliberations are effective and efficient is to incorporate an evaluation of the board's contribution on strategy in their annual self evaluation. Often this will begin with a conversation at a board meeting about "How are we doing on strategy?" Open dialogue in both regular and executive sessions of the board can, and frequently do, lead to richer board involvement and contribution to the firm's strategy and strategic planning processes and to the identification of barriers to strategy implementation. Evaluation of board involvement is best when confined to qualitative measures: do we have the information we need…are we devoting the right amount of our time to strategy…are we integrating our strategy deliberations with our consideration of succession planning and capital allocation decisions effectively? If the answers indicate areas for improvement, the board and the CEO can refine their strategy setting agenda. This process of regular evaluation and change can create a virtuous cycle in which the board and CEO continuously improve their strategy formulation capabilities. A word of caution about measures of board effectiveness and strategy though; the board should not use measures of strategy execution in evaluating its performance. These measures belong with management.

Resolving Conflict

The five-step approach outlined here helps directors engage effectively in corporate strategy. These practices in fact grew out of working with organizations where there was conflict over strategy or a lack of understanding of it or both. Conflicts frequently arise in the management ranks as resources are allocated and plans made. And conflicts over strategy between management and the board remain possible even after devoting much hard work to engaging the board systematically. So resolving conflict should become part of a firm's strategy-setting process.

When conflicts do arise, how can they be successfully resolved within the confines of the board of directors? From our experiences with a number of clients, here are some practices that lead to success:

- Asses the size and scope of the disagreement. Learn to live with some small disagreements and let the market be the arbiter.
- Go back to the facts. Is the disagreement about the veracity of the facts themselves or the conclusions and plans drawn from them? Focus on where the real disagreement is, not on any smokescreen issues.
- Bring all directors into the discussion about the disagreement. The Chairman can play an important role here in drawing out the views of each director. This can

prevent an unproductive confrontation between the CEO and one or two directors. Often the views of other directors will soften or dispel conflicts.

- If the conflict is on a crucial issue, make it an agenda item for the next board meeting so that everyone has an opportunity to give some reflected thought to the issue and research can be done to fill in any gaps in evidence.
- Finally, if the CEO is doing a good job, don't go to war on an issue. Remember the CEO has the responsibility to lead the company. Ask him to report in the future on how the area in conflict is going.

Conclusion

In the day-to-day life of boards of directors, when the company is executing against its strategic plan, all is well. If it is not executing well, the next strategy session with the board will be tense. If the company is still not executing against the strategy by the next session with the board, then the board will probably be thinking about its most important task, selecting a new CEO. Indeed, a 2005 McKinsey & Company study, which surveyed over 1,000 corporate directors, found that alignment on strategy between the CEO and the board was the #1 reason for success and the #1 reason for failure in CEO appointments.[vii]

The ideas developed here rest firmly on the premise that the strategic work of an organization—the delineation of a future direction, the commitment to that direction, and the execution of the work needed to achieve the goals of a strategy—is clearly a process that involves the whole of management. There should also be a process for appropriately engaging the board of directors in strategy. When the CEO thinks through this process and engages the directors, the board and the CEO can enter into a dialogue that leads to collaboration and a greater chance of achieving the goals of the organization.

[i] Adrian Cadbury, *Corporate Governance and Chairmanship* (Oxford: Oxford University Press, 2002), p. 3.

[ii] William Ian Miller, *Faking It* (Cambridge: Cambridge University Press, 2003), p. 1.

[iii] Clayton M. Christensen, *The Innovator's Dilemma* (Boston: Harvard Business School Press, 1997), p. 101-103.

[iv] Henry Mintzberg, *The Rise and Fall of Strategic Planning: Reconceiving Roles for Planning, Plans, Planners* (New York: The Free Press, 1994), p. 23-25.

[v] Tsun-yan Hsieh and Sara Yik (Hsieh & Yik), Leadership as the starting point of strategy. *The McKinsey Quarterly* 2005, number 1, p. 67.

[vi] Hsieh & Yik, p. 67.

[vii] Robert F. Felton and Pamela Keenan Fritz. The view from the boardroom [Electronic version]. *The McKinsey Quarterly*, 2005 Special Edition, p. 1-9.