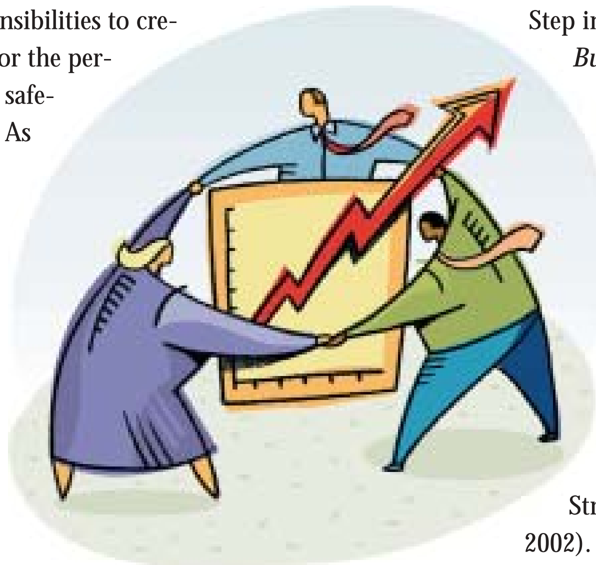
Strategy and the Board of Directors

By Mark L. Frigo

How well do directors truly understand the strategy of a business? I'll share my thoughts based on experiences at recent executive workshops and coaching sessions with CEOs, CFOs, and directors on developing a structure for understanding and prioritizing key elements of strategy that boards of directors must know.



Directors have basic responsibilities to create shareholder value, monitor the performance of a company, and safeguard its long-term viability. As part of their duties, they review corporate strategic plans. The challenge for them is to quickly and effectively grasp the key issues and see how a myriad of strategic activities and initiatives fit together.

Each director should be expected to have this knowledge. Jay A. Conger, professor of organizational behavior at the London Business School, and Edward Lawler, III, director of USC's Center for Effective Organizations, describe what should be expected from every effective director in terms of knowledge of the business by posing the following question: "Does the director have an adequate understanding of the company's strategies, industries, markets, competitors, financials, operating issues, regulatory concerns, technology, and general trends?" ("Individual Director Evaluations: The Next Step in Boardroom Effectiveness," *Ivey Business Journal*, May-June 2002).

Return Driven Strategy provides a framework for quickly evaluating corporate strategy and strategic plans with a critical eye.

Return Driven Strategy: A Framework for Directors

Previous columns have discussed this framework (Frigo and Litman, "What Is Return Driven Strategy?" *Strategic Finance*, February 2002). In summary, Return Driven Strategy is the set of guidelines for designing, developing, and evaluating business strategy aimed at maximum, long-term wealth creation. These guidelines are displayed as a hierarchical set of strategic activities built on three major foundations of great business strategies.

Hierarchy of Activities and the Board's Attention

Prioritizing attention to initiatives is critical in an effective board's evaluation of a company's strategy because discussion of strategy can often get caught up in the de-

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tails of particular strategic initiatives without fully considering how the activities will lead the company to superior financial returns. It is difficult to quickly evaluate the significance of particular activities and present a holistic context to all of the various strategic initiatives.

One approach I have used with executives in developing a board presentation is to compile a list of questions any effective director should be anxious to ask:

- Does the company demonstrate an ethical commitment to maximizing financial value?
- What unmet customer needs are being targeted by the business's strategy?
- Are these customers in market segments that are growing (or in markets that are stagnant or declining)?
- What Genuine Assets does the firm leverage? In other words, why should we, and not another larger or better equipped competitor, be doing this?
- Are other strategic initiatives aligned toward these top three overriding questions? For example, how does a new partnership help answer these three questions more convincingly? What about a new branding initiative?
- Are significant forces of change (population and demographic, economic and regulatory, etc.) being adequately considered for potential threats and opportunities?

Begin at the Beginning: Business Ethics and Long-Term Value Creation

The subject of business ethics is a central point that is pressuring boards today. Return Driven Strategy is built on research and application at companies that have demonstrated the highest levels of financial performance. It shouldn't be surprising that the first tenet of great business strategy is "Commit to Ethically Maximize Financial Value." Extensive research shows that the design of business strategy must begin with this commitment. In fact, the best way for a company to ensure that it will never experience an elite level of financial performance is to ignore this concept. This must be the first and foremost element of the corporate business strategy for boards to evaluate—not simply because it is key to protecting your own position, but because it is the first step in a path to massive shareholder wealth creation. These are questions directors should consider.

Noting Commitment to Long-Term Value Creation

Naturally, the board's audit committee must be careful as corporate scandals over the last few years have shown. But there is a specific charge for the compensation committee as well. This first tenet requires the right incentives for executives, management, and employees alike. If the pressure of compensation is based on delivering short-term results at all cost, horrible results can occur. Unethical accounting activities can be driven by a focus on these types of measures. Are the right metrics in place to foster ethical long-term financial value creation? Can financial metrics alone assure a long-term commitment to the shareholder's best interests?

Leading vs. Lagging Indicators

Boards must pay special attention to the metrics they are being given and the metrics being used that demonstrate the company's steps toward success or failure. Do directors receive the information they need to effectively discharge their responsibilities in understanding how well strategy is being executed?

The CFO must recognize that while quarterly data contains important information about the historical performance of the organization, share price is dependent on long-term discounted cash flow. Boards must ask for and be presented with leading indicators of performance and be wary of overemphasized short-term metrics like quarterly sales and earnings per share (EPS). Financial metrics tend to be lagging indicators, and the CFO must be tasked with determining helpful leading indicators, often nonfinancial, that define where the strategy is going and what foundations are being laid today for the future.

Edward Lawler suggests that leading performance measures are crucial for board member strategic activities ("Board Governance and Accountability," *Balanced Scorecard Report*, January-February 2003):

"Most directors would say that their most important role is contributing to strategy. That is also the area where they feel they don't do a particularly good job or have enough opportunity to perform. And one of the reasons they feel that way is precisely because they don't get the kind of lead indicators that they need to be meaningful partners in a strategy discussion."

Research into balanced scorecard implementations provides some insight into the desirable connection between information provided to the board and the strategy of the organization. The balanced scorecard is one means for making this connection. A 2002 study by the Society of Management Accountants of Canada (Epstein, Jones, and Roy, *Measuring and Improving Performance of Corporate Boards*) examined the useful-

ness of a balanced scorecard framework for boards in a variety of uses: "…boards can use the balanced scorecard as a useful tool for discharging their oversight responsibilities. It can be helpful to boards in the roles of defining and articulating strategy, ensuring that strategy is properly implemented, and obtaining the information necessary to monitor corporate performance, its own performance and the CEO's performance."

Jay W. Lorsch, Harvard Business School professor and thought leader on corporate governance, puts it this way: "If directors were regularly getting a balanced scorecard (or something like it), they would be much more likely to be informed about their companies on an ongoing basis. The scorecard's emphasis on strategy (linking it to all activities, day-to-day and long-term) could help directors stay focused." ("Smelling Smoke: Why Boards of Directors Need the Balanced Scorecard," *Balanced Scorecard Report*, September-October 2002).

Impetus for Boards of Directors

Return Driven Strategy is a framework built on identifying and aggregating the practices of the greatest long-term financial performers. Directors can benefit from better understanding the patterns that lead companies to the highest potential levels of long-term shareholder wealth creation. In addition to adequately understanding and examining corporate strategy and strategy plans, directors should demand more than just financial metrics that discuss the ongoing success or failure of those plans. Armed with these tools, directors can better fulfill their positions as representatives of shareholders and better ensure their personal success as shareholders themselves. ■

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