

The seven habits of an effective board

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Directors of the boards of listed companies are coming under heavy fire these days. Often, they are accused of providing weak oversight or even being complicit in fraud. But the public's push for stronger regulation of boards will do little to address the real issue boards face: corporate underperformance. Only one in eight companies achieves even modest targets for growth. In this article, Bain & Company's Alan Bird, Robin Buchanan and Paul Rogers explain why boards must not focus on appeasing increasingly short-term stock investors who are likely to head for the doors at the first sign of trouble anyway. Falling victim to that short-term myopia can be fatal. Instead, boards should concentrate on value growth, by practising seven habits that build their effectiveness. There is no particular magic in these habits, which most boards have adopted already to some degree. The question is not whether directors recognise the seven habits, but how well they act on them.



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Recruiting directors to join the boards of listed companies is a thankless task these days. It's not surprising. Rarely have corporate directors faced such a deep and widespread erosion of public trust. Boards are seen to provide weak oversight or,

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worse, to be complicit in allowing executive greed, rewarding underperformance and failing to prevent corporate excess and even fraud.

Predictably, the loss of trust in corporate oversight has produced two inevitable responses: lawmakers and regulators push for stronger regulation, while activist shareholders strive to exercise greater influence over corporate governance. Restoring trust is essential, but each of those responses, however well intentioned, risks creating new problems.

In the new era of regulation, directors' attention has become consumed by issues of governance and the accuracy of the next earnings pronouncement, instead of focused on helping companies to build sustainable value.

Although the details vary by country, the trend is clearly toward more stringent legislation and regulatory compliance, through measures such as Sarbanes-Oxley in the USA and Higgs in the UK. While these requirements have sent a clear signal

to the fraudulent few that businesses must clean up their acts, an unintended consequence has been to make boards more reactive and risk-averse.

The defensive climate prompted US Federal Reserve chairman Alan Greenspan to comment that ‘a pervasive sense of caution’ is influencing business leaders. How many boards would recognise themselves in Greenspan’s observation?

Empowering investors sounds good in principle, but it can backfire. Pressure from investor groups all too frequently engenders a simplistic ‘box-checking’ mentality toward complex governance issues.

CEOs and boards feel growing pressure to deliver short-term results at the expense of long-term sustainable performance

More important, one has to ask: Can investors handle a more active role? The average holding period for a US stock in 2001 was slightly more than one year – half as long as it was a decade before. A growing number of stock traders – day traders, short sellers, hedge funds, arbitrageurs – have no incentive to act as stock owners. Mainstream investors have also shortened their horizons. US mutual funds now turn over the stocks in their portfolios every 11 months, on average.

As a result, investors have become increasingly disconnected from the business fundamentals that make companies successful and drive value year after year. CEOs and boards feel growing pressure to deliver short-term results at the expense of long-term sustainable performance.

It’s not easy for fund managers to break out of this short-term cycle. Investors in their funds – individuals as well as pension fund trustees – often use short-term peer group benchmarks to track fund performance. Fund managers increasingly adopt ‘me too’ investment strategies and follow the herd. Those who manage to maintain a longer-term focus often lack the resources to engage effectively with boards, or rely on corporate governance staff who lack experience in business or boardrooms. Together with the industry associations, these watchdogs risk trivialising shareholder activism to compliance ‘box-checking’.

But the real problem with the watchdog activity

is that boards cannot afford to be distracted from issues of performance. Collectively, corporate performance is mediocre: only one company in eight achieves relatively modest targets for growth.

According to our research, just 13% of companies post top- and bottom-line growth of 5.5% or better over a 10-year period, while also earning back their cost of capital. Companies like American Express, Dell, Lloyds and Vodafone, to name a few, have managed to exceed this standard by keeping company performance front and centre.

Effective boards focus on sustained value and how they can contribute to its creation. What can directors do to affirm that role, and reclaim control over their agenda? In our experience, successful boards exhibit seven crucial habits. There is no particular magic in these habits, which most boards have adopted already to some degree.

But few boards hold the mirror up to their own performance in a practical way and assess where they need to improve. The question for directors is not whether they recognise the seven habits of an effective board, but how well they act on them.

Own the strategy

Most boards convene special strategy meetings and retreats, but typically they sit through presentations of the executive team’s plans. Effective boards ensure that non-executive directors contribute to developing the strategy and feel a sense of ownership of the strategy.

At Vodafone, for instance, each year the board helps develop the agenda for a multi-day strategy retreat with senior executives. Each director contributes to the list of key strategic decisions that need to be made at the retreat. The event begins with a highly analytic overview of Vodafone’s markets and competitors, providing data that will inform those decisions. Instead of just including presentations by executives to the board, Vodafone’s process fosters debate on options, investments and returns.

When boards understand the issues at this depth and ask critical questions early on – Is the strategy bold enough? Is it achievable? – they can respond more quickly to opportunities such as major acquisitions when they arise. Decisions unfold faster. Vodafone’s swift consummation of the Mannesmann acquisition aptly demonstrates the value of such an approach.

Build the top team

Boards have a key role to play in selecting, developing and evaluating the executive team. It's useful to consider the model adopted by many leading private equity firms: they view their involvement in building the executive team as a top priority – and a clear factor in creating market value. Following an investment, private equity firms look to replenish top management talent with people who instinctively act like owners. More often than not, they appoint key executives from outside the portfolio company. They rigorously screen for attitude, which turns out to be as important as a strong skill set and track record.

The incentive for boards to get involved in developing leaders is powerful. A study by Bain of 23 high-growth companies reveals that only a minority systematically try to develop leaders by advancing the right people through the right jobs. Those pioneering few experienced average shareholder returns of more than 10% a year above their cost of capital over a 10-year period. But the one in four companies that placed little emphasis on cultivating leaders averaged returns of less than 1% a year.

Match reward to performance

Rewards start not with pay systems, but with how the company chooses to measure success – and how closely these measures are tied to the drivers of long-term value in the business.

The right approach is critical, because CEO

Ensure that exceptional pay requires exceptional performance, and that failure to perform is not rewarded

remuneration is the most controversial issue for most boards. They want to attract the best talent, and yet the remuneration benchmarks just keep on rising. Part of the solution lies in ensuring that exceptional pay requires exceptional performance, and that failure to perform is not rewarded.

One company that has managed to get it right is Reckitt Benckiser, the UK-based maker of household cleaning products. Senior managers'

base salaries are well below their competitors', and long-term incentives don't pay out unless the company achieves growth rates that are double the industry average.

But the company's five-year, £60 million compensation plan rewards top executives handsomely if they achieve the tough goals – real encouragement to produce results. To earn their bonuses, Reckitt Benckiser executives must show measured progress toward the company's strategic targets.

Reckitt Benckiser's plan also ensures that its management team feels the pain if shareholders are suffering. Besides using stock-based incentives, Reckitt Benckiser mandates minimum shareholdings of 200 000 shares for senior executives and 400 000 shares for the CEO. The company's compensation plan prohibits repricing options and requires that bonuses be withheld when targets aren't reached.

Effective remuneration systems measure what matters – and only what matters. They pay for performance, with real downside for mediocre results. And they ensure that rewards are simple, transparent and focused on sustained value creation, balancing short-term and long-term focus.

Ensure financial viability

Sarbanes-Oxley has had its main impact here, focusing on the probity of financial reporting and the audit process. Yet beyond such issues, boards have a role in making key financial decisions, such as ensuring appropriate levels of debt leverage, and scrutinising major investments and acquisitions for value.

Directors must be able to understand as well as trust the numbers to provide a challenge where necessary.

Worst practices can sometimes be instructive. An external investigation by former US Attorney General Richard Thornburgh into \$11 billion in accounting irregularities found that WorldCom's directors were often kept in the dark, particularly in matters involving some of the company's more than 60 acquisitions.

The Thornburgh report on WorldCom found no evidence that WorldCom directors monitored debt levels or the company's ability to repay obligations. Yet, they 'rubber-stamped' proposals by WorldCom's senior executives to increase borrowings.

Directors were even told that a \$2.65 billion credit line WorldCom obtained in May 2002

would sit unused on the balance sheet, while the company had already decided to use it instead to make payments to its accounts receivable credit programme.

In today's climate, the first question directors ask must be: 'Do we have confidence that the finances are robust?' Boards need the right skills, sufficient time, access to information and an effective board process to ensure they can contribute effectively to key financial decisions.

Match risk with return

Boards typically have formal processes for assessing and managing operational risk that incorporate commercial, financial and legal considerations. Yet few boards understand the true risks inherent in their companies' strategies. This is critical: 70% of major acquisitions fail to create value, and 70% of moves made away from the core business and into new markets also fail.

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Indeed, according to Bain research, 18 of the 25 largest non-dot.com business disasters during the past 10 years occurred because owners failed to understand strategic risk. The majority of these companies ran into trouble after misguided expansion moves into new markets went awry – including Loral's entry into the Globalstar system, the Enron disaster and the collapse of Marconi. The shareholder value lost in these 25 meltdowns alone amounted to \$1.3 trillion.

Furthermore, over 40% of CEO departures not related to retirement came after a controversial or failed 'adjacency' move. The message is clear. Boards need to understand and accept the risks inherent in their strategy, and recognise the implications for required risk-weighted returns.

Manage corporate reputation

Doing what's right for the board and the company means not succumbing unduly to outside pressures. If boards are to avoid the trap of 'check-box'

compliance and short-term focus, they need to take action to reclaim control over the agenda, and to target those investors who are in for the long term.

Consider Gillette, which had missed Wall Street forecasts for 14 quarters in a row when Jim Kilts became its CEO in 2001. Kilts's refusal to provide specific earnings guidance triggered a predictable outcry from analysts, who questioned Gillette's stability. But Kilts had the board's mandate to make long-term shareholders his touchstone. Internally, Kilts set aggressive cost-reduction targets. Revenue targets were below the old unrealistic expectations but still required market share gains.

Two years later, when free cash flow had doubled to \$1.7 billion in 2002, analysts changed their tune. Said William Steele of Banc of America Securities: 'Gillette's ... focus [is] on longer-term investment rather than an unhealthy focus on near-term pennies.'

The power of the Gillette board's approach lies in having the confidence to steer by its own internal compass. Once boards set their course, transparency and effective communication are essential both to manage external pressures and to target shareholders focused on long-term value creation.

Drive effective board processes

An effective chairman sets the tone from the top and ensures a governance model that works in practice. He or she also focuses the agenda on issues of performance and reviews board effectiveness regularly. An able chairman builds a team of directors with the right mix of skills and experience. The board of an acquisitive company, for example, should be well represented with deal-making expertise and judgement, while the directors of a fast-moving technology company need a sound view of the industry's future direction.

No formula exists, of course, but the chairman must find an appropriate combination of skill, will and values, and then knit directors together into an effective group.

A board's ability to add value depends heavily on how well directors can work with the chairman and CEO. To that end, a chairman must be clear on the value a board can contribute, and ensure that directors have ample opportunities to fulfil their roles.

What information is given to directors and how is it packaged? How should the agenda be organised and focused? How can the chairman ensure that each director is given sufficient time? How can he or she demonstrate willingness to listen and act?

Ensuring effectiveness is the primary job of any board, regardless of the processes it adopts or the norms that guide its decision making. The focus of

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any review of board effectiveness should be on collective, rather than individual, performance. Most important, it should reflect how well a board performs on the substantive business issues underlying all seven habits, not just matters of board process. Indeed, reviews of board performance need to evaluate how the seventh habit – driving effective board process – applies to each of the others: owning the strategy, ensuring financial viability and so on.

Globally, corporate governance practices are beginning to converge, but important regional differences remain. Governance structures vary by region – in the proportion of non-executive directors, for instance, and whether the authority of the chairman and CEO is separated or concentrated in a single person. In some countries, boards have more decision authority, while others are largely advisory.

The country in which a board resides will influence how much progress it can make on the seven habits. In the UK, for instance, where boards tend to be smaller and half of the directors are non-executives, the quality of the chairman and his or her relationship with the CEO colours everything else.

Effective leadership and a sound working relationship create a powerful board, while poor leadership or a flawed relationship can lead to dysfunction, deterring dissent and tough action.

In the USA, the fulcrum of power is located

between a single, powerful chairman/CEO and the board's non-executive directors, who typically make up three out of every four members. Although US boards tend to be active, advising on strategy, sanctioning initiatives and providing oversight, CEOs still set the agendas. The problems inherent in such an approach have become all too clear in recent years. A dominant chairman/CEO can make it difficult for directors to contribute and guide effectively.

Elsewhere, the customary role of a board, its composition and its stance with senior management place practical limits on how far it can go in addressing all seven habits. In some countries, for instance, boards are viewed as a way to concentrate business experience and to reward past achievement.

Companies in Japan and Korea typically follow this model. The result is larger boards populated with current and former employees or group representatives. Building the top team or matching reward to performance in executive compensation typically is not the province of such advisory boards.

Similarly, large supervisory boards that place a premium on representing all major stakeholders, as many German boards do, don't usually engage directly in setting strategy, which is handled by a subset of directors on a smaller management board.

Despite these variations in practice and tradition, the seven habits remain valid as aspirations for directors in all countries. They offer a practical way for boards to address the diverse challenges and constraints that prevent them from performing their roles effectively – some of them structural, some arising from wrong-headed external pressures or shortcomings in values, capabilities and focus.

Whatever else the current duress in business produces, we have reached a turning point in the relationship between the board, the management team, regulators and the investment community. The trajectory and character of companies in the coming years will be decided in large measure by how well boards can improve their own effectiveness and regain initiative. If that happens – when that happens – boards will be back in the business of building great companies.