Change across the board

Robert F. Felton and Mark Watson

Investors are angry. Directors can run but they can’t hide.

How long must corporate boards look bad? A swath of scandals has eroded trust in US corporate conduct to levels last seen a century ago, when the abuses of monopolies ushered in an era of trust-busting. Having watched tumbling share prices batter capital markets and retirement plans, investors are now demanding that the government’s promises of reform be turned into action. A handful of the highest-profile scandals have called into question the integrity of US capitalism, and the longer uncertainty lingers over that question, the greater the risk that critical issues of corporate governance will be reduced to the currency of narrow political posturing.

The good news is that directors want to promote change: our survey of nearly 200 US corporate directors sitting on some 500 boards highlights a clear desire for substantial reform. These findings, bolstered by more than 50 interviews with directors, corporate-governance experts, and investors, show a growing concern among members of boards about whether those bodies truly understand the problems—including the risk of increased liability—that now confront business.

Our research and experience point to a clear path forward for directors who would usher in a new era of corporate governance. The essential objective
must be to reestablish the balance between management and the board so that the former runs the company while the latter contributes to its strategic and operational development and provides the oversight needed to satisfy shareholders. Although a minority of boards—in the United States and beyond—have struck the right balance, this delicate equilibrium has tipped too far in favor of management. The way to restore the balance is to strengthen the independence of the board and to give it clear leadership separate from management.

At many companies, achieving these goals may require the appointment of a nonexecutive chairman or of a strong lead director. It will also be necessary to revise management-compensation plans substantially and to raise performance criteria for CEOs and board members alike so that only active, engaged directors remain. In addition, there is a need for a new understanding of the risks companies run and for the transparent and effective communication of the principles of corporate ethics.

Although these elements are essential to any agenda for boardroom reform, they are just a few of the improvements that must take place within a broader corporate-governance context. Accurate and timely financial disclosure, stronger audits, and strengthened shareholder rights are necessary as well, since such steps all influence the behavior of boards and make them responsive to the interests of the shareholders.

Business has little time to waste. As part of a larger agenda for institutional change, the reform of boards must be pursued urgently to preempt even more regulatory activity and to send investors the correct message. The
people problems and power dynamics that invariably lie at the heart of such reforms create tensions that also take time to overcome.

Our seven-step framework for tackling the problems builds on our experience developing core board-governance processes, including new approaches to meet the evolving needs of business and investors. These suggestions are not startlingly new, but adhering to them would be. Keep in mind that we are not proposing an "à la carte" approach to board reform: while each step involves its own challenges, only the comprehensive and simultaneous pursuit of all seven core processes is likely to succeed in rebuilding trust at every level—not least the trust of investors.

1. Managing the board effectively

One of the central building blocks of board-governance reform is to ensure that boards can perform their roles. Almost without exception, our interviews showed that restructuring and new processes can't make up for a lack of independent, qualified, motivated, and honest directors who represent shareholder interests.

Needed: More independence

Every board should aim to strengthen its autonomy. A majority of its directors should be independent— free from commercial and personal ties that could impair their ability to probe and challenge management—and these

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Chairman and CEO: One role or two?

Currently, 75% of S&P 500 companies have a single person serving as both chairman and CEO. Since “it’s lonely at the top,” having a partner in thought is essential. Directors support several ways to realign power.

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<tr>
<th>Percentage of directors who support</th>
<th>Appointing lead director</th>
<th>Splitting CEO, chairman roles</th>
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<tr>
<td></td>
<td>73%</td>
<td>86%</td>
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‘You risk added divisiveness,’ and ‘splitting the roles reduces the CEO’s freedom of action.’

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independent directors should play a major role in committee work. At the very least, a senior (or lead) nonexecutive director should be appointed; a more radical solution would be to install a nonexecutive chairman, a practice generally favored outside the United States. Since nearly 70 percent of the directors we surveyed favor this approach, it could become more common here as well.

Another important step is the creation of a transparent nomination process led by an independent board-governance committee that knows exactly what skills are needed in the boardroom. Two essentials are an understanding of the financials and the ability to probe business models. Some directors regard experience in a company’s sector as critical, while others prefer outside perspectives.

Not needed: Board sitters

A board should remove underperforming directors quickly. To ensure that the skills of directors always meet a board’s needs, a large proportion of the respondents to our survey support some combination of annual elections, the evaluation of boards or their members, and age or term limits.

To get better performance from the board as a whole and from individual directors, regular assessments are essential: as one director put it, a thorough “evaluation hurts, but it is a great help.” These assessments, focusing on issues such as preparation, participation, and collegiality, can be made by the board itself or facilitated by third parties, but the tone should always be constructive, concentrating on the need for development and on the identifica-

**SHOULD BOARDS AND DIRECTORS BE EVALUATED?**

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<th>Directors rate 45% of their colleagues as average to low performers. As for themselves, they say they are <strong>willing to be evaluated.</strong> Percentage of directors who support:</th>
<th><strong>BUT</strong> Nearly 20% <strong>consider completely inappropriate</strong> any third-party <strong>evaluation</strong> of the board and its governance practices. “At this point in their careers, directors don’t want to be evaluated.”</th>
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<tr>
<td>Formal board evaluation</td>
<td>85%</td>
</tr>
<tr>
<td>Formal director evaluation</td>
<td>81%</td>
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tion of poor performers. Often, the very existence of a review process persuasive them not to seek reelection.

Restructuring the compensation of directors to reward commitment would be another effective response to the current collapse of investor confidence. The first need is to move away from input-based compensation, such as retainers or payments based on attendance records. Replacing cash payments with a more performance-based form of compensation would be another welcome step. Issuing restricted stock rather than offering stock options might be a better way to keep directors focused on long-term performance. Minimum required stock holdings may help meet the investors’ demand that directors have some “skin in the game.”

Limitations on the total number of directorships held by individuals can help make them more committed to their board work. Some directors call for even tougher measures. One said that a director who missed two meetings without reason “shouldn’t get paid”; another said that directors who failed to do their homework before board meetings should be removed.

Improving board basics

If directors don’t really understand what is happening at the company or if its board lacks the time to tackle an issue, management ought to identify the
board’s role in critical management processes such as budgeting, the making of strategy, and the evaluation of managers. Board and committee meetings should be restructured to ensure that directors have the time to discuss critical issues. Sessions when management isn’t present should be common at the end of board and committee meetings.

When directors complain about receiving too much information too late or too inconsistently, that is a sure sign the board’s information processes should be overhauled, starting with direct reporting lines to corporate secretaries. Key managers should report regularly to committees, answer the questions of their members, and educate them on specific situations and areas they wish to investigate. Boards should have discretionary budgets to obtain outside advice on issues such as management compensation and major financial transactions.

2. Overseeing strategy

Management can’t realistically be held to account for the performance of companies if boards have no role in setting corporate strategy. But although boards should agree on the overall scope of the business, protect the interests of shareholders, and guide the implementation of strategy, they can’t really create the strategy; if they did, there would be a risk of dangerous confusion about who ran the business.

Directors can master this arm’s-length guiding role by developing a better understanding of the industry, by playing a part in shaping strategy, and by monitoring its execution. A broad orientation program for directors—per-

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**WHO’S REALLY INDEPENDENT?**

Directors consider more than a quarter of their ‘independent’ colleagues not truly independent.

A third of all directors say their boards have, at best, an ineffective process for controlling potential conflicts of interest and that nearly as many directors do not understand those conflicts sufficiently.

Percentage of directors with little or no understanding of potential conflicts of interest among management, directors, and the company.

haps every 18 months—is invaluable, as are strong relationships with key managers and regular discussions with them about competitive challenges and trends.

Stronger relationships encourage good managers to seek out the views of directors about strategic initiatives early on and to maintain contact throughout the strategy-setting process. Directors should always be able to counter with alternative strategic options and to scan competitive threats. Such discussions could be held at regular board meetings, but it is better for the board and for managers to devote a number of days to strategy—preferably away from the office—in order to delve into specific topics, plan strategies, and build a consensus. To improve the implementation of strategy, boards and managers should agree about long-term indicators such as market share, capital productivity, and profit margins.

3. Ensuring effective risk management

Several corporate failures in the past year have shown that boards didn’t understand the risks their companies took. This isn’t an uncommon failing: more than a third of the directors in our survey admitted that they didn’t know the major risks facing the businesses on whose boards they sat, and more than 40 percent said that those boards had no effective processes to monitor risk. Despite this sorry state of affairs, risk management hardly figures in the debate about corporate-governance reform.

Good risk management can be achieved by adhering to four general principles. First, delineate the risks. Determining which ones (and how much) to...
bear is among the most important strategic decisions a company makes and should therefore be made at the top—by the CEO, with support from the board. Furthermore, this decision should guide the behavior of other managers, for without such guidance, a company’s risk strategy will be made—and repeatedly redefined accidentally—by dozens of everyday financial and business decisions.

Second, once the company is sure about its risk strategy, it must be able to measure its risk exposure and to update its risk profile routinely. Third, the company must ensure that the people who determine the risk policy and monitor and control its implementation are quite separate from those who manage the business; the referee can’t also be a player. Last, to reinforce good risk-management processes, companies must strive to develop a strong corporate-risk culture so that decision makers always consider the downside of their actions as carefully as the rewards.

It is the board’s job to make sure that managers implement effective risk-management processes and maintain the risk-reward profile that the board and the CEO have defined. Otherwise, senior managers and the board itself will be stumbling in the dark when they attempt to maximize the company’s performance and to protect shareholders from unwelcome surprises.

4. Monitoring corporate performance

Ensuring that the performance of a business matches the expectations of its shareholders is a board’s most important ongoing function—and one that requires accurate, independently assessed financial information. Investors...
clearly doubt the integrity of the financials of many companies, and regulators have turned to institutional remedies: CEOs in the United States, for instance, will have to certify the financials of their companies every year.

To rebuild a reputation for integrity, every board will thus have to start by ordering a comprehensive review of the accounting practices of the company and by testing its major assumptions about revenue, capital, off-balance-sheet items, and other key data, as well as any variances from generally accepted sector or market practices. Boards should highlight major inconsistencies in the data and resist the temptation to step back from contentious areas. One of the directors we interviewed noted that his board holds annual discussions with its external auditor on the top five areas of contention between auditors and management, such as approaches to new accounting measures and the possibility that management has pushed accounting standards to their limits. To ensure that the people conducting the external audit can speak freely about their concerns and share their views on improving internal audit systems, the members of the audit committee should meet them without management.

What is more, in the light of the past year’s scandals, why would a board want to use external auditors to provide any service besides auditing? If they must do so, companies should at least show why this practice makes good business sense and be prepared to demonstrate that no conflict of interest will result. Further, the audit committee, not management, should select and
appraise the external auditors annually. Companies ought to adopt clear rules about hiring an external auditor’s employees—for example, rules limiting the number of such appointments and implementing processes to maintain the integrity of the internal audit. The company should also have a rule requiring it to rotate the audit partner regularly, perhaps every five years.

With sound financials in place, the board can review key performance indicators to make sure that they line up with the overall objectives of the company and its investors. Management may need to educate directors about the significance of these indicators, such as budgets and quarterly earnings, for the strategic aims of the company and for investors. Ongoing corporate-level performance evaluations should aim to spot and investigate any failure to meet targets. When such failures occur, management should discuss corrective actions with the board.

5. Restructuring management compensation and evaluation

Angry investors point to inappropriate and excessive executive pay as a primary source of the current crisis in US corporate conduct. If corporate America is to restore trust, the board’s role will be crucial to ensure that the right managers run the company and that their evaluations and pay levels are in line with shareholder sentiment.

In the present environment, aligning the interests of managers and shareholders in a credible way is likely to test any board’s mettle. One starting point is to attack some of the most egregious practices and to develop a policy that suits the overall strategy of the business and its appetite for risk.

**H O W  I M P O R T A N T  I S  T H E  C E O ?**

*The CEO can make or break the effectiveness of a board,* and directors want CEOs to take on increased responsibility.

For instance, 74% of directors support making CEOs more responsible for the accuracy of financial reports.

64% of boards have no effective way to answer this question: *If our CEO ends up under a bus this morning, who will replace him?*

and reward. Boards, for example, must dismantle compensation models that encourage executives to “pump and dump” personal shareholdings. Pay ratcheting—for instance, top-quartile pay for average performance—ought to be shunned. At a minimum, boards should insist on indexing payouts to competitive benchmarks, on much longer retention periods (perhaps longer than an executive’s stay with the company) for shares issued as compensation, and on reducing the value of termination contracts.

Boards will have to restructure compensation. Management-development and compensation committees should directly appoint external pay consultants without shopping to find advice that managers will find especially palatable. Instead of accepting the consultancy’s recommendations outright, the board should judge compensation plans on sound business principles—an approach that seems to have been lacking in the past. The members of the compensation committee will be sorely tested as they try to balance the expectations of managers, who are going to assume that recent compensation practices will continue, and the demands of shareholders, who view those practices as outlandish. Warren Buffett, the chief executive officer of Berkshire Hathaway, has said that “the recent compensation of CEOs was the biggest peacetime wealth transfer in history.”

With shareholders particularly wary of overly complex compensation schemes, it will be crucial to clarify the new policies. One way of making them more acceptable would be to sound out leading institutional shareholders before putting them to the broader body of shareholders. The issue of precisely how to calculate the value of executive stock options may still be open for debate, but it is time for the management and boards of mature

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**Do Boards Really Evaluate Top Management?**

Directors are **dissatisfied** with the way they oversee top managers.

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<thead>
<tr>
<th>Role</th>
<th>Percentage Dissatisfied</th>
<th>Percentage Satisfied</th>
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<tbody>
<tr>
<td>Chief risk officer</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>External legal counsel</td>
<td>43%</td>
<td>57%</td>
</tr>
<tr>
<td>Chief legal counsel</td>
<td>31%</td>
<td>69%</td>
</tr>
<tr>
<td>CFO</td>
<td>30%</td>
<td>70%</td>
</tr>
<tr>
<td>CEO</td>
<td>37%</td>
<td>63%</td>
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“Boards shy away from digging for information on the CEO.”

Directors don’t have enough time to get to know top managers other than the CEO and tend to shy away from conflict.”

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companies in mature industries to seriously consider following Boeing’s example by listing stock options as an expense on profit-and-loss statements; Amazon.com, Bank One, Coca-Cola, and more than a dozen other companies recently jumped on this bandwagon. In our recent survey of investing institutions, 83 percent favored this approach.1 Regulators appear likely not only to mandate this change but also to require that shareholders approve any new stock-related compensation.

Finally, the most important decision that any board makes—beyond approving major constitutional changes such as mergers—is the appointment of a chief executive officer. The era of the CEO-centric business culture may well be at an end. In any case, no matter how strong-willed the CEO may be, the board should see that a process exists for ensuring the succession of the CEO and annually evaluate the ability of that process to develop a new generation of leaders. A surprising two-thirds of the boards to which the directors in our survey belong had either “no succession or ineffective succession processes.”

Too many boards today shy away from checking the performance of CEOs closely. At the very least, a board should institute informal evaluations led by the nonexecutive chairman or the lead director. The opinions of individual directors and managers should be sought and then synthesized in a report

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<th>Percentage of directors who...</th>
<th>Percentage of boards that...</th>
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<tr>
<td>Do not fully understand key value drivers</td>
<td>44%</td>
</tr>
<tr>
<td>Do not fully understand company performance against objectives</td>
<td>23%</td>
</tr>
<tr>
<td>Lack of effective processes to monitor performance</td>
<td>23%</td>
</tr>
<tr>
<td>Lack of sufficient processes to ensure management focus</td>
<td>29%</td>
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presented to the board and discussed privately with the CEO. More formal arrangements include structured board discussions in executive session as well as detailed evaluations by management-development and -compensation committees.

The strength of the senior management bench should also be tested annually. (Our survey found considerable unhappiness among directors about the board oversight of top management. Some 31 percent of them, to cite one example, were dissatisfied with the oversight of the CEO.) The management-development and -compensation committees should, for instance, review the evaluations of a company’s top 25 to 50 managers. Incorporating the feedback of directors in these evaluations can provide useful input on performance, career development, and training opportunities. Frequent, ongoing interactions between individual directors and managers should also be an integral part of a company’s efforts to develop talent, along with visits by directors to discuss strategy and meet employees at key sites.

6. Maintaining corporate and board values

Structures and processes are important in a company, but as successful business leaders know, the culture of the corporation is what ultimately shapes the ability of its people to work effectively. In selecting new directors, boards should consider how their own boardroom culture would mesh with the personal qualities of candidates for membership. Informal discussions about the board’s working style can help communicate to those candidates the board’s expectations for performance and conduct. The directors should aim not to select “people like us” for the board but rather to ensure that new members fit in with the culture of the company and, at the same time, bring creative friction to it.

If conflicts of interest arise among directors or senior management—as will happen, for example, when large shareholders hold positions on the board—mechanisms for proper and prompt disclosure are crucial, for with this information boards can ensure that individuals play no role in decisions in which they have serious conflicting interests. Any major potential conflict should be communicated to investors.

It is important for the board’s members both to shape corporate values and to exemplify those values in their own behavior. The board and the management of a company must also communicate their expectations about its ethical standards and values to its staff; employees are likely to be receptive to such efforts now that high-profile scandals have taught everyone a hard lesson in the consequences of ethical failure. The best boards will establish feedback systems to encourage whistle-blowing, perhaps through an
ombudsman with access to directors or through direct communication with senior ones. Remember, a company’s employees remain the first and best line of defense against damaging moral laxity.

7. Communicating effectively with shareholders

As recently as a decade ago, investor relations seemed to be a relatively low-level activity, often buried in the finance function. No longer. The spectacular decline in the confidence of investors over the past year has made the management of their expectations a priority for CEOs and boards. Too often, a board’s involvement with investors is limited to the annual general meeting. Typically, only a few directors—for example, independent chairpersons—engage leading shareholders in discussions about investor relations. All this will surely change.

In the current environment, moreover, perceptions of financial irregularity can be as damaging as actual problems. Boards should think twice about using alternative reporting approaches (such as pro forma earnings statements) and anticipate the way management might handle future changes in accounting standards. The overall approach to investor relations—for instance, the way a company communicates with its top 100 investors—should be reviewed regularly.

When core board processes are reevaluated, the concerns of the very largest investors should be considered.

Finally, boards ought to communicate their own governance standards to investors—at the very least by providing information about their overall approach. Some boards may wish to publish details on implementation, such as the impact of board evaluations on the way the board will work in the future.

Boards that pursue reforms through a framework like the one outlined here will enjoy advantages in the quest to restore investor confidence and trust. Yet corporate governance must amount to more than a set of best-practice approaches. Simply ticking off boxes on a governance agenda isn’t likely to encourage vigorous, performance-oriented behavior.

Instead, boards and managers should begin the process of reforming governance by frankly discussing the need and appetite for change. Certain tools

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3 See Kevin P. Coyne and Jonathan W. Witter, “What makes your stock price go up and down?” The McKinsey Quarterly, 2002 Number 2, pp. 28–39. The article outlines the impact on share prices of trades by the largest 100 investors in major public companies.
can not only guide and advance the process by bringing to bear objective data and experience but also relieve some of the tensions inherent in governance reform. Diagnostics that compare a company’s practices with those of a peer group or with the expectations of leading shareholders, for example, can unearth key areas for improvement and barriers to it. Workshops can build a consensus on goals and values, the overall scope of the business, and the extent to which the board should give operational freedom to management. Implementation calls for careful planning and may require the same trade-offs between short- and long-term results and the same kind of experimentation that is common when companies launch strategic business initiatives.

There is no easy way to allay the crisis in US corporate governance, but boards in the United States—and, eventually, in other countries—will change: investors are so angry that their interest in corporate conduct isn't going to fade. Only concerted efforts by individual companies to reform essential board processes and to incorporate broader corporate-governance trends will restore the integrity that investors now find lacking.

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