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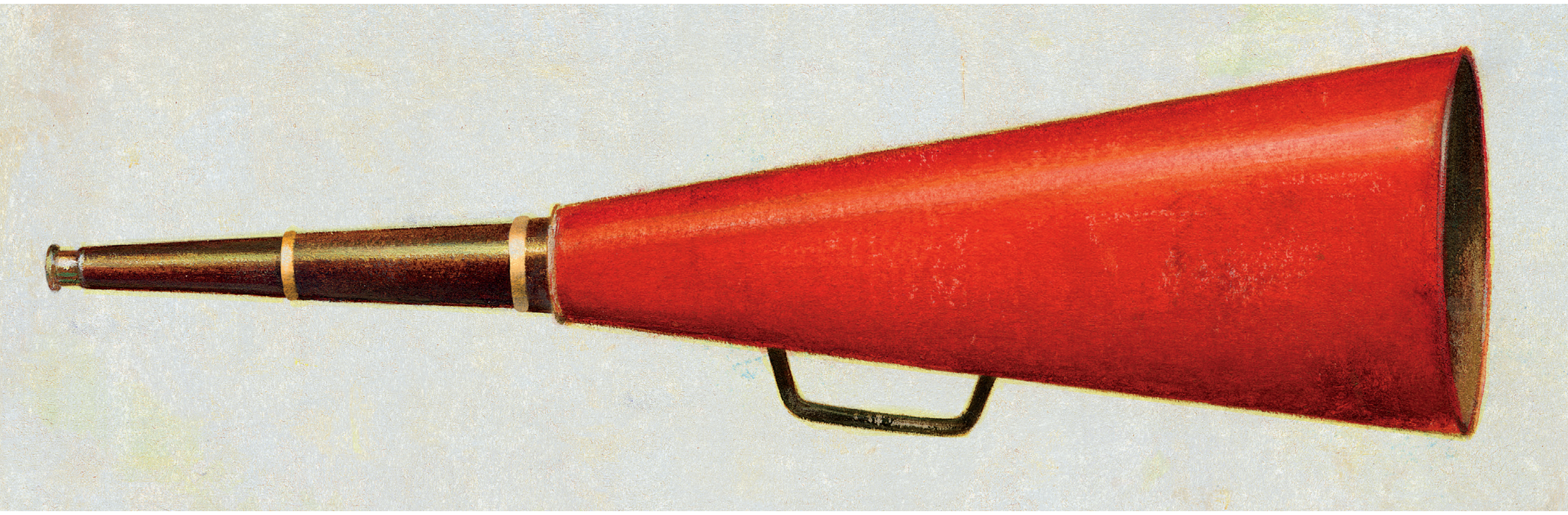

Are you getting all you can from your board of directors?

Veteran director David Beatty finds many boards wanting—and considers how to improve them.

Jonathan Bailey and Tim Koller

Boards of directors have always, in all cultures, represented the shareholders in publicly traded companies—validating financial results, protecting their assets, and counseling the CEO on strategy and on finding, then nurturing, the next generation of leaders. It's a tough and demanding responsibility, requiring individual directors to learn as much as they can about a company and its operations so that their insights and advice can stand up alongside those of executives. That, at least, is the ideal.

One litmus test of whether or not the ideal is coming anywhere close to being the reality these days is the growth and involvement of activist investors. If boards were doing their jobs, there would be no activist opportunities. That's according to David Beatty, Conway Chair of the Clarkson Centre for Business Ethics and Board Effectiveness at the University of Toronto's Rotman School of Management. Apparently, they're doing "badly enough that there's been huge growth in activist firms," says Beatty, who interprets that growth "as a direct comment on boards of directors and their past performance."

He ought to know. In addition to his academic position, Beatty has served on more than 35 boards in five different jurisdictions and has been board chair at eight publicly traded companies. He currently serves on three boards—one as chair—and is the leader of the Directors

Education Program offered by the Institute of Corporate Directors. In a recent interview with McKinsey's Jonathan Bailey and Tim Koller, Beatty discussed the role of corporate boards in guiding and overseeing public companies, offered recommendations for directors, and shared his thoughts on the CFO's role in working with boards.

McKinsey: *What do you see as the most important change in the way corporate boards function?*

David Beatty: Frankly, we used to be pretty lazy about boards. They were largely seen as being rewards for past service. There was an assumption that talented CEOs could move easily from their executive posts into a board setting. The boards were large and often perfunctory in the performance of their duties. I have been on the board of a large financial institution in a developing economy that had more than 50 directors, and the main event was always the lunch that followed the three-hour board meeting.

But a seat on a board is no longer a sinecure—and the day of a board comprising solely gifted amateurs is over. Partly because of external circumstances, collapses, and stock-market failures, there's a growing sense that boards have to be smaller, harder working, and more expert. And they have to be able to commit the time to do their work.

The last study I saw reported that directors were spending an average of around 240 hours per year across the S&P 500. That includes time spent at home studying, committee time, and board time. Today that number should be at least 50 percent greater—and if a potential director can't put in 300 to 350 hours a year, she shouldn't take the job. But even 300 hours per year has to be compared with the 3,000 hours a year that each member of a management team devotes to his or her work. And most managers these days have spent a lifetime working in their industry. Even a gifted amateur director who works hard is not likely to be able to add much value to an experienced management team about the day-to-day business.

The only place outside directors can really add value—aside from policing and oversight functions—is in offering a different perspective on the competitive environment and the changes in that environment. That's where their general business judgment comes in, helping management think through strategy and specific objectives for three to five years down the line. That's where directors have their best chance of making a difference.

McKinsey: *On average, how well are the boards of directors doing at most large public companies?*

David Beatty: Not well. Think of a long list of disgraceful performances at the beginning of this century—from Enron to WorldCom to HealthSouth to Adelphia Communications—and the recent collapse of the financial sector, which destroyed an aggregate of $1.2 trillion in shareholder value across the entire Organisation for Economic Co-operation and Development, and even of the more recent collapse of the mining sector, which has obliterated over $600 billion in shareholder value. You have to ask, "Where were the directors?"

Boards of public companies have apparently been doing badly enough that there's been huge growth in activist firms—which are in the business of studying companies deeply, putting their own money in, and then publicly advocating a better way—to the advantage of shareholders. I take that as a direct comment on the poor performance of boards of directors in publicly traded companies.

Part of the reason for this poor performance is that the boards of many companies still don't know the businesses in which they compete. Board directors are impoverished when it comes to the competitive insights they can bring that might make a difference. They're also 80 to 90 percent dependent upon management for the information they get about the business, its competitors, and alternative strategies. As a direct result, it's not uncommon for the CEO to assume control of the agenda, arrange fairly anodyne planning sessions, and be fairly closed minded about the potential value the board can add.

CFOs have a unique capability to unlock the potential of the board. The CFO knows the numbers, understands the businesses, and lives with the top-management team but does not "own" the business or businesses the way the operating managers do. The CFO is therefore in a unique position to work with and help the other members of the C-suite understand the needs of the board and to work toward making it effective.

David Beatty

Vital statistics

Lives in Toronto, Canada

Married, with 4 children and 5 grandchildren

Education

Holds a master's degree in economics from Queens' College, Cambridge, United Kingdom

Has a bachelor's degree in political science in economics from Trinity College, Toronto, Canada

Career highlights

University of Toronto
(1997–present)

Professor of strategic management, Rotman School of Management

Director of the Clarkson Centre for Business Ethics and Board Effectiveness

Founded the Directors Education Program in 2004 and has since led the joint initiative with the Institute of Corporate Directors

Canadian Coalition for Good Governance
(2004–09)
Founding managing director of this group of more than 50 institutional investors dedicated to improving board effectiveness

Peter F. Drucker Foundation for Nonprofit Management
(1992–2000)
Vice chairman

Old Canada Investment Corporation
(1990–99)
Chairman and CEO

Weston Foods
(1985–94)
President

Fast facts

Has served as a director on the boards of 35 companies in Australia, Canada, Mexico, the United Kingdom, and the United States, and has been chairman of 8

In 2013, was awarded a Queen's Diamond Jubilee Medal for his contributions to the mining industry and received the Order of Canada Medal for his work in corporate governance

Has rowed competitively with his wife in the Fédération Internationale des Sociétés d'Aviron World Championships for many years

"Talent and time are relatively easy components of a chair's task—the tough one is sensing and managing the tone of the board."

McKinsey: *How do you see the role of the board chair?*

David Beatty: Benjamin Zander once observed that he suddenly discovered at age 45 that as conductor of the Boston Philharmonic Orchestra he was the only person on the stage who didn't make a sound. His job, he realized, was to create great things out of the individual talents that were in front of him.

That's also a really good description of the job of a board chair: to bring out the very best in the talent that is around the board table, both the directors and the managers. A board chair is responsible for bringing individuals with the right mix of talent together, utilizing their time to the greatest possible effect, and ensuring that the tone around the boardroom is open, transparent, and productive.

Talent and time are relatively easy components of a chair's task—the tough one is sensing and managing the tone of the board. Tone breaks down into two components: trust and tension. There has to be trust around the board table among the directors themselves, and there has to be trust between the board and management. At the same time, there has to be a certain tension between the board and the CEO and the CEO and his or her team, since they have different jobs to do. So the job of the chair is to make sure everyone comes together to make beautiful music.

McKinsey: *Speaking of that tension, do you think the chair and CEO should be separate roles?*

David Beatty: Yes, definitely. I can't see any excuse for the US practice. The fundamental difficulty is that the same person can't do both jobs; it's difficult for the fox to look over the henhouse. And that kind of problem can spread much deeper if a CEO fills other board positions with friends and colleagues who always agree with her or, for example, appoints her personal accountant to chair the audit committee.

The practice isn't likely to change in the United States, but there are work-arounds. A strong lead director, for example, can take control of the situation and ensure, over time, that a board is independent of management. But it's an even tougher job than normal given the dual role of the CEO and the chair.

If the lead director can't establish an effective, open, transparent, problem-solving, creative interface between the board and management and has done pretty much everything she could, then she should resign. That's what I've done in those circumstances.

McKinsey: *Short of waiting for a crisis, what should a director do if the CEO isn't up to the job?*

David Beatty: If the company is in difficulty or if doubt begins to creep in about the CEO's effectiveness, a director needs to go into a different mode—because if you've got the wrong CEO, you're out of business for three to five years. You have to begin by talking to your colleagues to see if others are also concerned. And study analyst reports carefully to see how the company is doing relative to its competition.

And talk to your chair. This is where the chair's responsibility for in-camera meetings after board sessions can be hugely important. When I was chair of the board at Inmet Mining, at the time a $6 billion company, we'd invite the CEO to stay after every board meeting—so we could ask questions without other managers around. Once the CEO left, I would canvass the board, one by one, on what worked or didn't work about the meeting, what each would like to see improved, and whether views on the CEO, if any, had changed.

McKinsey: *How long should individual directors expect to serve on a board?*

David Beatty: It's very hard to get rid of directors, so I am definitely in favor of term limits, whatever the cost. The United Kingdom has decided that in publicly traded corporations, 9 years is enough; they can extend that to 12, but from 9 years on, a director can't sit on the audit committee, the nominating committee, or the compensation committee, so her functional utility drops by about 60 percent, and typically she just leaves.

That also brings up a question of board evaluations. This is a practice that's grown up over the past decade, where boards formally sit down and appraise themselves. That can be a paper-driven appraisal, and it could be done in-house or by third-party experts.

When I'm the chair of a company, I tend to alternate between paper and personal. Every year, I sit down with each director and run through an extensive agenda of questions about the board's talent, use of time, and tone. Every second year, I supplement that with a six-page questionnaire that inquires in more detail about the functioning of the board. I then use a third party to collate those results and report to the governance committee so that any critique of the chair can be included in the results.

Peer evaluations are not very common and can often be problematic. The basic purpose is an open and honest appraisal of colleagues against certain performance standards. The peer evaluation is designed to be helpful, not harmful, to individuals. If somebody's clearly underperforming, it's the chair's job to figure that out, seek out the advice of other senior directors, and then act.

As chairman, I've asked two directors to leave major boards, and it's a miserable job. But in both instances, I felt that the benefits of having that person continue were greatly overwhelmed by the potential costs. As a chair, I no longer use peer evaluations but rely instead on continual contact with my fellow directors.

McKinsey: *Is there anything that can be done to mitigate the social stigma of being asked to leave?*

David Beatty: Next to determining that your CEO is significantly underperforming and needs to go, asking a director to step down is the toughest job there is. So, all too frequently, nothing is done.

Here, too, we may learn from activist investors. Often, one of their first demands when they get involved with underperforming companies is to replace specific members of the board. It's also not unheard of for board members to resign on their own after a testy proxy fight for control. That's kind of a disciplinary function that ought to give spine and courage to chairs of boards who are wondering about their board's performance, wondering about the performance of individual directors, and trying to find that courage to say, "On balance, we're going to be better off without this director or that, adding some new talent that we don't now have, and asking him to move along." It's not easy. But again, maybe the activists are teaching us that while it isn't easy, it might be necessary. And if you, as chair, don't do something, there's a good chance someone else will.

McKinsey: *Some companies are extremely complex. How does a board develop enough knowledge to add value in such cases?*

David Beatty: The job gets asymptotically harder the bigger the company gets. The skill sets are so demanding, the level of understanding so deep, and the diversity of the company so profound that it gets ever harder even to conceive of the board adding value through strategic insight as opposed to general business judgment.

A company such as GE, for example, is a talent machine. The board's contribution to the future lies less in the arena of business strategy and more in talent development and managerial succession. Directors see GE as an incredible university of capable people whose talents they develop. The oversight of that function, with respect to the future of the company, is intense and highly value added, versus the ability to say we should get out of credit, we should be doubling turbines, or we've got to move more deeply into China.

McKinsey: *How can a board decide whether a company is making the right trade-offs between its short-term performance and its long-term health and ability to grow?*

David Beatty: This is another topic that I would raise with the chair during in-camera meetings. Say you're coming out of a one-and-a-half-day strategy session leading to decisions on capital expenditures and a competitive way forward, and you have anxiety about the timing. So, ask in the in-camera meeting, "Did anybody else feel that these investment decisions were being shaped more from a share-price perspective over the next six months than what's in the longer- or medium-term interests of the company?" Just putting it out there as a topic for discussion can be a powerful tool.

Interestingly, family-controlled companies in Canada that are publicly owned have significantly outperformed the rest of the market. It's kind of intuitive that they would have a longer investment horizon—you don't invest in your kids'

education for the next quarter. By their nature, CEOs of family-controlled businesses think longer term than the hired gun you bring in from outside to be the CEO and pay with a lot of options. The average tenure of an external CEO in the United States is around five years, and of course he or she is thinking shorter term. You get what you pay for.

Happily, most other markets in the world are family controlled, so short-termism may be an endemic disease only in the United States, the United Kingdom, and some parts of Canada. It's structured into our system, and we've fallen into the trap of measuring and compensating CEOs against "the market." Fortunately, we're now also hiring more from inside than outside—by a ratio of about 70 to 30 for the S&P. That's a huge plus because it means you don't have to go into the market to attract, retain, and motivate these gifted potential CEOs. But we're probably not going to get away from short-termism as long as we have options.

McKinsey: *What should the CFO's role be with respect to the board?*

David Beatty: I have a radical proposition: I'm a fan of the English system, where there are more executives on the board than just the CEO. And the first executive I would add to any North American board would be the CFO. That would give the CFO certain specific responsibilities with respect to his or her relationships with the audit committee, as well as with the board chair and other directors. It would also significantly enhance the quality of decision making around the board table over the medium term and empower the CFO to have an independent point of view—not necessarily in conflict with the CEO, but simply to have an honestly transmitted perspective on the company.

Where that doesn't happen, I'd encourage CFOs to think about their relationship with directors from the director's point of view—and how they can help directors do their job better. Certainly, a CFO should let the CEO know she was planning to do this, but she could reach out to directors independently and ask them what they feel about the quality of the material coming from her department. Are the numbers just too intense? Do they want more synthesis of what's going on? Would they like more in-depth analysis? The CFO has the numbers and the intelligence and understands the business without emotionally owning the business.

McKinsey: *What do you feel makes the best CFOs stand out?*

David Beatty: As a director, I like strong, independent CFOs, not those who are deferential to the CEO. I want a CFO who understands the numbers, understands what's behind them, and stands up independently. I've served on boards of companies with a CEO who had no trouble with me asking the CFO for more insight about this number or that, and the CFO himself would have no difficulty interrupting management meetings to clarify a point if it wasn't quite what he'd understood during audit-committee meetings. So I really regard a strong, independent CFO, in the handling of board matters, as offering a great deal of value. ○

Jonathan Bailey is a consultant in McKinsey's New York office, where **Tim Koller** is a principal.