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The Role of the Board in Creating a High Performance Organisation

Extract from PARC Research Report

November 2005

Research Report

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1 Executive Summary

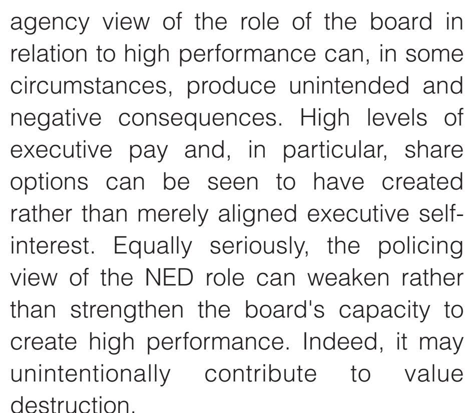
1.1 This study

This report explored what boards can do – in terms of behaviour, roles and processes – to ensure that they contribute to creating and sustaining high performance businesses, and thus long-term shareholder value. It focussed on the role of the board in creating a high performance business, moving beyond a defensive view of corporate governance to explore the more positive role of the board in creating value for shareholders. In total we interviewed almost 40 individuals, many of whom held several directorship, chairman and chief executive as well as executive and non-executive director positions. We also included company secretaries, advisers and consultants who could offer insights into the current state of development of boards at UK listed companies. Some top business leaders whose experience spanned several countries, and directors of large private family-owned companies, were also interviewed. Our research covered many companies whose performance could be characterised as 'good'. For example, we interviewed directors of 10 of the top 30 FTSE 100 performers as rated by Total Shareholder Returns over the last three years.

1.2 Investor-driven versus strategy-led boards

While most large public company boards broadly comply with regulatory codes, we found this masks significant differences in the focus of the board's attention, individual director conduct and the dynamics of board relationships. Two opposing philosophies are highlighted that shape a board's purpose and conduct – we describe these as 'strategy-led' or 'investor-driven':

- The investor-driven approach derives from the economics concept known as 'agency theory'. This assumes that executive self-interest is liable to be pursued at the expense of shareholders, and hence envisages the primary role of the board ¬and of non-executives in particular – as being to monitor executive conduct. 'Board performance' is thus seen as centring on 'control', adherence to regulatory rules and narrow financial outcomes.
- The focus on control has been heightened by reactions to recent scandals and abuses of executive power. Directors in turn are feeling pressured to devote greater time and money to investor relations, and to meeting regulatory and reporting requirements.
- Executive directors' rewards for delivering high performance are considerable, but so too are the risks – for example, in job security. Non-executives spoke both of increased time commitments and risks regarding personal reputation and liability.
- Our research suggests that the dominant



agency view of the role of the board in relation to high performance can, in some circumstances, produce unintended and negative consequences. High levels of executive pay and, in particular, share options can be seen to have created rather than merely aligned executive self-interest. Equally seriously, the policing view of the NED role can weaken rather than strengthen the board's capacity to create high performance. Indeed, it may unintentionally contribute to value destruction.

- The danger here is that the board becomes distracted from focusing on strategy, divisions are created between executive and non-executive directors, and the board can become divorced from the business.
- Our respondents regard business risk as more significant than the risk of executive self-interest, which is borne out by objective research. While the latter should certainly be guarded against, the primary contribution of non-executive directors should be to facilitate strategic thinking and support effective organisational performance. Sensible code compliance is part of good reputation management.
- If high performance is interpreted as long-term value maximisation, then the board should achieve a sustained strategic focus on the drivers of value creation.
- This requires a boardroom culture of trust and openness through which executives are able to draw upon the experience and skills of their non-executive colleagues in support of their own and the organisation's performance.

1.3 Roles and relationships

This report's findings provide a guide to how board roles and relationships should be shaped to contribute to organisational performance. These are some of the headlines:

- **Company chairmen.** The work of the chairman can make or break a board's performance and contribution to organisational value. Our research found big differences in the commitment and effectiveness of chairmen in different companies. We identified the essentials that should govern the selection and conduct of chairmen.
- **The key relationship is the chairman's with the chief executive.** In this, it is essential for the chairman to understand his or her non-executive status. Executive responsibility lies with the chief executive. Ideally the two will have complementary skills which, as the relationship develops, will provide the chief executive with a vital resource in support of his or her decision making. The chairman's relationship with the wider executive team and the business can ensure they bring a developed understanding of the business both to the relationship with the chief executive and, as importantly, to leadership of the board.
- **Chief executives and executive directors.** It is in the organisation's interests that information is shared openly with non-executives, and that robust, challenging discussion is welcomed. This realises the full value of non-executive contributions, mutual trust, and the ability of the board to demonstrate to stakeholders the value it adds.
- **Non-executive directors.** Board credibility depends increasingly on rigorous selection and induction processes – and

on achieving a rich and deep diversity of experience and perspective. Non-executives need to retain their independence of view while building a deep and knowledgeable relationship with the organisation, the business and its context.

In a high performance company the strategic role of the board is the basis of effective control and the board's collective long-term memory is a resource rather than a liability.

1.4 Board processes

To convert strategy into high performance, the board needs to work hard to stay focused on the strategic and the operational drivers of value creation. High performing chairmen and boards are attempting a number of innovations that make debate around trends in markets, technologies, products and organisational capabilities a central feature of every board meeting. Some of the levers connecting the work of the board to corporate performance are:

- Appropriate executive remuneration systems reward genuine long-term company performance and value creation, as well as effective leadership and do not create collusive relationships between executives and fund managers in share price management. Share options are not felt to create these conditions.
- Performance metrics that shift from purely financial and short-term share price measures to measures of company 'health'.
- In order to perform effectively, strategy-led boards need a clear line of sight into the business. Where boards are divided by schisms between the roles and concerns of executives and non-executives, this is seldom possible. Non-executives as well as executive directors need to be enabled to 'see' into the enterprise in ways that investors can never hope to do.
- New forms of measurement and assurance can create transparency in relation to business performance.
- Recent years have seen the proliferation of new board policies on ethics, citizenship and diversity, with associated new forms of external reporting, as well as mission and value statements.
- Board evaluation processes, such as those suggested by Higgs, can be grasped as an opportunity for continuous improvement.

Our research showed that generating high performance is best done under a strategy-led board. Compliance, while necessary, is seldom sufficient to generate maximum or sustainable value. Part of the reason why boards struggle to create high performance is that they are caught up with responding to relentless demands, which can force boards into a narrow compliance role. We suggest that sustainable high performance comes from a broader, strategy-led approach.

2 Defining the Elements of a High Performing Board

To identify the components of a high performing board, and its role in creating a high performance business, clarity is needed about both the role and the nature of high performance. Our research pointed to very different interpretations among boards as to the meaning of both governance and performance.

Crudely, the companies we studied can be placed along a continuum from either a narrow or broad view of these terms. The narrow view, which often seemed to arise more by default than design, was externally driven – the board's work was influenced by shareholder demands for both good financial performance and conformance with governance codes. In what follows, we argue that such **investor-driven** performance – whilst appearing responsive to shareholder demands – in practice involves an under-development of the role of the board that potentially weakens or undermines long-term performance.

In contrast, those following a broader view of governance and performance saw the board's primary role as the setting of long-term company objectives – and the monitoring of executive performance through a wide range of metrics in relation to these. Such **strategy-led** performance, with its focus on the long-term drivers of business success, requires a much fuller development of board roles and relationships and a much stronger set of links between the board and the business which, in our view, has much greater potential to deliver sustainable long-term value to shareholders.

2.1 Rival theories of governance

In his 2003 review of the role of the non-executive director, Derek Higgs observed that the work of boards is largely invisible – and hence poorly understood. Directors' understanding is heavily conditioned by their experiences of working on particular boards, whilst investors must rely from a distance on received prejudice as to what constitutes a good board. Our research suggests that both board and company performance often suffer from a lack of clear thinking about the board's proper role. Hence, we briefly examine four sets of ideas that have each played an important part in shaping the UK governance system:

- Agency theory
- Resource dependence theory
- Stewardship theory
- Stakeholder theory.

In our view, individuals involved in corporate governance frequently apply what they believe is common sense –

when in reality they draw sub-consciously on long-established economic theory and assumptions that are challengeable.

2.2 Agency theory

Probably the most influential theory in this context is agency theory, which has helped to shape recent codes of practice on governance.

The debate about corporate governance is typically traced back to the early-1930s and publication of *The Modern Corporation and Private Property* by Adolf Berle and Gardiner Means. They noted that with the separation of ownership and control – and the wide dispersion of ownership – there was effectively no check on the executive autonomy of corporate managers. In the 1970s, these ideas were further refined in what has come to be known as agency theory. In a series of now classic articles, writers such as Jenesen and Meckling, Fama, and Alchian and Demsetz offered a variety of explanations of the dilemmas faced by the 'principal' who employs an 'agent' to act on his or her behalf. As applied to corporate governance, these are key points of the theory:

- It suggests a fundamental problem for absent or distant owners/shareholders who employ professional executives to act on their behalf.
- In line with neo-classical economics, the root assumption is that the agent is likely to be self-interested and opportunistic.
- The assumption of owner or shareholder property rights obviates any need to think about the principal's motives.
- This raises the prospect that the executives, as agents, will serve their own interests rather than those of the owner/principal.

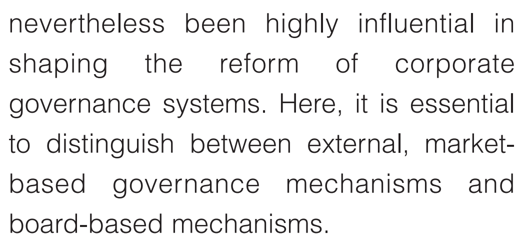
To counter these problems, the principal will have to incur 'agency costs' such as those arising from the necessity of creating incentives that align the interests of the executive with those of the shareholder, and costs incurred by the necessity of monitoring executive conduct to prevent the abuse of owner interests.

Critique of agency theory

It is important to note that agency theory is deductive in its methodology. Its assumptions have been the subject of extensive empirical research – but this has typically relied on the testing of various propositions in relation to large data sets. Furthermore:

- Agency theorists take self-interested opportunism as a given.
- They feel no need to explore the attitudes, conduct and relationships that actually create board effectiveness.
- Instead they busy themselves with exploring the effectiveness of the various mechanisms designed to make executive self-interest serve shareholder interests.
- To date, such studies have proved entirely equivocal about the relationship between good governance and the organisation's performance.

Agency theory assumptions have



nevertheless been highly influential in shaping the reform of corporate governance systems. Here, it is essential to distinguish between external, market-based governance mechanisms and board-based mechanisms.

Market governance mechanisms

In relation to market governance, the openness and integrity of financial disclosures are vital to the operation of the stock market in determining a company's share-price and its underlying market valuation. Market governance relies for its effectiveness on the remote visibility such financial information creates and, as importantly, on the effects on the executive mind of the knowledge of such visibility. Agency theorists point to the important disciplinary effects of two further market mechanisms. The first is the 'market for corporate control' – the potential for takeovers to discipline executives by providing a mechanism whereby ineffective executive teams can be displaced by more effective executive teams. The second – 'the managerial labour market' – operates at an individual level. Poor executive performance will threaten an individual's future employment potential – whilst good performance will have positive reputational, and hence career-enhancing, effects.

To these external 'market' mechanisms must be added the disciplinary effects on company and executive performance of external monitoring, both direct and indirect. Formally, it is the annual general meeting that provides an opportunity for directors to report face-to-face to their shareholders. In practice, however, the formal accountability of the AGM has been augmented and diverted by other mechanisms. At the time of results announcements, companies will typically conduct presentations for ‘sell-side’ analysts who then serve as key intermediaries between companies and their investors. These general briefings are then supplemented by a large number of private face-to-face meetings between executives and their key investors.

Board-based mechanisms

In addition to external market and monitoring mechanisms, agency theory has also influenced the internal reform of boards of directors. One of its most significant contributions came in the form of the widespread adoption of executive share option schemes, which have only recently fallen into disrepute in the UK. Such schemes follow directly from the agency assumption that the exercise of executive self-interest must be aligned with the interests of shareholders. Less directly, the influence of agency theory assumptions can be seen in the seminal reforms promoted by the Cadbury Committee Code of Best Practice, its subsequent elaboration by Greenbury, Hampel, Turnbull and, most recently, by the work of Higgs and associates. With the possible exception of Turnbull, the work of these different committees was occasioned by visible corporate failures or perceived

executive abuses of power – and has resulted in a progressive elaboration of the 'control' role of the board:

- The 'independence' of the non-executives directors who must now constitute 50% of the board.
- Their lead role on audit, nominations and remuneration committees where conflicts of interest between executive and shareholder are potentially most acute.
- Progressively more stringent provisions around the separation of the roles of chairman and chief executive.
- All these are consonant with agency theory's assumption that the interests of the owner/shareholder are potentially at risk from executive self-interest, in the absence of close monitoring by independent non-executives.

2.3 Resource dependence theory

Resource dependence ideas were originally developed by Pfeffer and Salancik (1978) in the late-1970s. Unlike agency theory, their original ideas were inductively derived from empirical studies.

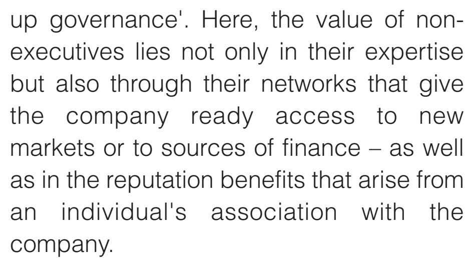
Their key contribution is the observation that the board – and in particular the non-executive element of a board – can provide the firm with a vital set of resources.

> *"When an organisation appoints an individual to a board, it expects the individual will come to support the organisation, will concern himself with its problems, will variably present it to others, and will try to aid it."* – **(1978:173).**

Seeing the board as a source of resources for a company opens up a very different way of thinking about its role in creating high performance. Resources can take a variety of forms, each of which, it may be argued, adds to the 'capital' of a company. (Hilman and Dalziel, 2003). Non-executive directors can be a source of expertise on which executives may draw, in specific skills as well as advice and counsel in relation to strategy and its implementation. They can also serve as an important source of contacts, information and relationships that allow executives to better manage some of the uncertainties in the environment. These relational resources can be both practical and symbolic; the association of particular individuals with a company has the potential to enhance the reputation or perceived legitimacy of an executive team.

Resource dependence theory allows us to think of the very different needs that companies have at different stages of their life-cycle, as the following examples show:

- Entrepreneurial firms – The young entrepreneurial firm, even if owner managed, can look to its non-executive directors as a source of skills and expertise that it cannot afford to employ full time. Here, the non-executive is a relatively cheap source of part-time legal, financial or operational management skills that are not otherwise available to the entrepreneur.
- Publicly listed firms – Once a firm is publicly listed, then the provision of expertise will have to be blended with what one of our participants called 'grown-



up governance'. Here, the value of non-executives lies not only in their expertise but also through their networks that give the company ready access to new markets or to sources of finance – as well as in the reputation benefits that arise from an individual's association with the company.

- Mature businesses – More mature businesses might draw upon the non-executive as a source of relevant market or managerial experience. Board composition would hence be managed primarily in terms of the relevance for the company of the non-executive's past experience – rather than in terms of formal independence. But even in a more mature business, the non-executive directors required to manage radical processes of organisational change might be very different from those needed to support the roll-out of a successful business model. The non-executive might be vital as a source of expertise in relation to the delivery of financial performance and in the management of other key sources of business risk – for example, in relation to regulation or government policy, or consumer confidence or their knowledge of campaign or pressure groups.

In short, whereas the agency view of non-executives emphasises their local policing role on behalf of investors, resource dependence theory sees them primarily as a context-specific resource to support the performance of both the executives and the company.

2.4 Stewardship theory

Stewardship theory (Donaldson, Kay) makes a related set of observations to resource dependence thinking about the motives of senior executives. It is also more optimistic about director motives.

Contrary to agency theory's pessimistic assumptions on self-interested and self-serving motives of executives, stewardship theory suggests the potential for the 'pro – organisational' motives of directors. What drives performance here is not the aligned greed of an executive but their personal identification with the aims and purposes of the organisation. Stewardship theory refutes the assumption that executive aims and motives are opposed to those of the shareholder – both, it insists, have an interest in maximising the long-term stewardship of a company and are therefore already well aligned. From this, stewardship theory highlights the potentially negative impact of a division of responsibilities between a chairman and chief executive. The roles, it suggests, should remain combined in order to protect a key aspect of high performance – the strength and authority of executive leadership.

Arguably, the key contribution of stewardship theory lies in its questioning of agency theory's negative views about human nature. Like MacGregor's contrast between theory X and theory Y managers, it suggests the problem of governance may lie not in the self-interest of the executive but rather in the assumptions that distant others, notably investors and regulators, make as to their self-interested motives. The danger stewardship thinking

highlights is that negative investor assumptions may inadvertently distort or weaken the leadership of a company.

2.5 Stakeholder theory

Stakeholder theory is a final influence on governance and performance. Its ideas were originally developed by Ed Freeman in the 1980s, but have achieved wider UK penetration through initiatives such as the RSA's Tomorrow's Company project.

Governance thinking

Stakeholder theory challenges agency assumptions about the primacy of shareholder interests. Instead, it argues, a company should be managed in the interests of all its stakeholders. These interests include not only those of the shareholder but also a range of other direct and indirect interests. The employee is obviously a key stakeholder and there have been long-running arguments amongst governance academics such as Margaret Blair that employees – just as much as shareholders – are 'residual risk-takers' in a firm. An employee's investment in firm-specific skills means they too should have a voice in the governance of the firm. However, stakeholder theory also insists that other groups have strong direct or indirect interests in company performance. They include suppliers and customers, local communities, environmental groups and society at large.

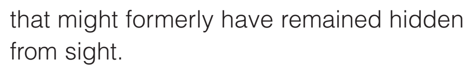
The argument repeatedly raised against a stakeholder view of the firm is that it is hard to operationalise because of the difficulties of deciding what weight should be given to different stakeholder interests. In terms of corporate governance, it is argued that – were executives to be made accountable to all of a company's stakeholders – they would, in effect, be answerable to none.

Enlightened stakeholder theory therefore suggests the practical value of accountability to shareholders even if a board takes other interests into account in its conduct of a firm.

Corporate performance

In relation to company performance, however, stakeholder theory has made a number of key contributions. The recent profusion of interest in business ethics can be traced to stakeholder ideas. For example:

- Excessive levels of executive pay – and the way these are often associated with company downsizing and its negative impacts on employees and local communities – undermine the legitimacy of the demand for 'shareholder value'.
- Corporate failures and pension fund collapses threaten both the basis of the traditional psychological contract as well as the 'licence to operate' that underpins the privileges afforded by society to corporate entities.
- Globalisation has also brought with it the rise of single-issue pressure groups and a heightened visibility to corporate practices – the use of child labour, environmental damage, corruption, etc



that might formerly have remained hidden from sight.

The importance now given to corporate value statements, as well as the board's role in creating corporate ethics codes, and social and environmental reporting, all reflect an acknowledgement of a wider set of corporate obligations that go beyond the delivery of shareholder value – or at least insist that such performance must be realised within certain ethical constraints.

The balanced scorecard

While ethical codes have the potential to constrain how performance is pursued, arguably the most direct contribution of stakeholder ideas to company performance is to be found in Kaplan and Norton's (1992) ideas about the balanced business scorecard – along with the 'revolution' in business performance management and measurement that this has encouraged. Kaplan and Norton acknowledge the power of measurement on performance – as well as the potential distortions on operational effectiveness that can arise from purely financial accounting measures like earnings per share or return on investment.

The scorecard embodies key stakeholder interests through firm-specific sets of measures that link operational drivers to financial performance. It therefore provides managers with a way to explore the inter-dependencies between customers' needs, and what the company must do operationally to meet these needs and sustain competitive success. It also has both an immediate performance focus as well as pointing to key areas for continuous improvement and innovation. Kaplan and Norton suggest that the orientation of traditional performance systems is the 'control' of individual behaviour through measurement. By contrast, the focus of the balanced scorecard, they suggest, is 'strategy and vision', that establishes goals but then promotes initiative and learning – individual, team, and across-functions – in pursuit of such goals. From this perspective the key role of senior executives and the board lies in the setting of company strategy and vision. High performance depends on the board's understanding of the key business and competitive drivers, its capacities for strategic thought, and its communication and leadership skills in relation to staff, customers and financial markets.

It should be noted that the balanced business scorecard is, like any model or framework, only beneficial if used with skill and experience. By itself, it does not guarantee a more strategic perspective. Practical experience has shown that organisations vary widely in their ability to identify and deploy good measures – and tend to struggle most in the 'learning and growth' perspective.

2.6 Summary of four theories

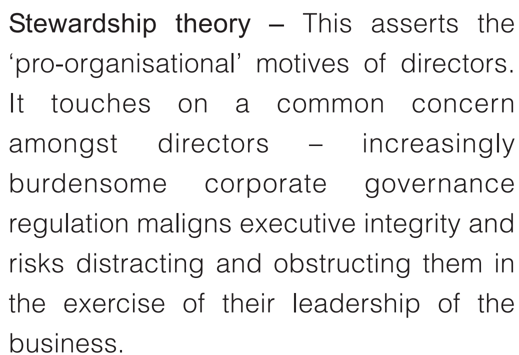
Each of the influential frameworks reviewed above identifies with a particular set of interests, offers a different view of risk, and implies a different view of both the role of the board and what counts as high performance. Brief summaries of the theories follow.

Implications of Four Conceptual Frameworks

Conceptual Framework	Interest Focus	Perceived Risk	Role of the Board	Meaning of 'High' Performance
Agency Theory	**Investor interests**	**Executive self-interest, abuse of executive power, satisfying behaviour**	**Control role of non-executives – monitoring of executive performance, executive appointment and dismissal, executive reward, audit**	**Improving earnings per share, return on investment**
Resource Dependency Theory	**Board performance, executive interests**	**Business risk**	**Non-executives as a resource for executives and company – functional expertise, advice and counsel, links to external sources of uncertainty**	**Finding ways to attract and make full use of board 'capital' by executives**
Stewardship Theory	**Stewardship of the business**	**Governance regulation weakens effective leadership**	**To support leadership of the business**	**Effective business leadership**
Stakeholder Theory	**Key drivers of business success**	**Long-term value destruction**	**Strategy and vision – define company objectives in relation to key drivers, monitor performance against these**	**Long-term sustainable value creation Balanced scorecard**

Agency theory – This is really a theory of governance and the role of the board from the perspective of the distant investor. Investors want the self-interest of the executive because, they believe, this will drive company performance – as long as it can be aligned with investor interests. It looks, therefore, to both market and board-based mechanisms to monitor, incentivise and sanction executives in order to align their pursuit of self-interest with those of the owner/investor.

Resource dependence theory – This sees the world from the perspective of executives recruiting non-executive directors. The preoccupation here is with the non-executive as a resource to support executive and company performance. It can be functional expertise, advice and counsel, business and financial contacts, as well as knowledge and relationships that will allow executives to better manage sources of uncertainty in the environment.



Stewardship theory – This asserts the 'pro-organisational' motives of directors. It touches on a common concern amongst directors – increasingly burdensome corporate governance regulation maligns executive integrity and risks distracting and obstructing them in the exercise of their leadership of the business.

Stakeholder theory – This offers a broad view of all the different groups that have a legitimate interest in the performance of the firm. Positively, its refusal of shareholder primacy acknowledges the potential moral damage of dominant interests. Negatively, it raises fears that executives can escape any accountability by playing interests off against each other. The balanced scorecard, if used with skill, has arguably begun to provide boards and managers with the performance measurement systems that might allow them to avoid the potential distortions of a reliance on purely financial output measures such as EPS and ROI. Its focus is on the firm-specific drivers of sustainable competitive advantage, and the necessity for an integrated, systemic view of customer, product, and organisational processes if sustained financial performance is to be achieved. From this perspective, senior management and the board play a key role in reconciling different potentially competing stakeholder interests through a shared corporate strategy and vision.

2.7 Which model will win?

While academics thrive on the proliferation of such divergent views above, the practical challenge for the high performing board is how to reconcile these potentially conflicting aspects of governance and performance.

Despite their differences, we argue that each of these conceptual frameworks identifies a vital aspect of what should count as high performance. Although they clash on some points, they are not mutually exclusive. The pessimism of agency theory concerning executive motives has proved to be correct in repeated governance failures over the years. Ensuring the probity of executive conduct is therefore an important aspect of the work of a high performing board. However, it is also necessary to understand the potential for the solution to create the disease of overly cynical expectations of executives resulting in a self-fulfilling prophesy.

Enlightened Value Maximisation

Jensen and Murphy, who were strong and influential advocates of a greater use of share options in the early-1990s, have recently argued for a more sophisticated understanding of high performance – what they call *Enlightened Value Maximisation* (2004). Significantly, they note that share options, once seen only as the remedy of agency problems, can also, unintentionally, create agency

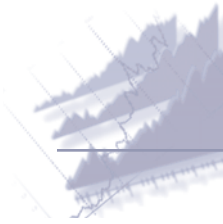
problems. They explore the dangers of over¬valued equity and the collusion of interests between fund managers and executives in inflating the share price above a company's real underlying value. Once over-valued, there are huge incentives for executives to pursue increasingly wild strategies in an attempt to realign the actual and market value of companies. The differences in value also create incentives for deceit and the withholding of information both from investors and the board. Importantly, enlightened value maximisation has a long-term focus on wealth creation and the strategies that are needed to realise this. Unintentionally – and in part as a result both of perverse incentives and investor ignorance and self-interest – the control role of investors and non-executives can actually destroy value, according to Jensen and Murphy, especially since options have been viewed until very recently as cost-free.

Non-executive issues

In addition to such perverse consequences for company performance, agency views also neglect other important aspects of performance. Resource dependency theory tells us that non-executives should be recruited not only for their formal independence from the company, but also as a resource to support executive and company performance. The risk created by executive self-interest has to be set against business risk – and the value of the non-executive as a resource for executives in managing such risk. As stewardship theory suggests, in the recent focus on the 'control role' of non-executives, there is a danger that executives will lose the support and counsel of the non-executive in managing business risk. The challenge for the high performing board, therefore, is to fulfil its control role – but in such a way that non-executives can still be used by executives as a resource to support their own and company performance.

Connections to value drivers

Finally, the core observation of stakeholder theory is that the sources of long-term value maximisation are specific to particular companies and industries – and are in any case open to creative development. The high performing board cannot confine its attention to the executive directors and the members of the executive team, critical as this level of management is. Instead, this type of board needs to be connected to the business and to understand the underlying drivers of value creation. High performance requires that non-executives acquire a sufficient understanding of these context-specific value drivers in order to fulfil their obligations in relation to both strategy and control. While agency theory has traditionally set the control role against the strategic role of boards, stakeholder theory suggests that it is impossible for a board to exercise control without a developed understanding of the



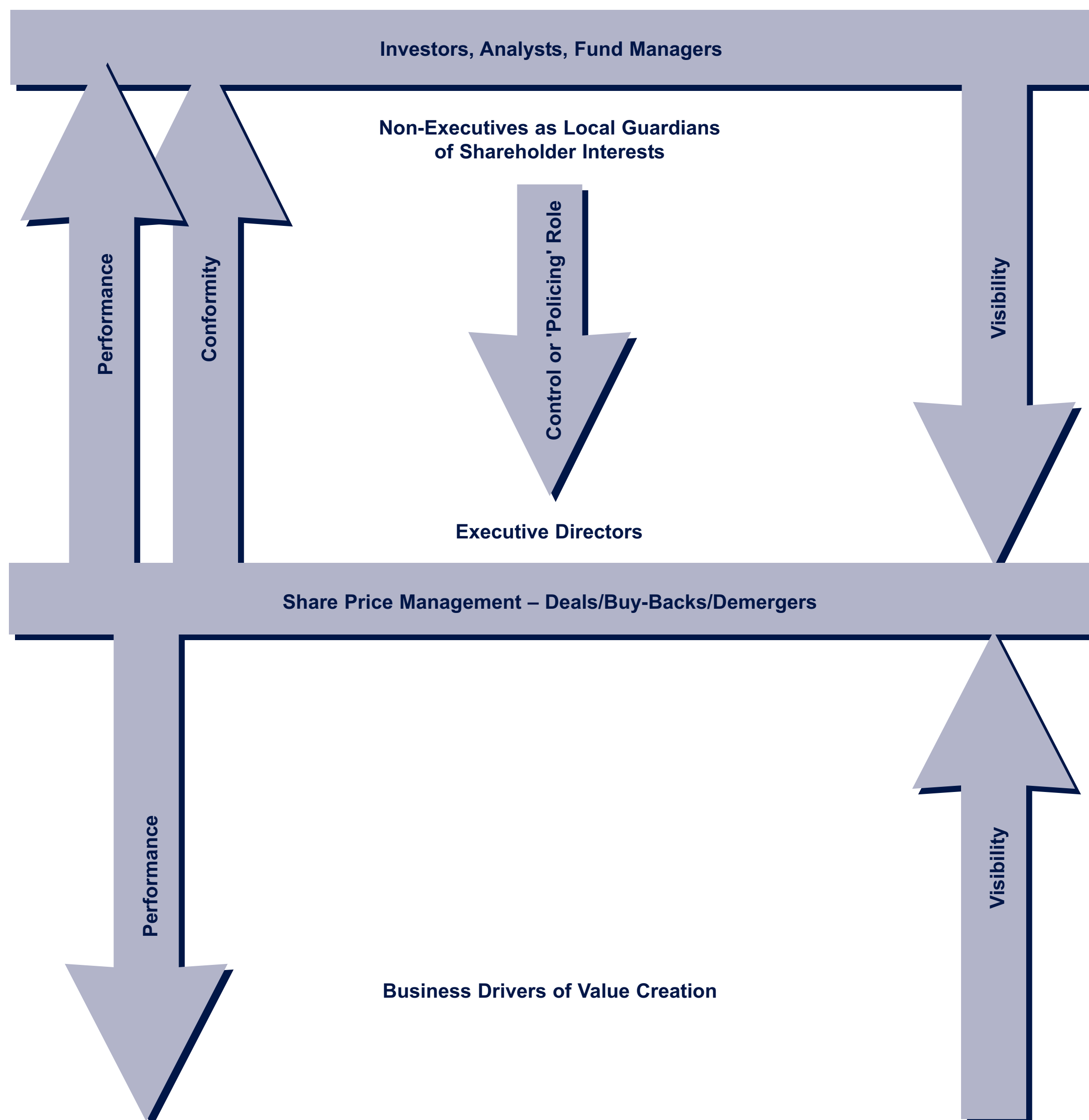
business and its strategy. In other words, the proper and essential focus of a high performing board is the creation of a high performing business. This link has been borne out by our research.

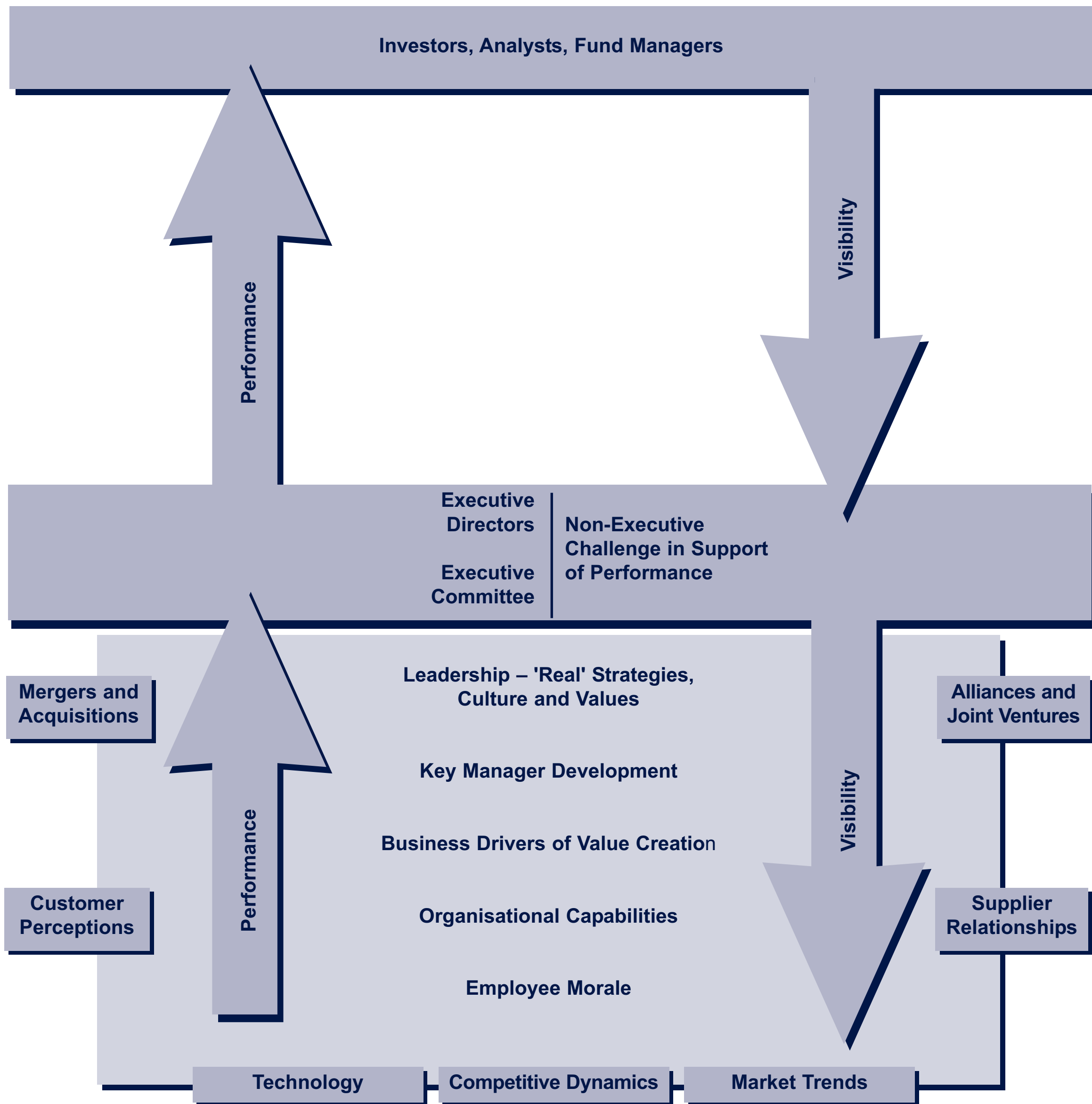
Within the context of this integrated view of high performance, and the board's role in creating it, we present in the next section an overview of our research results built around two contrasting models of high performance: “Investor-driven performance” and “Strategy-led performance”.

3 The role of the board in creating a high performing business

A summary of the models of Investor-driven and Strategy-led performance is represented in the following figures.

Investor-Driven Performance




Investors, Analysts, Fund Managers
Performance
Visibility
Executive Directors
Executive Committee
Non-Executive Challenge in Support of Performance
Mergers and Acquisitions
Leadership – 'Real' Strategies, Culture and Values
Alliances and Joint Ventures
Key Manager Development
Performance
Business Drivers of Value Creation
Visibility
Customer Perceptions
Organisational Capabilities
Supplier Relationships
Employee Morale
Technology
Competitive Dynamics
Market Trends

3.1 Investor-driven performance

Investor-driven performance represents the dominance of an agency view of board roles and relationships. By default rather than design, the non-executives on such a board are effectively outside the business. Their contact with it is limited to executive directors at board meetings with, at best, limited exposure to the senior management team. Relationships between executives and non-executives are suspicious and distant, creating a formal and possibly defensive board culture.

This kind of board can be wholly compliant with governance codes, and scrupulous in the exercise of its formal governance responsibilities for monitoring executive performance and through audit, remuneration and nominations committees. To investors, it offers the visible appearance of high performance, precisely because it conforms to the investor model of what a board should do.

Nevertheless, in our view, this will be an under-performing board because, in its responsiveness to external visibility, a dynamic is created through which non-executives become divorced from both executives and the business. From an investor perspective, this may be seen as precisely what allows the board to drive performance. But, in our view, this simply misunderstands the necessary conditions for a board to create a high performance business.

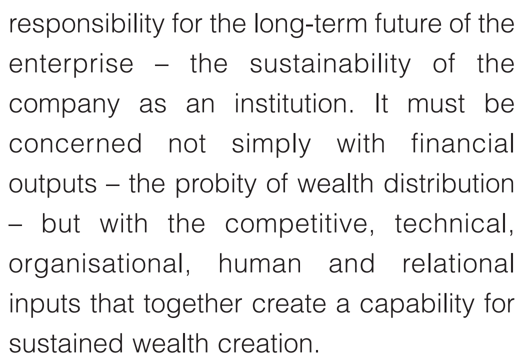
We will now use this model of investor-driven performance as a foil against which to develop our alternative model of a high performing board: Strategy-led performance.

3.2 Strategy-led performance

All large FTSE companies face intense external scrutiny and performance pressures. Our research suggests that what distinguishes the high performing board is the way in which it seeks to meet and manage these pressures. From the outside, with regards to visible compliance and performance in the short term, such a board is virtually indistinguishable from its investor-driven counterpart. From within, such a board is very different as regards executive and non-executive perceptions of their roles and the quality and perceived value of board relationships.

In strategy-led performance, we suggest the need and potential for a much fuller development of the board's role in the leadership of a company. The demands of shareholders are still taken absolutely seriously, but they are treated as a necessary – not sufficient – condition for high performance. Rather than simply conforming to shareholder demands for immediate financial performance, the board's essential orientation is with setting long-term company objectives and monitoring executive performance.

Strategy-led, therefore, means that the board asserts its own unique authority and



responsibility for the long-term future of the enterprise – the sustainability of the company as an institution. It must be concerned not simply with financial outputs – the probity of wealth distribution – but with the competitive, technical, organisational, human and relational inputs that together create a capability for sustained wealth creation.

To meet these leadership responsibilities, the strategy-led board refuses to allow its functioning to be overwhelmed by a narrow agency view of governance. The forces of greed and fear that promote aggressive individualism are still present in such a board but they are successfully subordinated to the board's collective responsibility for its stewardship of the company. The objective may still be to deliver value to shareholders. However, in the high performing board, this is achieved not by passive compliance but through enhancing the board's own operational focus on the drivers of sustainable competitive advantage.

3.3 Characteristics of the high performing board

Framed within the above models of board performance, our research suggested that the high performing board has these key characteristics:

- It takes responsibility for defining the objectives of the company, and monitoring executive performance against these through a range of financial and non-financial indicators.
- It maintains a strong and continuous strategic focus on its work in which both executives and non-executives co-operate in the development and implementation of strategy.
- It has a high performing non-executive chairman, strongly engaged with the executive and the business, who is then able to lead the board in support of company performance.
- It has a chief executive and executive directors who recognise the value of board accountability and seek to make the fullest possible use of non-executive experience and judgement.
- It has non-executives who identify with the success of the company, bring relevant experience from elsewhere and are then enabled to develop a strong operational understanding of the business.
- It emphasises the unitary nature of its responsibilities and seeks to meet them through the development of open, trusting but challenging relationships between executives and non-executives.
- It is scrupulous in the exercise of its formal governance responsibilities through the work of non-executives on audit, remuneration and nominations committees – however, these responsibilities are pursued in the context of the board's understanding of, and attention to, the sources of long-term value creation.

While the focus of investors and codes is primarily on board structures and composition, our research suggests it is difficult, if not impossible, to distinguish the high performing board from others in these terms. For the most part, visible code compliance is a given of all major listed

companies.

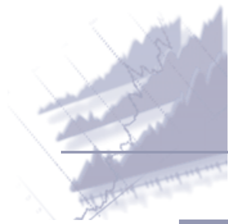
To understand what creates a high performing board – and what allows it to play its full role in creating a high performance business – we need to go beyond structure and composition to examine individual conduct and the dynamics of relationships within a board. Certainly, structure, composition and proper processes are important conditioning factors for high performance. High performance itself, however, depends upon the attitudes, thought and skilful conduct of individual directors – and the ways in which such individual energies are then combined in support of company performance.

As an attitude, high performance arguably means a refusal to be complacent. It represents an alertness to the constantly changing conditions of a dynamic market and organisation, and a conscientious application to understanding these. It is about taking full responsibility. As a thought process, high performance is about a willingness to question repeatedly the adequacy of one's own and others' assumptions and beliefs about markets, technologies and established ways of working. As skilful conduct, high performance is about clarity of role and responsibilities and the ability to provide oneself and others with constructive challenge. High performance concerns relationships that reflect respect, openness, trust and challenge.

The tables which follow briefly summarise some of the key differences between investor-driven and strategy-led board performance.

Investor-Driven Performance
Dominance of financial performance
Governance compliance
Dominance of individual ambition, self-interest, self-defence
Investor visibility drives attention
CEO dominant
CEO identifies with personal success Anticipates short tenure Big pay differential to other executives
Political climate in executive team – cabals

Strategy-Led Performance
Financial performance and wealth creation capability
Willingness to explain if in interests of the business
Self-interest plus identification with longer term company success
Long-term sustainable company performance drives attention
CEO leadership through executive team
CEO identifies with company success Anticipates long tenure Modest differential to other executives
Shared executive team ownership of key business issues



Investor-Driven Performance	Strategy-Led Performance
Executive directors follow party line in boardroom	Differences of executive view are shared with board
Executive directors see board as irrelevant	Executive directors see board as a source of essential challenge and counsel
Careful stage management of board by executive, including rehearsals	Openness with chair and non-executives
Chief executive drives board agenda	Chairman takes full ownership of board agenda
Chairman and chief executive meet only in relation to board	Chairman constantly available to chief executive, with regular open agenda meetings
Chairman with executive ambition	Chairman without executive ambition
Chairman who has too many other roles	Chairman who works hard to understand the business

Investor-Driven Performance	Strategy-Led Performance
Chairman who misreads non-executive as non-engaged	Chairman who is able to be engaged without becoming executive
Chairman works only through the chief executive	Chairman has developed non-executive relationship with executive directors, senior management and company.
Company secretary works to chief executive	Company secretary works to chairman
Non-executives selected on basis of city perceptions	Non-executive selected on basis of business development needs
Bad papers	Good papers
No contact between chairman and non-executives between meetings	Chairman communicates by telephone and letter between boards
Board time spent on routine agenda items	Board time cleared by taking routine items as read and approved – pre-board clarification of issues by non-executives with executives

Investor-Driven Performance	Strategy-Led Performance
Non-executive involvement confined to main board and committee work	Use of informal dinners to allow executives and non-executives to discuss difficult issues
Non-executive involvement confined to main board and committee work	Use of dinners with chief executive to discuss executive director performance and succession
Little off board contact between executives and non-executives	Contact between executives and non-executives - phone calls, trips to plants, travel, one-on-one involvement in the business, pairing of executives and non-executives
Governance role is felt to be dividing the board, but is allowed to do so.	Governance is held in the committees and space is made for on-going strategic debate in main board
Strategic role confined to away days	Strategic role is continuous
Strategy is brought 'fully cooked' to the board by the executive	Strategic issues are brought to the board early and repeatedly – 'warm up'
Dominance of financial metrics to monitor performance	Use of appropriate balance of financial and non-financial KPIs
Non-executives define role (reluctantly) in terms of governance	Non-executives define role in terms of challenge and support in furtherance of company performance

4 Implications and Recommendations

4.1 For the board

- Both executive and non-executive directors owe a duty of care to the business and are accountable to shareholders.
- Maximising value in the long term requires the full development of the strategic role of the board.

Recommendations

- The chief executive and executive team are responsible for delivering performance. Ensure that the right executives are appointed, and create an environment that then supports their performance.
- View governance broadly, in terms of setting the objectives of the company, and monitoring executive performance and strategy in relation to these objectives.

4.2 For chief executives and executive directors

- A chief executive's relationship with his or her chairman is key. It's a relationship; it will take time and effort to develop.
- Executive responsibility lies with the CEO and other executives, but one-to-one meetings with the chairman can provide a vital space for provisional thought, advice and support.

Recommendations

- Take the appointment process for a new chairman very seriously. Look for someone who has complementary skills to you and where the chemistry between you is good.
- Encourage the chairman's non-executive involvement with you, the senior executive team and company – the better they understand the company, the better they can support your decision making and performance.
- We are prone to treat our leaders like gods; the damage arises when you, the executive, begin to believe it. Encourage discussion and debate in both the executive team and board – it will help keep you sane.
- The executive team are responsible for delivering performance and developing strategies that will make this discussion sustainable. The non-executives should be viewed as a resource to help you do this.
- Avoid the temptation to 'manage' and 'minimise' the role of the board. The non-executives are highly dependent on executives for the quality and timeliness of information. Executive openness is key to creating confidence among non-executives.
- Allow the non-executives to see differences of view in the executive team – it's a measure of your executive confidence.
- Do not take strategy 'fully cooked' to the board; it precludes non-executive involvement and creates frustration.

4.3 For chairmen

- The effectiveness of the board depends almost entirely on the chairman's conduct.
- The key skill is to learn how to be both non-executive and engaged.

- The greater the chairman's non-executive involvement with the senior executive team and company, the more able he or she is to support executive performance.
- This greater involvement with executives allows the chairman to act as a bridge to the non-executives, and create the conditions under which they can be effective.

Recommendations

- Don't take on a chairmanship until you have fulfilled your own executive ambitions. The last thing a chief executive needs is a rival.
- In the appointments process, check out what you can bring by way of skills and experience to the chief executive.
- Don't take on too many roles. You need to identify, and be seen to identify, with the success of the organisation. This is impossible if you spread yourself too thinly between multiple organisations.
- It is difficult to be both non-executive and engaged. Don't treat your non-executive status as an excuse for non-involvement.
- Up to the point where you decide to replace the chief executive, your role is to support them and their performance. Learn to take pleasure in their accomplishments.
- Frequent and regular one-to-one meetings with the chief executive, with an open agenda, are at the heart of your effectiveness. Executive responsibility lies with the chief executive – it is always his or her decision. Only if this is crystal clear can you then exert influence through valuable counsel and advice.
- Ensure that non-executives are recruited on the basis of their complementary skills in relation to executives and the business.
- The agenda is the chairman's responsibility, in consultation with the chief executive. Make space at every meeting for discussion and dialogue.
- Use meeting locations, and informal dinners and off-board events to build non-executive exposure and an understanding of the business, to build the board as a team, and promote open and vigorous debate.
- Do not dominate discussions but help the board focus.
- Make strategy live in the boardroom. In addition to current financial performance, focus the board on the long-term drivers of value creation – along with the competitive, market and organisational threats and opportunities in relation to these.

4.4 For non-executives

Recommendations

- You need to be non-executive. You are respected because of the executive responsibilities you have, or have had elsewhere, but your role is to create accountability for the executives – not to secondguess their executive decisions.
- Build your understanding of the business to make relevant your experiences gained elsewhere. This is vital as a condition of both your own confidence in contributing to board discussions, and the confidence of the executive in your value and commitment.
- Preparation is key.
- Executives will always know more than you. Challenge from a position of relative ignorance, since it is your independence of mind that adds value.

4.5 For remuneration committees

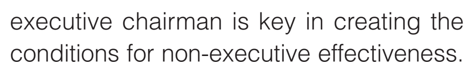
- The current system involves a self-feeding escalation of top-executive pay. Comparisons with top-quartile pay in comparable companies ensure this escalation.
- High levels of executive pay are derived from economic theories of the need to align executive self-interest with the interests of shareholders. It also promotes self-interested behaviour in executives.
- The meaning of pay for executives is largely symbolic – and relative pay (internal and external) carries much of the symbolism.
- Shared identification with the company, the value of what it produces for customers, the employment and opportunities it creates for employees, and the values that support its public reputation – are all powerful sources of meaning and motivation.

Recommendations

- Only reward high performance.
- Shift the balance of incentives to the longer term.
- Measure and reward executive leadership – it is this that will create a high-performance culture.
- Consider the impact of absolute and comparative remuneration on staff perceptions of the credibility of executive leadership.

4.6 For fund managers

- The fund manager is typically the agent of the ultimate beneficiaries rather than the owner – accountability in this relationship is weak.
- Board structure and composition condition, but cannot determine, a board's effectiveness. These form the elements that are visible from a distance for investors but many of the real levers of board effectiveness are invisible.
- The strengthening of the 'control' role of non-executives can be counter-productive if it divides the unitary board and creates a strong division between executives and non-executive directors. Increased controls can unintentionally weaken control.
- Strong short-term pressure from investors for high performance can be destructive of long-term value. Share options did not just solve the 'agency' problem, they created it.
- Risk in relation to performance and governance arises not just from the dangers associated with poorly aligned executive self-interest. The board has a key role in supporting executives' management of business risk, through allowing executives to draw upon the skill, judgement and experience of non-executives.
- The non-executive is not just the local representative of investors and shareholders; they owe a duty of care to the company. By virtue of their age, business experience and greater involvement in the company, they can create a very different kind of accountability for executives than is possible through remote transparency and annual meetings between fund managers and the CEO and finance director.
- While 'independence' from executives and a business is reassuring from a distance, it is the exercise of independence of mind in relation to the executives that contributes most to high performance.
- The level of engagement of the non



executive chairman is key in creating the conditions for non-executive effectiveness.

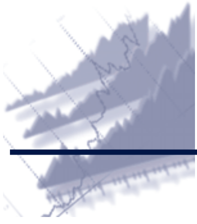
- The Operating and Financial Review (OFR) may create some new transparency around the manner and degree to which a company board is strategy-led, but all forms of remote transparency encourage self-presentation. The executives are accountable to the board, the board to the investor, and the investor to the ultimate beneficiaries.

Recommendations

- Learn to trust the non-executives. Take their greater involvement with executives as a good sign rather than evidence of collusion. Don't try to second guess the board.
- Ask questions about the board strategy process. The full development of a board's strategic role is the key to sustainable high performance.

4.7 For regulators

- Corporate governance reform has two different, but related objectives. It should enhance the effectiveness of boards, and enhance the confidence of distant investors as to the effectiveness of boards. Actual effectiveness should not be confused with what is visible from a distance – nor should the appearance of effectiveness be pursued at the expense of actual effectiveness.
- Successive rounds of reform have progressively strengthened the 'control' role of non-executives. This has the potential to be counter-productive for it is the full development of a board's strategic role that is most critical to the maximisation of value creation in the longer term.
- The control role of the board can only be effective in the context of its strategic role.
- Corporate governance is a system – a set of interdependent relationships. Investors are often confused with owners but are typically their agents, and yet little attention has been given to the accountability of the institutional investor to the ultimate beneficiaries. It makes little sense to deliver high short-term performance to pension funds, if these are achieved at the expense of employment and the sustainability of the enterprise.
- As agents, fund managers are highly incentivised in relation to very short-term performance league tables. There is potential for a collusion of interest between fund managers and executives in share price management that can be destructive of value in the longer term.
- The rationale of executive incentive payments schemes was that they aligned executive self interest – treated as a given of human nature – with the interests of shareholders. Post-Enron and WorldCom, it is beginning to be understood that such schemes also fed and created executive self interest – and the incentive to create over-valued equity. Shared identification with the objectives and success of the company is an alternative and counter to self-interest.
- The board's role, and in particular the role of the non-executive, should be seen in relation to the company, not the investor. They owe a duty of care to the company, but are accountable to shareholders. Likewise, the shareholder owns shares in the company, rather than the company itself. A company is a social institution rather than an assembly of assets.



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