Crossing the Line –
LEADING PRACTICES AND PITFALLS IN THE BOARDROOM

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Companies everywhere around the globe can prosper from an effectively functioning board of directors. Not only can a strong board bring much-needed skills and expertise, but it also offers an independent point of view that supports the chief executive in formulating and executing strategy in a rapidly changing global market place. In addition, a chief executive who works with, and is held accountable by, a board consisting of a majority of truly independent directors in both fact and appearance presents a credible governance structure to shareholders and other external stakeholders.

This article explores how a board contributes value to advancing an organization's journey toward achieving its mission and vision. Specifically, it explores some of the keys to board effectiveness and some causes of dysfunctional boards, and offers some leading practices when evaluating boards.

Board/Management Engagement

The process by which directors oversee the organization must foster effective communication, mutual trust and understanding between directors and the CEO, executive management and other key stakeholders. Constructive engagement encourages best practices in the way boards operate and seeks a healthy balance in the dialogue between the board and management.

To illustrate, in a single-tier board structure, such as we have in the United States, management typically sets strategy and policy, executes the business plan and reports on results and stewardship. The board oversees these managerial activities, but in doing so, board members should rarely cross the line over to where executive management is doing its job. The key is to balance the role of advising and counseling management with the fiduciary role of monitoring and overseeing management's exercise of its stewardship responsibility.

Fundamentally, this balance means that board members should know what's going on in the business and in the markets in which the organization competes, and should understand the organization's differentiating capabilities and the various risks, trends and issues it faces. They should understand what's working and what is not. They should challenge management's assumptions when necessary, ask the tough questions when called for, request clarifying information for matters they do not understand and provide value-added input and perspective to the CEO.

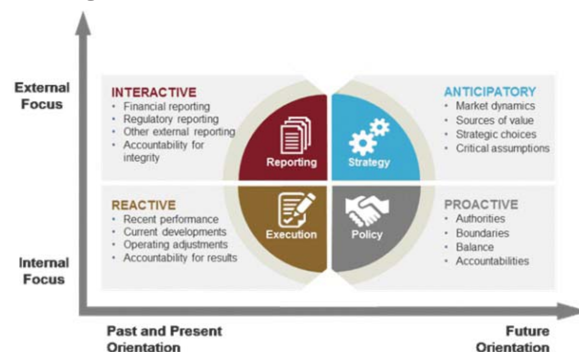
At the same time, independent board members (serving either in a single-tier structure or on the supervisory board of a two-tiered structure) should not disempower executive management from running the business by running it for them. They should not paralyze the organization by forcing it to wait for board approval on ongoing day-to-day business decisions. They shouldn't interfere and meddle on trivial matters, second-guess every decision, try to control every move or go around management to tell people at lower levels what to do. In short, effective boards do not micromanage the activities of the business; instead, they oversee management's discharge of their responsibilities.

Effective board/management engagement emphasizes four broad themes:

- Strategy: Evaluate all aspects of the strategy to ensure it is effective in creating enterprise value.
- Policy: Clearly articulate authorities and expectations so that management has the resources and capabilities needed to execute, is empowered to make decisions and execute the strategy within prescribed boundaries, and is accountable for results.
- Execution: Oversee management's conduct of the organization's affairs with integrity.
- Reporting: Ensure management reports performance in a fair and transparent manner.

In summary, the effective board knows how to delineate its responsibilities from management's responsibilities.

Below is a 2x2 matrix framework for understanding the scope of the board's oversight to provide a context for effective engagement. On the vertical axis, one can look externally or internally. On the horizontal axis, one can look at the past and present or can look at the future. Thus, this framework provides a comprehensive view of board oversight.



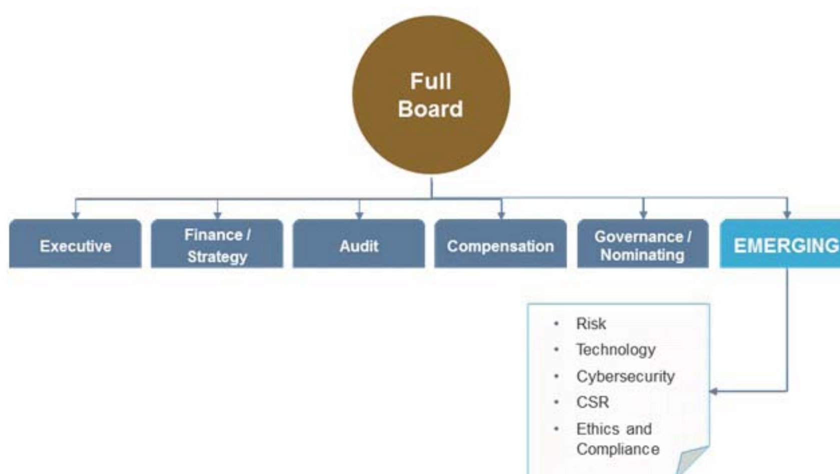
Using this framework, we can position our four themes of effective engagement:

- Strategy has an external focus and a future orientation. It requires directors to be anticipatory, because they must be forward looking in their oversight to be of use to the CEO on strategic matters.
- Policy has an internal focus and a future orientation. It necessitates that boards be proactive, as policy setting provides an opportunity for directors to offer appropriate guidance on how the affairs of the organization should be conducted, including the organization's risk appetite and its commitment to ethical and responsible business behavior.
- Execution has an internal focus and a past and present orientation. It drives reactive behavior for directors as they receive management's reports on the results of recent performance, current developments, mid-course adjustments and other aspects of executing the strategy and business plan.
- Reporting (particularly public reporting) has an external focus and a past and present orientation. It is interactive as directors provide input on management's reporting to shareholders, regulators and other external stakeholders.

The point is that progressive boards trend more toward strategy and policy matters in their oversight. Ineffective boards often devote too much of their oversight focus on execution and reporting.

The Role of Directors in Committees

Given that directors' work is demanding and its oversight focus is comprehensive, boards frequently delegate oversight responsibilities to various standing committees. There is no one-size-fits-all approach, but the general rule is that board committees should be established as deemed useful to the work of the board. Below are some examples of board committees to consider:



Traditionally, most boards have three committees in lieu of handling matters as a full board:

- The audit committee is responsible for overseeing external and internal audit activities, evaluating management's activities to maintain the effectiveness of internal control, approving external reporting, and often, overseeing other areas of compliance.
- The compensation committee evaluates CEO and executive team compensation, linking rewards to performance, and assesses the compensation structure to ensure it incents appropriate behavior and risk-taking.
- The governance/nominating committee is responsible for the health and functioning of the board, defining director independence standards, recruiting and orienting new directors, and evaluating performance of the board, individual committees and individual directors.

Each of these committees should consist of independent non-executive directors. Desirably, the audit committee should have at least one director with expertise in financial management.

There may also be a finance and/or strategy committee ("finance" and "strategy" are sometimes used interchangeably, while other times these committees are focused on specific areas). A "pure" strategy committee oversees strategy setting, considers strategic options, reviews business plan roll-forwards and monitors strategy execution. A "pure" finance committee oversees development and execution of the annual operating budget, setting long-range financial goals and funding strategies, integration of operating budgets with strategic planning priorities, management of insurable risks, investment policy, and performance of investment managers/advisers.

Finally, the board may establish an executive committee, which oversees operations of the board, coordinates the activities of the various board committees, and often acts on behalf of the board during on-demand activities that occur between regularly scheduled meetings (and these actions are later presented for full board review). This committee typically comprises the board chair and committee chairs.

These are traditional board committees. There is no one-size-fits-allstandard, as committees may be titled differently or their work may be handled by the full board in lieu of specific committees. Regardless of the committees in place, the full board generally makes major decisions. To clarify responsibilities, appropriate charters and periodic reporting to the full board should be in place.

In addition to the traditional committees, we see other board committees emerging to meet new demands. Whether these other committees are permanent or ad hoc or stand-alone or they are subcommittees of a traditional committee, their purpose is to focus the appropriate expertise and attention on areas the full board deems important and of high priority.

One example is a risk committee, which oversees the organization's risks to ensure the board's overall risk oversight addresses the

critical enterprise risks and that there are no significant gaps or overlaps across the activities of the various standing committees. (Note that each standing committee often considers risk to the extent of the risks inherent in its chartered activities and that the full board retains responsibility for risk oversight.) Other examples of emerging committees include:

- Technology – Oversees emerging technology risks, including risks of disruptive change, technology investments, cyber security, and identity and privacy management issues.
- Cyber security – Established as a separate committee to address cyber risks.
- Corporate Social Responsibility (CSR) –Addresses sustainability issues (emerging on some boards, particularly in developing economies).
- Ethics and Compliance – Develops and applies guidelines for ensuring ethical and responsible business behavior and resolving ethical conflicts, and oversees compliance in critical areas of the business (may be a subcommittee of the audit committee).

Every organization is different in terms of its strategy, industry issues, culture, operating philosophy and financial wherewithal. Accordingly, the board must decide the best way to organize itself to discharge its oversight responsibilities effectively, and that often entails delegation of the work to various committees.

Keys to an Effective Board

For many high-performing boards, the fundamental objective is about building long-term sustainable growth in enterprise value and preserving the reputation and brand image of the organizations they govern. Specific objectives may relate to expanding market share, strengthening customer loyalty, undertaking more innovation risk, and attracting and retaining human capital, among others. Whatever the objectives, there are success factors and leading practices common to effectivelyfunctioning boards. I lista few below:

1. Keys to an Effective Board

1. *Appoint a strong leader.*
2. *Build a great management team and position it to succeed.*
3. *Foster a strong tone at the top.*
4. *Create a culture of trust and respect.*
5. *Understand the key strategic drivers and risks.*
6. *Link rewards to performance.*
7. *Organize for effective engagement and oversight.*
8. *Preserve transparency.*
9. *Work to a strong independent majority.*
10. *Engage effectively with shareholders.*

1. **Appoint a strong leader:** Setting the tone for strong corporate governance, an effective board chair builds an effective team by working effectively with the CEO and, in collaboration with the governance/nominating committee, establishing appropriate procedures, with established criteria, for the selection of talented directors to maintain the requisite experience, diverse perspectives, skills and interpersonal qualities to contribute to effective functioning of the full board and its committees. A strong chair keeps an eye toward the future, focuses the agenda on the tough topics of the day, communicates well with key stakeholders and reviews board effectiveness periodically. If the chair is not independent, a strong independent lead director plays this vital role.
2. **Build a great management team and position it to succeed:** Strong corporate governance begins with an effective process for recruiting, selecting, developing, empowering, evaluating, rewarding and terminating the CEO. Likewise, the board approves the appointment of competent and qualified executive officers and their designated roles and responsibilities (as recommended by the CEO). Finally, an effective board ensures there is sufficient executive bench strength and an orderly succession plan for the CEO and key executive positions.
3. **Foster a strong tone at the top:** The board charges management with the primary responsibility for creating a culture of performance with integrity and commitment to ethical and responsible business behavior; this is often accomplished through a code of conduct applicable to directors, executive officers and employees that is communicated to the organization, monitored and enforced. In addition, the board should ensure there are practices in place to identify, assess and resolve actual and potential significant conflicts of interest.
4. **Create a culture of trust and respect:** For the board to function as an effective team, there must be a working environment of mutual respect that fosters the candid and constructive dialogue which may be necessary at times when the CEO and executive team can benefit from a challenging, robust debate.
5. **Understand the key strategic drivers and risks:** An understanding of the key drivers of the strategy positions the board to be of highest and best use to the CEO. Simply stated, the board should own the strategy to creating value. In addition, directors should understand the critical enterprise risks, how management is responding to those risks and the processes in place that inform management's risk-related assurances to the board. In addition, they should understand the critical assumptions underlying the strategy and management's responses to monitoring the continued validity of the assumptions.
6. **Link rewards to performance:** CEO remuneration is a controversial issue for many boards. Part of the solution to attracting the best talent and rewarding that talent fairly lies in the fundamental principle that exceptional pay requires

exceptional performance. Effective remuneration systems measure what matters – and only what matters – in paying for performance and providing for meaningful downside in the event of poor results. A compensation committee should be in place with at least three members, all independent directors, to oversee the reward system and make recommendations to the full board. The committee should keep the compensation structure simple, transparent and focused on sustained value creation, while balancing the tension between rewarding executives over the short term and preserving the long-term interests of key stakeholders. The committee should have authority to retain consultants and advisers in carrying out its responsibilities.

7. **Organize for effective engagement and oversight:** As noted earlier, allocation of the board's responsibilities to various standing committees and delineating committee responsibilities (and that of the full board) leads to more efficient and effective oversight.
8. **Preserve transparency:** Well-governed companies ensure that appropriate disclosure policies and practices are in place. Investors are also held to appropriate levels of transparency (e.g., security ownership is disclosed on a timely basis).
9. **Work to a strong independent majority:** A majority of independent directors is viewed as the optimum composition of an effective board. Non-independent directors – members of the executive team – are present as necessary to provide an appropriate range and mix of board expertise, diversity and knowledge.
10. **Engage effectively with shareholders:** With respect to communications to shareholders, the board should provide effective oversight of external communications to ensure consistency, clarity and candor, as well as reliable, timely and regular reporting of company performance. With respect to communications from shareholders, the board should have procedures designed to encourage shareholders to communicate with the board in a manner consistent with the applicable securities laws. Shareholders should have opportunity to approve specified transactions (e.g., in conjunction with the annual general shareholders' meetings).

Everyone has a list. The above is mine. I make no claim that it includes everything that drives board effectiveness. That said, I do believe the above practices are fundamental to a successful board. In effect, the board needs to a lignits activities with the rhythm of how the business is run and ensure that value is contributed in addressing the right topics and the tough issues at the appropriate time. In providing oversight, directors should offer useful advice, counsel and perspective, and should support the CEO during challenging periods in advancing the strategy.

Avoid Dysfunctional Behavior

What differentiates an effective board from a weak or dysfunctional board? I have listed six disruptors that contribute to boardroom risk:

- Subservience to the CEO occurs when a board “rubber stamps” the CEO's decisions and allows the CEO to do whatever he or she wants to do. Too often, we read stories about a CEO driving an organization into the ditch, such as what we saw in the United States during the time leading up to the financial crisis. In these instances, there are no checks and balances to a CEO's implementation of a flawed strategy. In more than one instance, directors did not ask the tough questions because of fear the CEO would remove them. What purpose does a board like that serve?
- Confusion over the board's role results from a lack of clarity on the roles of individual directors and the board as a whole. Role ambiguity slows decision-making and causes unnecessary conflicts among directors and, worse, the possibility of disempowering management.
- Poor process management hinders effective board preparation, meeting management and communications. This results in indecisiveness, a lack of urgency on critical challenges facing the organization, and excessive agenda time devoted to detailed presentations without sufficient dialogue on important topics between directors and management. The result: Whatever value the board has to offer is largely untapped.
- Lack of alignment and agreement on company strategy impairs the CEO's ability to formulate and execute strategy and causes discord among board members. Poor strategic alignment hampers a board's ability to prioritize issues and can result in too much engagement with the traditional oversight roles of execution and reporting and excessive focus on regulatory and compliance issues. As stated earlier, it is vital that directors focus enough oversight on strategic and policy matters in setting the agenda.
- Poor team dynamics fracture boards and lead to power struggles. Like any effective working group, a board should consist of professional peers who respect and work well with each other. A good chemistry serves the best interests of the organization.
- Board composition can present a serious challenge, if not done right. Today's challenge of a rapidly changing business environment requires new perspectives and skills appropriate to the organization's business and circumstances. Boards may lack the ability to objectively evaluate their makeup to determine whether they have the right people and skills at the table given the company's needs at the time.

It is a shared responsibility of the board chair, the individual non-executive directors and the CEO to avoid the above pitfalls.

Laying the Foundation for Effectiveness

Board effectiveness begins with an oversight and accountability

framework that articulates the roles and responsibilities of the full board and its respective committees. Structuring the board to add value begins with its composition and appropriate competencies, with directors having a commitment to integrity, an independent and objective frame of mind, and an ability to exercise sound judgment.

The size of a board should be appropriate for the entity's business. Corporate governance guidelines should require a majority of independent directors (or non-executive directors) and enable those directors to meet regularly in executive session (without management present). Directors should submit themselves for reelection at regular intervals to facilitate meaningful shareholder involvement in the selection process.

As to engagement and effective board interaction, directors should provide sufficient time and commitment to the role, acting in the best interests of the company and its shareholders (and not focused on the interests of a particular constituency). They should exercise the degree of skill and diligence reasonably expected of an ordinary person of their knowledge and experience, in the way they make decisions and in good faith, that will be most likely to promote the company's long-term success and best interests. They should do so for the benefit of shareholders taken as a whole and in compliance with their common law and other legal duties. These duties include the responsibility to act honestly, to inform themselves about the affairs of the company, and to join with the other directors in supervising and overseeing the company's affairs prudently and effectively. No individual or small group should dominate board decision-making.

Boards improve themselves through continuing education and awareness, access to information and advice, effective board operating processes and work flows, sufficient attention to strategic matters, and periodic assessments of board, committee and individual director performance.

Gaining Confidence in Facing the Future

These are exciting times. Wherever companies operate on the planet, they function in a dynamic global economy full of opportunities and emerging risks from disruptive change. How confident is executive management and the board of directors that the organization will advance its vision and execute its strategy successfully over the foreseeable future? What does it mean to assert the organization has confidence in facing the future? What are the essential behaviors underlying that confidence? And how can the board instill those behaviors?

There are three fundamental questions that are vital for an organization to ask so that it can face the future with confidence:

1. Directionally, do we know as an organization where we're going and why?
2. Are we prepared for the journey we are undertaking?
3. Do we possess the ability, will and discipline to cope with change along the way?

Positive responses to the above questions enable organizational confidence in facing the future. If this is a bit obtuse, attributes or characteristics of organizations will help enable them to answer these three questions with positive responses.

The first attribute is about visualizing where the organization is going. Confidence is maximized if there is commitment to the organization's long-term vision, providing its people a shared vision that is both inspiring and motivating.

The next two attributes facilitate preparation for the organization's journey: First, a confident organization constantly “reality tests” its understanding of the market so it is in touch with the environment. For example, it implements processes that facilitate real listening to customers, suppliers, employees and other stakeholders as sources of new learning and systemic thinking in distilling and acting on the feedback received.

Second, a confident organization organizes its capabilities by making it a never-ending priority to ensure that the capabilities needed to differentiate itself and execute its strategies successfully are in place and appropriately aligned. For example, differentiating capabilities include an organization's superior know-how, innovative processes, proprietary systems, distinctive brands, and exclusive supplier and customer relationships. Alignment involves policies, processes, people and other elements of infrastructure.

These first three attributes lay a foundation for beginning and sustaining an organization's journey. But that alone is not enough. Organizations must be able to cope with change. This coping mechanism is much more than strong survival instincts and capabilities and being adept at fighting crises. The ability to cope with change must be driven from within and requires resilient and creative people. There are four attributes for coping with change:

- A confident organization is risk savvy. The confident organization routinely identifies its risks to executing its strategy and achievement of its performance goals so that it can ensure that the most critical exposures are managed effectively. It applies contrarian analysis beginning with understanding the critical strategic assumptions that represent management's “view of the world” throughout the strategic planning horizon and beyond to understand what can happen that could threaten the strategy.

  Through contrarian analysis, management is secure in the knowledge that it has considered all plausible scenarios; understands the organization's breakpoint in the event of extreme scenarios; has effective contingency response plans in place, including plans to exit the strategy if circumstances warrant; and, most importantly, has an early-warning capability in place to detect vital external signs of relevant changes in the market that make affect the validity of critical strategic assumptions.

- A confident organization fosters an aggressive learning environment. A commitment to learning facilitates the pursuit of opportunities and undertaking of risks and all that entails, including the inevitability of mistakes that stimulate further learning. It views success and failure as equivalent experiences to proactively avoid the plague of complacency, with past successes becoming ingrained within the culture.

- Confident organizations place a premium on creativity. They make innovation an integral part of their culture by setting accountability for results with innovation-related metrics at the organizational, process and individual levels. They understand that transformation is more of a continuous process than a dramatic event. Innovative companies focus on staying ahead of the change curve by identifying market trends and acting on that knowledge while the iron is still hot, rather than waiting until it is too late.
- Confident organizations are unwaveringly resilient, meaning they have the ability and discipline to act decisively on revisions to strategic and business plans in response to changing market realities.

So what's the point? As a director, ask yourself:

- Is your organization confident in facing the future (e.g., that it will survive and thrive in a rapidly changing environment)?
- How would your management and board rate the organization against the seven attributes of confident organizations, as outlined above?
- Using these attributes and the behaviors they represent, are there changes your organization needs to make to prepare and/or sustain its readiness for the journey that lies ahead?

As a board, should you focus on these topics and how they relate to your organization in these dynamic times?

Concluding Comments

We've discussed many aspects of board governance best practices – board/management engagement, the role of directors in committees, keys to an effective board, signs of dysfunctional behavior, laying the foundation for effectiveness and positioning the organization to face the future with confidence. We hope that our coverage of the topics serves as a catalyst for boards to improve their governance process. Their companies will benefit from strong governance.

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