Chapter 7

The Board's Role in Strategy Development

7.1 Who Is Responsible for Strategy Development?

Boards are being urged to play a more active role in strategy formulation. If evaluating the quality of management's strategic and business plans, including the likelihood of realizing the intended results, is a key board responsibility, so the argument goes, should it not determine for itself whether the company has the capacity to implement and deliver? It is a good but tricky question. How might a board do this? What, for example, should a board do if management presents a bold plan for spinning off or acquiring strategic assets worldwide? Assume that the logic is consistent, that the plan makes sense, that the numbers look good, and that management has a convincing answer for every tough question asked by the board. Has the board met its fiduciary responsibility or should it seek an independent opinion to "audit" the strategic assumptions made by management and its consultants? After all, directors do not have the equivalent time and resources to review the details of strategies presented to them.

A strong argument can be made that if the board feels compelled to retain outside experts to review corporate strategy, it probably has lost confidence in the CEO and should simply fire him or her. Conversely, one can argue that hiring outside consultants is the most cost-effective way for the board to prove its independence and positively challenge top management. Which is it?

In attempts to provide guidance on this issue, numerous "codes of best practice" have been proposed in recent years urging boards to define their responsibilities with respect to strategy development as

- setting the ultimate direction for the corporation;
- reviewing, understanding, assessing, and approving specific strategic directions and initiatives;
- assessing and understanding the issues, forces, and risks that define and drive the company's long-term performance.Bart (2004), pp. 111–125.

As the simple example above demonstrates, however, reality is considerably more complex. Traditionally, boards have become involved in strategy mainly when there were specific reasons for them to do so. The most common are the retirement of an incumbent CEO, a major investment decision or acquisition proposal, a sudden decline in sales or profits, or an unsolicited takeover bid. In recent years, however, as regulatory and other pressures increased, many boards have sought to become more deeply involved and create an ongoing strategic role, for example, by participating in annual strategy retreats or through the CEO performance evaluation process. Still, in most companies even today boards limit their involvement to approving strategy proposals and to monitoring progress toward strategic goals; very few participate in shaping and developing the company's strategic direction.

There are a number of reasons for this. First, there is a longstanding concern on the part of both executives and directors regarding where to draw the line between having directors involved through contributing ideas about the company's strategic direction and having directors who try to manage the company.Lorsch (1995, January–February). Specifically, there is a widely shared belief that strategy formulation is fundamentally a management responsibility and that the role of the board should be confined to making sure that an appropriate strategic planning process is in place and the actual development—and approval—of strategy is left to the CEO. Even those who do favor greater director involvement in strategy say that the degree of involvement should depend on the specific circumstances at hand. A significant acquisition proposal or a new CEO, for example, may indicate the needs for greater board involvement.

Second, in the aftermath of the Enron and other governance scandals, many boards had to focus on internal issues and on digesting the new accounting compliance rules of the landmark Sarbanes-Oxley Act. In a number of companies, this turning inward has had the undesirable side effect that the board's decision making has become so focused on compliance issues that strategic considerations have taken a backseat.

Third, some CEOs simply do not want their boards involved in strategy discussions; they view the board's engagement in developing strategy as interference into their managerial responsibilities and a threat to their sense of personal power. Of course, the downside of this posture is that the board may not fully understand or buy into the organization's strategy and that board talent is underutilized. Taking this approach sometimes backfires on CEOs when formerly disengaged boards become overengaged and then make their CEOs "walk through fire" on tactics.

Fourth, there is the delicate question of how knowledgeable even the most capable directors are to assist with strategy development. Most are quite effective in dealing with short-term financial data. Strategy development, however, also demands a detailed understanding of more future- and long-term oriented issues, such as changing customer preferences, competitive trends, technological developments, and the firm's core competencies. A typical board of directors is poorly designed and ill-equipped for this task. According to a recent McKinsey survey, more than a quarter of directors have, at best, a limited understanding of the current strategy of their companies. Only 11% claim to have a complete understanding. More than half say that they have a limited or no clear sense of their companies’ prospects 5 to 10 years down the road. Only 4% say that they fully understand their companies’ long-term position. More than half indicate that they have little or no understanding of the 5 to 10 key initiatives that their companies need in order to secure the long-term future.Felton and Fritz (2005).

Finally, while board meetings are conducive to questioning specific strategic assumptions and monitoring progress toward strategic goals, they are not a good forum for the more creative, elaborate, and nonlinear process of crafting strategy. Board discussions tend to focus on the implementation and tactics of an ongoing strategic direction. Revealing serious reservations about the underlying strategic assumptions sometimes not only is seen as distracting and inappropriate but also may be interpreted as a vote of no confidence in the current management.

The bottom line is that carving out a significant role for the board in strategy formulation is extremely difficult. First, as we have seen, there is the nature of the strategy development process itself. Characterizing a board’s involvement in strategy on a continuum from “passive” to “active” is a dangerous oversimplification. A passive posture assumes that strategic decisions are both separate and sequential, that managers generate options that boards choose from, and that managers then implement the chosen option and boards evaluate the outcomes. An active conception assumes that boards and management formulate strategy in a partnership approach, that management then implements and both groups evaluate. In reality, strategic decisions often evolve through complex, nonlinear, and fragmented processes. What is more, a board can be actively involved in strategy without being involved in its formulation. For example, a board can “shape” strategy through a process of influence over management in which it guides strategic thinking but never actually participates in the development of the strategies themselves.de Kluyver and Pearce (2009), chap. 1.

Second, as noted, certain situations dictate a more influential strategy role for the board than others. For example, at times of crisis, such as a sudden decline in performance, a new CEO, or some other major organizational change, boards tend to become more actively involved in strategy. Other determinants of the degree of board engagement in strategy issues include firm size; the nature of the core business; directors’ skills and experience; board size; occupational diversity; board tenure and board member age; board attention to strategic issues; and board processes, such as the use of strategy retreats, prior firm performance, and the relative power between the board and the chief executive officer, particularly in terms of board involvement in monitoring and evaluating this position. External factors include the concentration and level of engagement of the firm’s ownership and the degree of environmental uncertainty.Bart (2004).

Third, as a consequence of recent governance reforms that focused on making boards more independent, many now lack directors with relevant industry expertise to participate effectively in shaping strategy—much less to reshape it in an increasingly fast-paced business climate. In the current post-scandal governance climate, even as the business landscape is becoming more complex, many boards continue to give priority to compliance-oriented appointments rather than visionary ones.Carey and Patsalos-Fox (2006).

Finally, there are the ever-present constraints on time and knowledge. To become meaningfully engaged in strategy formulation, boards must become much more efficient, particularly since their time has already been stretched in recent years: The average commitment of a director of a U.S.-listed company increased from 13 hours a month in 2001 to more than twice that today, according to Korn/Ferry.Korn/Ferry (2007). Directors also need to become far more knowledgeable and proactive about grasping the company's current strategic position and challenges more clearly. To understand the long-term health of a company, directors must pay attention not only to its current financials but also to a broader range of indicators: market performance, network positioning, organizational performance, and operational performance. Similarly, a broader appreciation of risk—including credit, market, regulatory, organizational, and operational risk—is vital. Without this knowledge, directors will have only a partial understanding of a company. While boards receive and discuss all sorts of "strategic information," financial measures—probably the least valuable component of a board member's strategic information requirements—still dominate. Even with better information, time constraints may prevent a broader role for the board. Boards typically perform their strategic governance role in the course of a couple of hours at every third board meeting—annually supplemented by a 2-day strategy retreat. A more active role in strategy development requires much more time.

Despite these difficulties, Nadler (2004) argues that companies should try hard to create a meaningful role for their boards in the **strategy development**[1] process. The key is to create a process in which directors participate in strategic thinking and strategic decision making but do not infringe on the CEO's and senior executive team's fundamental responsibilities. In such a process, the CEO and management should lead and develop strategic plans with directors' input, while the board approves the strategy and the metrics to assess progress. The direct benefits of such an engagement are many, including a *deeper understanding* by directors of the company and its strategic environment, a *sense of ownership* of the process and the resulting strategy, *better decisions* reflecting the broader array of perspectives, *greater collaboration* between the board and management on other initiatives and decisions, *increased board satisfaction*, and *more effective external advocacy*.Nadler (2004).

1. The process of a board's setting the direction for the corporation; reviewing, assessing, and approving strategic directions and initiative; and assessing and understanding the issues, forces, and risks that define and drive the company's long-term performance.

But, as Nadler notes, while the benefits can be significant, broader board participation in strategy development also has costs. First, directors must have a thorough understanding of the company—its capital allocation, debt levels, risks, business unit strategies, and growth opportunities, among many issues—and that takes time and commitment. Importantly, they must engage management on the major challenges facing the company and have a firm grasp on the trade-offs that must be made. A second potential cost is that increased board participation can result in less management control over outcomes. Real participation means influence, and influence means the ability to change outcomes. A well-designed process yields the benefits of participation while limiting the amount of time and potential loss of control.Nadler (2004).

7.2 A Framework for Board Strategy Engagement

To create a workable framework for board engagement, Nadler (2004) distinguishes between four, roughly sequential, types of strategic activity:

1. *Strategic thinking*. The collection, analysis, and discussion of information about the environment of the firm, the nature of competition, and business models.
2. *Strategic decision making*. Making a set of core directional decisions that define fundamental choices concerning the business portfolio and the dominant business model, which serve as the platform for the future allocation of limited resources and capabilities.
3. *Strategic planning*. Identifying priorities, setting objectives, and securing and allocating resources to execute the chosen directional decisions.
4. *Strategy execution*. Implementing and monitoring results and appropriate corrective action. This phase of strategy development can involve the allocation of funds, acquisitions, and divestitures.Nadler (2004).

It will be apparent that the board's role can and should differ dramatically in these four development phases. Early in the process, the board's focus should be on providing advice and counsel about issues, such as the process followed, perspectives taken, the inside–outside balance of environmental and competitive analyses, and presentation formats. Later, when key directional choices must be made, the board's role becomes more evaluative and decision focused. Once directional decisions have been taken, reviewing and monitoring progress should become the board's primary focus.

Nadler organizes the various discussions and decisions the board needs to undertake into a multistep "strategic choice process":

1. *Agreeing on the company vision*. This step entails restating or confirming the company vision—a description of its aspirations in relation to multiple stakeholders, including investors, customers, suppliers, employees, legislative and regulatory institutions, and communities. Such a vision statement should be aspirational and paint a picture of what the company hopes to accomplish in tangible and measurable terms. Good vision statements talk about measures of growth, relative

positions in markets or industries, or returns to shareholders. They provide a benchmark against which to assess strategic alternatives.

2. *Viewing the opportunity space*. This second step focuses on an analysis of the full array of strategic options the company should consider from different perspectives. For example, the analysis might look at different emerging markets, the range of available technologies to meet a customer need, the potential set of customers, or the constellation of competitors. Each of these presents a different set of "lenses" through which to look at the environment.
3. *Assessing the company's business design and internal capabilities*. This third step looks inward, focusing on an assessment of the company itself, including its current business design and organization. The objective is to analyze the relative strengths and weaknesses of the firm, including its human capital, technologies, financial situation, and work processes, among others.
4. *Determining the company's future strategic intent*. In this fourth step, the vision, the view of the opportunity space, and the assessment of the current business or organization are brought together to identify a future strategic intent. The purpose is to identify the most attractive opportunities for their vision and their capabilities.
5. *Developing a set of business design prototypes*. Having identified a strategic intent, the next step is to develop prototypes for each business design. It is useful to consider a number of distinct, viable options to provide the opportunity for real comparison, contrasting approaches, and true choice. The final decision should be made against a set of criteria developed in the strategic intent stage. The leading choices should also be tested against current organizational capabilities to understand the nature of the challenges inherent in executing each strategy. When this choice is made, initial planning of execution is complete.

This process unfolds over a period of months, with numerous meetings, work sessions, and rounds of data collection and feedback, and provides a way of building board engagement. Perhaps more importantly, management will benefit from the board's informed point of view.Nadler (2004).

7.3 The Board's Involvement in Strategy: Special Situations

Two dimensions of strategy formulation merit special attention because they require substantial board involvement and typically are subject to detailed scrutiny by investors and other stakeholders—crafting a capital structure for the corporation and dealing with a takeover, merger, or acquisition proposal.

Deciding on a Capital Structure

Deciding on an appropriate capital structure is a strategic board responsibility. Businesses adopt various capital structures to meet both internal needs for capital and external requirements for returns on shareholders investments. A company's capitalization shapes its balance sheet and is constructed from three sources of capital:

1. *Long-term debt*. Debt consisting mostly of bonds or similar obligations, including notes, capital lease obligations, and mortgage issues, with a repayment horizon of more than one year.
2. *Preferred stock*. Equity (ownership) interest in the corporation with claims ahead of the common stock and normally with no rights to share in the increased worth of a company if it grows.
3. *Common stockholders' equity*. The firm's principal ownership, made up of (a) the nominal par or stated value assigned to the shares of outstanding stock, (b) the capital surplus or the amount above par value paid the company whenever it issues stock, and (c) the earned surplus (also called retained earnings), which consists of the portion of earnings a company retains after paying out dividends and similar distributions. Thus, common stock equity is the net worth after all the liabilities (including long-term debt), as well as any preferred stock, are deducted from the total assets shown on the balance sheet.

Debt Versus Equity

In deciding on a company's financial structure, management often seeks to minimize the cost of capital, whereas investors look for the greatest possible return. While these desires can conflict, they are not necessarily incompatible, especially with equity investors. This is because the cost of capital can be kept low and the opportunity for return on common stockholders' equity enhanced through what is called "**leverage**[2]"—creating a high percentage of debt relative to common equity. Doing so, however, increases risk. This is the inescapable trade-off both management and investors must factor into their respective decisions.

2. A high percentage of debt relative to common equity.

The leverage provided by debt financing is further enhanced because the interest that corporations pay is a tax-deductible expense, whereas dividends to both preferred and common stockholders must be paid with after-tax dollars. Thus, it is argued, the lower net cost of bond interest helps accrue more value for the common.

Higher debt levels increase a firm's fixed costs that must be paid in good times and bad, and can severely limit a company's flexibility. Specifically, as leverage is increased, (a) the risk of bankruptcy grows; (b) access to the capital markets, especially during times of tight credit, may diminish; (c) management will need to spend more time on finances and raising additional capital at the expense of focusing on operations; and (d) the cost of any additional debt or preferred stock capital the company may have to raise increases.

Because of its tax advantages and stability relative to equity capital (common stock), some finance experts have argued that higher proportions of debt capital may be advantageous to corporations. Their advice is not always heeded, however. Although periodically companies use debt to buy back common shares, a practice that can improve stock performance, most large companies rely heavily on equity financing.

Companies tend to use debt under certain circumstances more than others. For example, the decision whether or not to use debt is often related to the nature and risks of the cash flows associated with the capital investment. When diversifying into new lines of business, companies that are moving into related fields tend to use equity capital and those entering unrelated fields tend to use debt. Ownership structure is another factor. Firms with a high degree of management ownership, for example, are less likely to carry high levels of debt, as are corporations with significant institutional ownership.

Changing Patterns

In earlier days, a debt-free structure was often considered a sign of strength, and companies that were able to finance their growth with an all-common capitalization prided themselves on their "clean" balance sheet.

The advent of **leveraged buyouts (LBOs)**[3] of the 1980s brought a new twist to the capitalization issue. Because of their low degree of leverage, large corporations with conservative, low-debt capitalizations became vulnerable to capture. Corporate raiders with limited financial resources were successful in raising huge amounts of noninvestment grade ("junk") debt to finance the deals. The captured companies often would then be dismembered and stripped of cash holdings so the raiders

3. Acquisitions of other companies with a large amount of borrowed monies. Typically, the assets of both the acquired company and the company doing the acquiring are used as collateral in the purchasing.

could pay down their borrowings. In effect, the prey's own assets were used to pay for its capture. As a takeover defense, potential targets began to assume heavy debt themselves, often to finance an internal buyout by its own management.

By purposely leveraging their prey so highly (at times with current income insufficient to meet current interest requirements) that the company could not continue to conduct business as usual, raiders forced cuts in low-return growth avenues and the sale of those divisions, which are more valuable outside the firm. In the process, a significant amount of intrinsic firm value was distributed to stockholders—especially those who had bought in for just that purpose—at the expense of other stakeholders and the company's long-term needs. They justified their actions by stating that managers who operated with low leverage were either inept or feathering their own nest, or both.

Takeovers, Mergers, and Acquisitions

Takeovers, mergers, and acquisitions are an integral part of corporate strategy and not only provide important external growth opportunities for companies but also involve considerable risks for the firm and its shareholders. A **merger**[4] signifies that two companies have joined to form one company. An **acquisition**[5] occurs when one firm buys another. To outsiders, the difference might seem small and related less to ownership control than to financing. However, the critical difference is often in management control. In acquisitions, the management team of the buyer tends to dominate decision making in the combined company.This section is based on de Kluyver and Pearce (2008), chap. 9; and Rérolle and Vermeire (2005, April 29).

The advantages of buying an existing player can be compelling. An acquisition can quickly position a firm in a new business or market. It also eliminates a potential competitor and therefore does not contribute to the development of excess capacity.

Acquisitions, however, are also generally expensive. Premiums of 30% or more than the current value of the stock are not uncommon. This means that, although sellers often pocket handsome profits, acquiring companies frequently lose shareholder value. The process by which merger and acquisition decisions are made contributes to this problem. In theory, acquisitions are part of a corporate growth strategy based on the explicit identification of the most suitable players in the most attractive industries as targets to be purchased. Acquisition strategies should also specify a comprehensive framework for the due diligence assessments of targets, plans for integrating acquired companies into the corporate portfolio, and a careful determination of "how much is too much" to pay.

4. The joining of two companies to form one company.

5. The purchase of one company by another.

In practice, the acquisition process is far more complex. Once the board has approved plans to expand into new businesses or markets, or once a potential target company has been identified, the time to act is typically short. The ensuing pressures to “do a deal” are intense. These pressures emanate from senior executives, directors, and investment bankers who stand to gain from *any* deals, shareholder groups, and competitors bidding against the firm. The environment can become frenzied. Valuations tend to rise as corporations become overconfident in their ability to add value to the target company and as expectations regarding synergies reach new heights. Due diligence is conducted more quickly than is desirable and tends to be confined to financial considerations. Integration planning takes a backseat. Differences in corporate cultures are discounted. In this climate, even the best designed strategies can fail to produce a successful outcome, as many companies and their shareholders have learned.

Most studies carried out in this area show that the probability of a major acquisition or merger failing (as measured in terms of financial return) is greater than the probability of success. Empirically, the probability of failure increases with the size and complexity of the merger and with the degree of unfamiliarity with the target business. They also show that the buyer often pays too much for the target company because it is overoptimistic in terms of its ability to (a) do better than the existing management, (b) implement the synergies identified, and (c) integrate the target within its own company in a timely manner.

The application of new international accounting standards (and, more particularly, International Accounting Standard (IAS) 36 on impairment of assets) forces companies to examine the value of their assets, especially that of their intangible assets, on a recurring basis. As a result, each overpaid acquisition will inevitably result in impairment of goodwill, and, sooner or later, the board and management will have to publicly admit that their decision has destroyed shareholder value. This new regulation alone is a powerful reason for boards to go beyond merely approving major transactions and become much more actively involved in merger and acquisition (M&A) activity than in the past.

The very nature of the M&A process makes the board’s involvement a particularly sensitive issue, however. An acquisition frequently results from a long, confidential negotiation process, often involving extremely technical issues, and its outcome is largely uncertain. These factors lead management to present the board with only summary and high-level information on the opportunity and to wait for the outcome of the process before organizing in-depth discussions with the board.

This is unfortunate because M&A activity represents a unique opportunity for a board to add value. Outside directors may have unique experience with the M&A

process, particular intermediaries, or with all too often overlooked merger integration challenges. At the very least, the outside view offered by the board at an early stage may counterbalance the optimism of the executives driving the deal or the partiality of numerous experts pushing for its completion, resulting in a more "realistic" attitude to the opportunity.

Rérolle and Vermeire (2005) identify a number of useful best practices to assist boards in M&A planning and execution:

1. *Validate the strategic benefits of the transaction*. Every major acquisition must take place within an established strategic framework. Many mistakes are attributable to acquisitions that are justified only after the fact as a "strategic fit." At a minimum, the board should ask how the opportunity came about—whether it is something the company's management has been working on for some time, whether it concerns a business activity or market with which the company is familiar, and whether it represents geographical or other diversification.

   Also, rarely can an acquisition be justified solely on the grounds of the savings it will generate because they are often illusionary. It must either meet a need that has been clearly defined up front and which the company cannot meet using its own resources, or it must enhance the company's competitive position. In order to create value, the acquisition must make it possible to build a genuine competitive advantage or to decisively prolong an existing competitive advantage. The directors' role is to test the solidity of this premise.

2. *Verify that the price paid is reasonable*. Ultimately, analyzing an opportunity culminates in a valuation. Such a valuation should reflect a realistic assessment of (a) the intrinsic value of the target in accordance with a number of different scenarios, (b) the value of expected synergies (and the cost of implementing them), (c) the positive and negative impacts of the transaction on the value of the purchaser's company (e.g., management will have to devote considerable time to integrating the target, which may have an adverse impact on the purchaser's business activities), and (d) the price that management offers to pay and the terms and conditions of payment.

   Furthermore, when a proposed acquisition is of particular significance in light of the company's size and when there is a possibility of a conflict of interest or a challenge by the minority shareholders concerning the price paid, it is advisable to have a fairness opinion drawn up by an independent expert.Usually, such opinions are prepared by the company's financial advisers or other consultants hired by management (who naturally hope to gain repeat business). The board must ensure that this expert appraisal is carried out in a truly independent manner. The board must therefore verify the independence and skills of the expert(s), and, when the report is submitted, it must ensure that the work was carried out properly, in accordance with the professional standards in force. This assumes that at least one member of the board has adequate, relevant experience or that the board is assisted by another expert to help it in this task of supervision.

3. *Ensure that a comprehensive due diligence process has been carried out*. Due diligence is of critical importance as it enables the purchaser to verify the integrity of the seller's financial statements, representations, and warranties, and to identify potential problems.

   The due diligence must be based on broad (but relevant) objectives concerning the integration of the target. All too often, due diligence is mainly based on legal and accounting criteria, whereas the company needs to identify all the areas of major risk and, in particular, current and future operating risks, or others that may constitute an obstacle to effective integration. A comprehensive due diligence process covers items, such as an analysis of the target's competitive advantages and their durability, the identification of key people (in particular those that the company may rely on for the purposes of integration), and the measurement of the stability of the most significant customer relations and the long-term prospects of formal or informal alliances.

4. *Approve a specific integration plan*. Experience has shown that integrating the target is the most complex part of the M&A process. In spite of a broad consensus on this point, this difficulty remains largely underestimated. The board can play an important role in alleviating this major problem by asking management to provide it with an **integration plan**[6] prior to concluding the transaction. In particular, this plan needs to include (a) a timetable for the integration program, (b) an identification of the main initiatives undertaken by management to recover a significant portion of the control premium paid, (c) an assessment of the human resources and expertise to be earmarked for the integration process, and (d) a detailed business plan showing all the costs and benefits associated with integration.

   During mergers and acquisitions, boards tend to focus on the strategic, financial, and governance aspects of a transaction. They often neglect one of the greatest sources of value in many M&A transactions: the talent of the management team in the target company. Exercising due diligence about talent is as important as paying close attention to the

6. The process of uniting or blending either a merged or an acquired company into another.

balance sheet, cash flow, and expected synergies of a deal. By asking management a series of questions about human capital in a merger or acquisition, boards can contribute to a smoother transition to a single company, a better merging of cultures, the loss of fewer "A" players, and a stronger talent bench for the merged company—all of which should ultimately create more value from the deal.

5. *Organize the board's work so that it is able to assist management upstream*. The board's contribution will be even more useful if it is able to contribute to management's thought process as early as possible in the analytical and decision-making process. If M&A is a cornerstone of the company's strategy, creating a special committee may be a useful way to deal with issues of efficiency, confidentiality, and the constraints inherent in a long and uncertain negotiating process.Rérolle and Vermeire (2005, April 29).

7.4 Monitoring Strategy Implementation: Choosing Metrics

A key determinant of greater board effectiveness in the area of strategy is the set of **metrics**[7] the board selects to monitor a company's performance and health. The goal should be to identify a manageable number of metrics that strike a balance among different areas of the business and are directly linked to value creating activities. In addition to the standard financial metrics, key indicators should cover operations (the quality and consistency of key value-creating processes), organizational issues (the company's depth of talent and ability to motivate and retain employees), the state of the company's product markets and its position within them (including the quality of customer relationships), and the nature of relationships with external parties, such as suppliers, regulators, and nongovernmental organizations (NGOs).This section is based on "What directors know about their companies: A McKinsey Survey" (2006, March).

In selecting an appropriate set of metrics, it is useful to distinguish between value creation in the short, medium, and long term. Short-term health metrics show how a company achieved its recent results and therefore indicate its likely performance over the next 1 to 3 years. A consumer products company, for example, must know whether it increased its profits by raising prices or by launching a new marketing campaign that increased its market share. An auto manufacturer must know whether it met its profit targets only by encouraging dealers to increase their inventories. A retailer might want to examine its revenue growth per store and in new stores or its revenue per square foot compared with that of competitors.

Another set of metrics should highlight a company's prospects for maintaining and improving its rate of growth and returns on capital over the next 1 to 5 years. (The time frame ought to be longer for industries, such as pharmaceuticals, that have long product cycles and must obviously focus on the number of profitable new products in the pipeline.) Other medium-term metrics should be monitored as well—for example, metrics comparing a company's product launches with those of competitors (perhaps the amount of time needed to reach peak sales). For an online retailer, customer satisfaction and brand strength might be the most important drivers of medium-term health.

For the longer term, boards should develop metrics assessing the company's ability to sustain earnings from current activities and to identify and exploit new areas where it can grow. They must monitor any threats—new technologies, new customer preferences, new ways of serving customers—to their current businesses. And to ensure that they have enough growth opportunities to create value when those businesses inevitably mature, they must monitor the number of new

7. In business, typically the measurements of a company's finances or performance.

initiatives under way (as well as estimate the size of the relevant product markets) and develop metrics that track the initiatives' progress.

Ultimately, it is people who make strategies work, so a good set of metrics should also show how well a business retains key employees and the true depth of its management talent. Again, what is important varies by industry. Pharmaceutical companies, for example, need scientific innovators but relatively few managers. Companies expanding overseas need people who can work in new countries and negotiate with governments.

7.5 Creating a Strategy-Focused Board

Fostering a strategic mind-set on the board is difficult and takes time. It requires rethinking its composition, how it approaches its responsibilities, and the way it interacts with management to help develop a strategic vision, although that must originate with the CEO. Progressive CEOs, for their part, must be able to articulate a clear strategy and have the personal confidence to build board teams that include experts who may be far more skilled in certain industry and operational areas than the CEOs themselves are.This section is based on Nadler (2004)., Carey and Patsalos-Fox (2006).

Rather than immediately seeking a deeper involvement in the strategy development process, it may be useful to ask boards to first seek a more effective balance between short- and long-term considerations in their oversight. As part of first step, they should identify and agree on a core set of metrics reflecting a balance that is tailored to the specifics of a company's industry, maturity, culture, and current situation. In turn, management should be asked to draw up a set of long-term strategy options that the board can test and challenge. Management then can develop a detailed plan for the board's final approval.

Ideally, this process unfolds over several board meetings and allows board members to probe specific strategic issues—does the company really have the ability to execute in a particular area, for example, and has it analyzed different options to enter the markets it wants to compete in? Finally, the board can play an important role in monitoring the progress of the plan and any changes in risk it involves. While the board can be selective in its focus on details, management must deal with all aspects of the strategic plan. Once accepted, the strategy can be expected to evolve over time, and therefore will require an ongoing dialogue between the board and management.