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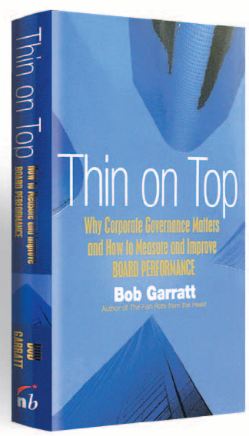

By Bob Garratt

How to Measure, Manage and Improve Board Performance

THIN ON TOP

THE SUMMARY IN BRIEF

Corporate boards of directors have seen better days. The roles played by corporate boards and the people who direct them are misunderstood by stakeholders, employees and the general public. Many see boards as ineffective groups of former top executives who have settled into retirement and attend board meetings now and then to keep busy.

But "corporate governance" has become an important topic in the executive suite. Given the high-level scandals of recent years, companies are concerned that corporate boards not only make decisions that improve a company's profitability, but that they conduct their activities in an organized, efficient and ethical manner.

In Thin on Top, *Bob Garratt discusses the current condition of corporate boards, dispels troublesome myths and gives step-by-step recommendations on how to help board members and directors learn, develop and perform.*

CONTENTS

What You'll Learn In This Summary

✓ **There is a difference between managing and directing an organization** — Effective board directors must create strategic direction for an organization, not just manage day-to-day operations.

✓ **To be effective, board directors must understand their roles** — The director is the "boss of the board" charged with steering it to wise decisions about moving the company forward while maintaining control.

✓ **The ten universally applicable "directorial duties"** — These duties are guidelines for directors that form a useful basis for improving corporate governance.

✓ **Why corporate boards fail** — Many directors let ignorance of their roles or personal and group cowardice create conditions in which negative things happen.

✓ **How to develop an effective board** — Continuous training, learning and evaluation are the keys to improving a board's performance.

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THIN ON TOP

by Bob Garratt

— THE *COMPLETE* SUMMARY

The Future of Corporate Boards

There are basic differences between managing and directing an organization, and most of today's corporate board directors are actually glorified managers. There is a crisis in corporate governance in both the public and private sectors that is a complex mixture of board directors' ignorance, strategic incompetence and greed.

A key to resolving this crisis is to induct, train and evaluate directors as true professionals. Unless a systematic upgrading of directorial competence and board performance takes place, our corporate and economic systems will sharply decline.

The crisis in corporate governance exists because the roles and responsibilities of corporate boards are not understood by politicians, business executives or the general public. As a result, public confidence in corporations and the people who run them is at an all-time low. Developing effective corporate governance and board performance is essential to solving this problem.

We must install a system for selecting board directors and training, developing, evaluating and regulating them, which will bring the type of rigor to the boardroom table that is usually found at other levels of the business. In other words, we must learn how to measure and reward directorial — apart from executive — competence.

It's wrong to assume that friends of the CEO or distinguished executives from other companies will automatically become effective board directors. Experience is required, but not sufficient, for a place at the boardroom table. Only distinct directorial skills will do, and these skills are difficult for many existing and aspiring board members to obtain.

It's no secret that most board directors aren't fully competent. Most can't distinguish between managing a business and directing one, and their success has come from being effective managers, not from giving strategic direction. Most board directors are given that role late in their careers, and it doesn't occur to many of them that they must be trained to become a competent board director. ■

The Crisis of Corporate Governance

Corporate governance is the activities, processes and values of the people and board structures that must cope with the rapidly changing demands of shareholders and stockholders.

Many businesses haven't made the connection between the demands of shareholders and those of stakeholders. Stakeholders are individuals and groups who have the power to sanction board actions. If anything, boards have turned their backs on both shareholders and stakeholders and have created inappropriate reward systems for executives. We have over-praised "celebrity chief executives" and over-rewarded the clever maneuvering of financial professionals.

It's time to return to basics, to remember what companies are for, to manage businesses correctly and create value. We must reaffirm and rigorously apply rules on the roles, tasks, duties and liabilities of boards of directors. Diligently enforcing these rules will prevent most of the "directorial disasters" we read about in our newspapers every day.

Myths of Corporate Governance

The following are three powerful, widely held organizational myths that are obstacles to effective corporate governance:

1. The myth of the all-powerful chief executive.

Many chief executives believe they "own" the organization that employs them and have total freedom to do whatever they want with it. This is not true. CEOs aren't "free agents"—they're directly accountable to the board

(continued on page 3)

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The Crisis of Corporate Governance

(continued from page 2)

of directors and, ultimately, to the shareholders. CEOs must use care and sound judgment in their work, and nurture and develop the company for future generations.

2. The myth that a director's primary duty is to the shareholders.

The second major myth of corporate governance is that the main responsibility of a director is to the shareholders. This is not the case. In most societies with a developed system of commercial law—including the US and UK—the moment a director is appointed to a board, his or her main loyalty switches from those who appointed them to the company itself.

3. The myth of executive and non-executive/independent directors.

The third myth is that there are two types of directors, executive and non-executive. This is not true. In case-law countries the only term used is director, and even then much of the description of the director's role is found in the Insolvency Acts rather than company law. The key assumption is that the board acts together as a group of equals around the boardroom table, driving the enterprise forward while keeping it under control. ■

For Additional Information on the myths of corporate governance in the U.S., go to: http://my.summary.com

Back to Basics: Reasserting The Superiority of the Board

Directors who are unaware of their role, rights, duties and tasks cause abuse of the direction-giving process around the boardroom table. This usually leads to under-performance by both the board and the business.

A main problem of ineffective board directors and boards is a misunderstanding of the roles and tasks of the CEO. A chief executive is not a full member of the board but reports to it. Though CEOs often behave as if they own the corporation, they do not. Most of today's problems with corporate governance are caused by this incorrect assumption.

A true chief executive reports to a board, debates with it, takes instructions from it, but is not a voting part of it. The title Chief Executive Officer illustrates that this is the head of the executive function—the operational side of the organization—not of the board.

How Chief Executives Take Unlimited Power

Given many board directors' lack of legal and practical knowledge, it's easy to see how we have reached the point at which shareholders and stakeholders are demanding much higher levels of competence from directors. But instead of relying on boards, most companies still rely on a powerful chief executive to get things done. Those CEOs usually have the power to "bet the business" with very little input or criticism from the board.

There are four main reasons for this over-reliance on a powerful CEO:

1. Most people chosen to become board directors have little or no knowledge about board roles, tasks and liabilities.

In 1992 the Institute of Directors in London surveyed its members and found that less that eight percent of the directors had even one day's training in being a director. Internationally, that figure was even less than eight percent. By 2001, the number of directors who had been trained for the role had increased to only 15 percent.

These percentages make a very disturbing comment about the global condition of effective corporate governance. There seems to be a general acceptance of the fact that one of the most important jobs in an organization—directing the board and its future—is given virtually no training.

2. After a successful managerial or professional career, many board directors don't want to "rock the boat" by asking probing questions of a powerful CEO.

If directors are for the most part ignorant of their roles and tasks, they don't want to make this known, even within the board. As a result, such directors are more likely to ask questions that relate only to their previous discipline and avoiding any position that might put them in an embarrassing spotlight.

3. A misperception by the public that the chief executive's role is not only important in itself but symbolic of the cultural philosophy of the company.

Chief executives may be no more competent than any other board member, but they are assumed by most, inside and outside the corporation, to have absolute competence and are granted absolute power.

One reason is that with weak board directors and chairmen, criticizing the CEO or managing director is often viewed as beyond the board's authority.

Also, since the board chairman is not the boss of the company and its day-to-day affairs, the chairman is viewed as less important to the company's welfare then the CEO. In addition, most people view the corporate board as an amusing, useless anachronism. Finally, the media and the general public tend to emphasize the chief executive role, rather than the board, as the leadership of a company.

4. Shareholders, trustees and the general public have no knowledge of the board's true roles and tasks.

(continued on page 4)

Back to Basics: Reasserting The Superiority of the Board

(continued from page 3)

Educating shareholders and the general public on what boards should be doing is key. But there is still a ways to go. For example, corporate governance is not a serious part of any MBA program.

In the end, boards of directors will re-establish their credibility only by recapturing their role of properly giving direction and providing control. To do this effectively, the chief executive role must be moderated and the board director's role enhanced in the minds of all players. ■

The Ten Directorial Duties: Back to Basics

The ten duties of a board director are designed to be universally applicable. They're a useful basis for developing improved corporate governance. They ask a board and its director to behave within the legal and ethical bounds of:

1. The duty of legitimacy.

It is essential for a board and its director to stay within national and international law. Many directors find themselves, usually through a lack of knowledge of their role, ignorant of the ways they can be held corporately and personally liable.

2. The duty of upholding the three values of accountability, honesty and openness to stakeholders.

Accountability to the owners. The owners' appointment of a board of directors is based on the assumption that the directors will be fully accountable, corporately and individually, for their actions on behalf of those owners.

Honesty in dealing with the board and stakeholders outside it. Honest dealing is the key to board competence and prevents board corruption, including the abuse of power and privilege. It is based on mutual trust and having confidence in your colleagues.

Opening the decision-making process to the owners of the company. Many directors, especially new ones, are horrified by the lack of rigor in their board's decision-making processes. Shareholders should be aware that there is an agreed and transparent process by which decisions are made by the board.

3. The duty of trust.

Board directors have their company entrusted to them for the future. But in these turbulent times, that duty conflicts with the desire of some shareholders to take their money quickly and run. While the owners of the business have the right to overrule the directors at a general meeting, it's unclear how courts would rule if the directors show that shareholders' demands could threaten the future of the business.

4. The duty of upholding the primary loyalty of a director.

From the moment a person is elected as director, their primary loyalty must be to the company as a legal entity, rather than to those who appointed them. Directing is

(continued on page 5)

The Legal Foundation of Boards

Let's go back to basics again, specifically to the legal basis for the theory and structure of boards.

By the mid-nineteenth century, the original, closely held ownership of companies couldn't direct or control increasingly complex businesses. Managers were now employed as agents of the owners to interact with both customers and the workforce.

But as businesses expanded further, so did the need for capital. With the original owners often unable to supply it, the search for capital spread wider. As the original ownership became diluted, legislation in the form of company law was needed to regulate the relationship between the managers and the more distant owners.

In 1776, Adam Smith was concerned that in the long run, centuries before the anti-globalization movement, the new corporations could gain the power to destabilize society through:

- ✓ **Unlimited life**
- ✓ **Unlimited size**
- ✓ **Unlimited power**
- ✓ **Unlimited license**

Smith argued that corporations could potentially become a force for harm as well as good. He realized that those companies would need effective regulation inside, through a controlling group elected by the owners, and outside, through the legislators.

Smith's second and equally radical idea was the development of a board of directors made up of "merchant adventurers." The concept of a board of directors under a governor developed with the formation of the East India Company in 1600. This company was based on the novel assumption that previously autonomous merchant adventurers would do better to pool their funds and become owners of a "joint stock" company. It was only after the mid-eighteenth century that the idea of the company itself having a separate legal personality and limited liability was accepted. This paved the way for boards of directors becoming more common.

The Ten Directorial Duties: Back to Basics

(continued from page 4)

all about exercising judgment, corporately and individually, and this issue is always a contentious one.

5. The duty of care.

Directors must perform their roles and tasks competently. They must be careful in what they do and how they do it, and ensure that what they decide is for the benefit of the company, not themselves.

It's essential that directors know what they should be doing and are evaluated on the results.

6. The duty of critical review and independent thought.

The responsibilities of a board director can seem intimidating to a new—or incompetent—director. Every director must be sufficiently self-aware and mature enough to make their own judgment on the best direction for the health of the company.

7. The duty of delivering the primary roles and tasks of the board.

The roles of the board can be described as four intertwined dilemmas. 1) Driving the enterprise forward while keeping it under control; 2) Knowing the day-to-day workings of the business while developing a longer-term overview of developments outside the business; 3) Balancing short-term, local demands with broader regional, national and international trends; and 4) Focusing on the commercial needs of the business while acting responsibly toward other stakeholders in your society.

8. The duty of protecting minority owners' interests.

This is another aspect of honest dealing. In most developed economies this is not a major issue because regulators are making it more difficult for minority shareholders to be treated poorly. But in countries where the rule of commercial law is weak, minority shareholders are not given enough respect.

9. The duty of corporate social responsibility.

On this issue, it's easy to take an extreme position and much more difficult to take a moderate, balanced one. But that is what any board must do if its enterprise is to survive. Corporate social responsibility must be built into directors' business calculations.

10. The duty of learning, developing and communicating.

Too many directors still assume that the reward of a directorship is the acknowledgement of a long and successful executive career, not the beginning of a new one. They assume they don't have to learn anything new. But accepting a directorship is the start of a new and challenging career. It requires a systematic retraining to break away from the old professional behavior and acquire an approach that emphasizes policy-making and strategic thinking. ■

The Triple Bottom Line

After an unfortunate series of events at one of its oil rigs caused bad publicity, political damage and potentially negative long-term economic effects, Royal Dutch/Shell Group learned that its "science and reason only" approach to corporate issues didn't work in a customer-oriented society. The company recognized that, as a major international investor and employer, it must play a positive role in both economic and social development through its choice of investments and corporate behavior. Shell set out to reposition itself and its reputation by accepting its corporate social responsibility. It developed the concept of the "triple bottom line"—it now strives to reach established goals in three essential areas:

- ✓ **Financial performance**
- ✓ **Physical environmental performance**
- ✓ **Corporate social responsibility performance**

Why Boards Fail: Power and Corruption on the Board

A common public perception of corporate boards is that they're always up to some form of corruption or another. In reality, that's the exception, not the rule. But many directors let ignorance of their roles or personal and group cowardice create conditions in which bad things happen.

A fundamental building block for any board is trust: trusting each other and being trusted by the owners and stakeholders. Trust is defined most simply as "having confidence" in oneself and in others. Directors need to know that once a decision is made, the other directors will stay committed to it outside the boardroom and be comfortable living with the consequences. A lack of trust, especially when big egos are involved, usually causes great uncertainty and diverts the board's attention from their primary duties.

The Abuse of Board Power

For the last two decades, the media have been intensifying their campaigns against incompetent, corrupt businesspeople. But these attacks have been general in nature. To achieve focus, we must consider specifically the abuse

(continued on page 6)

Why Boards Fail: Power and Corruption On the Board

(continued from page 5)

of power by the managing director or CEO, especially around the boardroom table. Its debilitating effect on board performance has rarely been examined in detail.

The ideals behind the three values of corporate governance best practice — accountability, probity and transparency — are rooted firmly in the notion that people with an official position in the private, public, or not-for-profit sectors should not abuse their office. They should be paid sufficiently to do their job well without the temptation of bribery or greed, or the need to exploit their position to support their families or friends.

The Shadow Side of Boards

At what point does the interaction around the boardroom table stop being legitimate discussion and turn into bullying, harassment, discrimination and the abuse of power? That point has been reached when a director and/or board members feel they can't fulfill their roles and are becoming depressed, have low morale, don't participate and show signs of absenteeism, sickness, self-censorship and under-performance.

A great deal of such abuse comes not from one powerful person, but from collusion, implicit or explicit, among board members to avoid dealing with differences between the members and to maintaining the status quo regardless of the negative impact on the company.

The Chairman's Neutral Role

All boards are political. It's human nature that a group of people with big egos is going to be very competitive. This is where the psychological aspects of boardroom abuse come into play. This will ultimately spell disaster for any board because the members' psychological energies are focused on fighting interpersonal battles rather than on developing imaginative, practical strategies.

The interplay of the powerful personalities around a boardroom table will always need careful handling. This is the chairman's job, and it's a demanding one. While powerful personalities often enjoy controlling others, they do not enjoy being controlled themselves.

The chairman is technically neutral and must declare his interest in the issues under discussion. Very basic training in the processes of chairing a board will allow a chairman to umpire a board in a neutral manner. When his interests are in conflict, he must relinquish the chair, letting a director who is neutral on that subject chair the meeting.

Professionalizing Board Performance

Originally, boards were designed to ensure proper auditing and development of a company's purpose, vision, values and performance. These needs must continuously be monitored and developed for any board to be effective.

Training and coaching directors to competence — giving them directorial knowledge, skills, and attitudes — then celebrating the diversity around the boardroom table is essential. Only then can the true power of a board be released. Working in such a group should be an enjoyable experience. After all, the word "company" derives from the Latin *companio*, which means an association of people coming together in trust to break bread. ■

Directorial Dashboards: The New Board Metrics

On most boards there has been an over-reliance on management numbers. But directors are not managers. They must keep their eyes on a different pattern of figures, so they need a *directorial dashboard* to help them oversee total business performance.

If boards use only the balance sheet, profit and loss account, and management accounts, they tend to be seduced into micro-managing and cost-cutting rather than generating revenue.

Directorial Dashboards

Directorial dashboards measure the performance of both the board and the total business. The approach is to develop systems that clearly reveal the performance of the company and its subsidiaries in such a way that the board can monitor and understand trends.

The dashboard concept helps the board focus its attention on key business performance indicators, prioritize actions that need to be taken, implement strategies and learn from the results.

On a car's dashboard, there are three critical dials: a speedometer that shows the speed at which the car is traveling, an odometer that measures miles traveled, and a fuel gauge that tells how much fuel is in the tank. Using a simple business analogy, if the business's "engine" is running efficiently, the speedometer and odometer can show overall business achievement in terms of the number of miles that must be traveled to achieve its goals. The fuel gauge measures the cash flow that keeps the business engine running and tell the directors when they must take action to keep the business from stalling.

The Number of Dials on a Dashboard

How many "dials" should there be on a directorial

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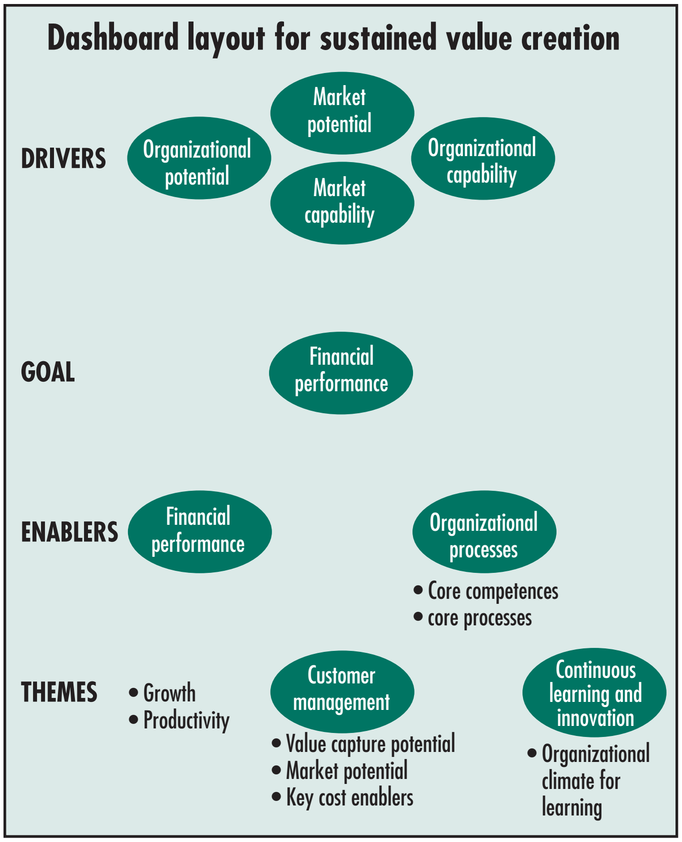

Directorial Dashboards: The New Board Metrics

(continued from page 6)

dashboard? Since the main dial will show added shareholder value, between seven and ten dials are needed to assess the opportunities, risks and costs involved in making a strategic decision, as shown in the example above. ■

Developing the Learning Board

Many boards don't have a total process for their decision-making or the consistent leadership and support of the chairman. They often don't understand that decision-making is a continuing cycle of learning from their decisions on the four board dilemmas rather than a simple process of saying "yes" or "no" to executives' proposals. What is usually lacking is a linked, rigorous sequence for making effective strategic decisions.

Strategy and Uncertainty

Nothing is ever certain in the world of directing. Even the seemingly "easy controllables" of internal performance can cause unexpected problems when, sales targets are not met, staff are unruly, budgets are overspent, project times are extended or customers do not pay. Such examples are heard frequently around the boardroom table. But all these examples are from the operational world of executives, and it's not the directors job to resolve executive problems. Their job is to oversee the pattern of executive performance within the context of delivering the board's policies and strategies. The board must not be seduced into trying to micro-manage such problems.

The Board's Strategic Learning

All learning has a moral dimension—we learn good and bad things all the time. The key question about board learning is whether we learn in a "good," open, questioning manner or in a "bad," unquestioning, blame-giving and information-hiding manner. It is crucial for directors to be viewed by the colleagues and their stakeholders as aware of their roles, tasks and duties in relation to developing their strategies. To do this effectively, they must be comfortable generating a range of ideas for implementing their strategies and giving organizational leadership by learning from their decisions and being true to their values.

The Learning Board Process

The model the author has developed over the last 15 years to help professionalize directors is called the *learning board*. This model has been effective in bringing directors from a basic understanding of their roles, tasks, and duties to a higher, more professional level. Two conditions must be met—that the chairman and managing director are totally committed to making this change happen, and that they are willing to learn and change—for the process to succeed.

The learning board model was constructed using the two fundamental roles of the board—driving the enterprise forward while keeping it under control—then adding both business timelines (short-term and long-term) and business perspective (internal and external) dimensions. This concept is fully formed by adding the four key tasks of a board:

- **Formulating policy and foresight.**
- **Strategic thinking.**
- **Supervising management.**
- **Accountability.**

The four board tasks of the learning board model can be fleshed out by adding detailed tasks and assessable behavior in a cycle of board learning.

The sequence begins with *policy formulation and foresight,* which involves:

- **Stating organizational purpose.**
- **Giving organizational vision and values.**
- **Creating an effective emotional climate and organizational culture.**
- **Monitoring the external environment.**

The link to *strategic thinking* is through the board's

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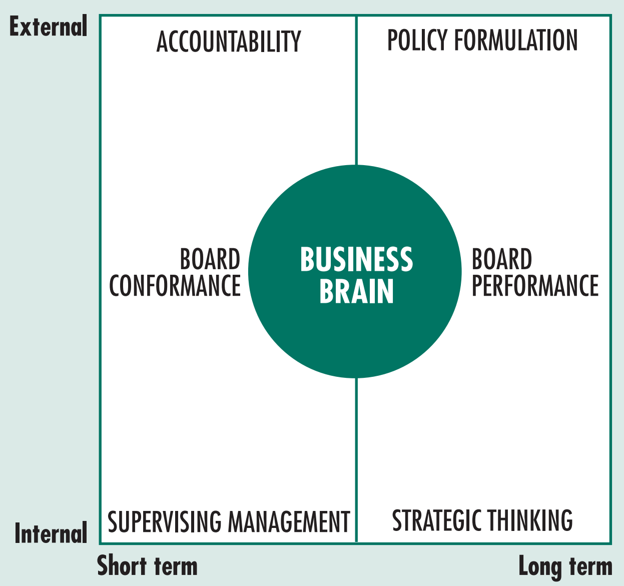
The learning board basic framework



Developing the Learning Board

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crucial strategic debates and risk assessments on the relationship between monitoring the external environment and positioning in changing markets. This is the crucial debate of the board. These decisions are the lifeblood of the organization because they generate future revenue streams and lead to:

- **Setting corporate direction.**
- **Reviewing and deciding key resources.**
- **Deciding implementation processes.**

The second crucial board debate is over the relationship between implementing strategy and ensuring organizational capabilities, which test whether the proposed strategy is workable and properly resourced. The board and executive learning from this helps inform the rest of the *supervising management* tasks:

- **Reviewing key business results.**
- **Monitoring budget control.**
- **Overseeing management performance.**

Ultimately, *accountability* takes the main place in the board's annual learning cycle as the board alone is responsible for the total control and performance of the business and must account for its stewardship in order of legal precedence to:

- **The company (as a separate legal personality).**
- **The owners.**
- **The regulators and legislators.**
- **The other stakeholders.** ■

Professionalizing the Board

The end of a board's decision-making cycle is not the end of its learning, it's simply the start of a new round of higher-quality learning.

Board Evaluation and Appraisal

The first step in board evaluation and appraisal is to create a system of benchmarking for individual and group capabilities. The techniques for board appraisal are no different from any other appraisal system:

1. Identify key performance areas (tasks) and value-based behaviors (processes) that reinforce the business's purpose and vision.

2. Develop a system for assessing board members and assess them regularly and rigorously.

The Basis of a Board Appraisal System

The simplest system of board and director appraisal consists of five elements:

1) A review of the self-disciplinary processes of the board, essentially its self-control mechanisms.

2) A review of its working processes, especially its budgeting of time and development of its competencies.

3) A review of its future income-generation and control mechanisms.

4) A review of the values used in learning opportunities offered to the board.

5) A review of the overall performance of the business and the board's specific contribution to shareholder value.

Developing the Content of Board Training

An effective board-appraisal process reveals the need for training and development of the individual directors. A problem with today's director development is that training is a replica of the "mini-MBAs" being taught to directors using the functional areas of accounting, human resources, strategy, marketing, procurement, etc. This type of education is not helpful for board directors.

In the future, the development of director and board competencies must be very different. Training should cover the following topics:

- **Working on a board effectively.**
- **Performing the legal roles, tasks and accountabilities of the board.**
- **Formulating policy.**
- **Developing strategic thought.**
- **Assessing risks.**
- **Effective board decision-making.**
- **Implementing and learning from strategy.**
- **Funding.**
- **Overseeing organizational change.** ■