

You're more than the 'hall monitor'

How directors contribute to strategy development determines the real value they add to a company. But governing strategy means asking tough questions and putting the proper 'scaffolding' in place. **BY MIKE KIPP**

IT IS HARD TO HAVE a conversation about governance without getting the impression that the board is the “hall monitor” in the affairs of an organization. The business press, the analysts, and the critics seem single-mindedly focused on oversight — driven by SOX, related-party transactions, options backdating, and executive compensation, among other concerns. Heads nod with exaggerated solemnity as someone says, “You have to be ready to ask the tough questions.” It’s as if managers were errant children in need of adult supervision. (And, indeed, some are.)

But here’s a tough question for directors themselves: How does the board *add value*? More specifically, what is the board’s role in *developing* and *governing* strategy?

This is far from an academic concern. A recent McKinsey study surfaced the discomfiting finding that “less than 25% of directors know their company’s strategy” and “less than half are knowledgeable about the 4 or 5 key initiatives underway at any given time.” No wonder CEOs often see their boards as too conservative and too uninformed to contribute to strategy beyond receiving *good* intentions and *good* news.

So, as directors we’re good with Section 404. Are we done? No. Compliance is “table stakes” — only a precondition to placing the kinds of “bets” that add value over time.

Series of ongoing choices

One of the board’s key responsibilities is to guide strategy, policy, and core ideology. This goes beyond simply *knowing* the “game plan” to actively and appropriately *participating* in robust dialogue around aspirations and direction. Directors who truly add value also know that strategy goes beyond the col-

lective enthusiasm to “grow the business.” They see it as a series of ongoing choices about customers, competitors, and competencies — a “pattern of response to market needs, consciously selected in light of probable shifts in the environment, relative competencies of the firm, and the contingent moves of intelligent competitors” (definition of strategy from *The Intelligent Enterprise*, James Brian Quinn, Free Press, New York, 1997).

Clearly, the CEO is the chief strategist for the company. Boards shouldn’t kid themselves on this. Strategy development, though, is the product of a conversation between leadership and the board, starting with the CEO and proceeding as a kind of “volley.” As with all good conversations, it is fueled by *good information* and *good questions*.

Leadership’s opening salvo always raises governance choices that will ultimately guide strategy and inform its execution: the adequacy of capital structure, the implications for various stakeholders, the implied compromises and risks, etc. These should be teased out of the working hypothesis and deliberated by the directors and management in what might be called “generative dialogue.”

That’s where the real tough questions come in, the ones that invite reflection rather than closure. They don’t pull answers out of someone’s “mental inventory” but breathe life

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into the issues themselves. They are legitimized precisely because they defy simple resolution. They take the conversation to the place where business judgment lives and value gets added (or destroyed).

As in this scenario: “Thirty-five percent of our turnover is unprofitable and half isn’t growing, so how come 90 percent of our balance sheet is committed to a North American business that’s got nowhere to go but down?” No one may be hiding these “inconvenient truths” but they may be languishing for a whole variety of legacy reasons that can be confronted only at the governance level.

A tough scenario for a bank board

Let me personalize this even more. For nearly five years, a board that I am involved with, American Home Bank, has watched subprime, Alt A, no-doc, interest only, and other innovative “products” — products introduced in part to drive home ownership beyond 60 percent consistent with a Clinton administration policy on facilitating home own-

ership — challenge our differentiation strategy in new construction lending. Given our mission “to help people afford, buy and enjoy the home of their dreams,” we applauded this policy even as we worried about the fundamentals. As the home ownership index approached 70 percent, \$1.5 trillion in transactions — more than half the total for 2006 — “left” the traditional mortgage-lending business as we knew it. We kept our powder dry and held the question of our participation in offering riskier loan products through every board and three annu-

The board should own the objectives — not the strategy.

the business gets “hired.”

- Have a common view of the mechanics of the business model.
- Know how customers “use” the business.
- Understand how value is created or destroyed for all parties.
- Grasp the key choices involved in strategy.

This is a great “punch list” for board development, by the way. The answers can be brought into sharp focus through the use of three deceptively simple frameworks — boundary conditions, rules of engagement, and a context map.

Boundary conditions

Boards govern best when they establish and maintain a set of boundary conditions that embody their vision and values, the aspirations that capture their stakeholders’ best hopes, their preferences regarding key tradeoffs, and a “working hypothesis” on the path to their “preferred future.” As Exhibit 1 points out, boundaries also define the discretion the CEO can exercise pursuant to those aspirations. A governing board that struggles to be *civil* rather than *clear* on these matters sets the stage for what will inevitably become a strained working relationship. The boundaries framework keeps conversations about relative risks and self-imposed constraints from coming off the rails. It also greatly facilitates the recruitment process for a new CEO, informing both the board and the candidate.

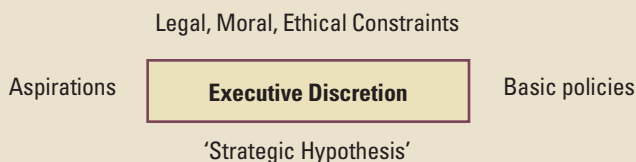
Rules of engagement

This is a set of explicit agreements on “how we work together” — how business is conducted, how members interact with management, how decisions are made, and how difficult conversations are carried out. These agreements are often “baked in” to formal bylaws and committee structures. They are best developed against the backdrop of a few simple principles:

- Governance is a form of ownership, not an extension of management.
- Boards need frank, unfiltered dialogue.
- The board speaks with one voice or not at all.
- Trivial “board packages” invite trivial discussion.
- Board deficits drive board development.

These are common sense but uncommon practice. In a world that loves SWOTs (analysis of “strengths, weaknesses, opportunities, and threats”), directors have been curiously exempt from the assessment of their own deficits. Companies and their constituents are well served by “rules” that engender periodic evaluation and continuous improvement. And as for the value-adding power of sound policies, boards can save hours of well-in-

EXHIBIT 1 Boundary Conditions



al shareholder meetings, all the time being chided by those who felt that our growth lagged industry standards. None of us knew the answer, regardless of how it was asked, but board and CEO alike were convinced it was the right tough question.

To successfully partner around such questions, both directors and executives must:

- Be aligned around the value proposition — why

tioned manipulation by agreeing to speak with one voice or not at all.

Finally, the practice of a standing executive session in the spirit of frank and unfiltered dialogue takes the “uh oh” out of calling them.

The context map

Both boundary conditions and rules of engagement are developed for a particular context. In the final analysis, they are intended to ensure alignment between governance and management and fidelity to the interests of the market. Exhibit 2 reflects the defining attributes of any context and the relationships among its parts. An informed board should be clear on the nuances of each and their impact on the range of available options. Until board members fully understand their context and agree to shoulder responsibility for its internal contradictions, they will be unable to separate their prejudices from their business judgments. The “map” enables them to appreciate the complexities of their situation and have the conversations necessary to enjoy success.

A fine point

With this foundational scaffolding in place, the value of the board in strategy is its perspective. Utter detachment serves no one, but excessive identification with a specific game plan disempowers the CEO and dilutes accountability.

To put a fine point on it, the board should own the *objectives* — not the strategy. Examples of this in action:

- The directors of a financial services firm insisted on a sustainable 5 percent market share to preserve customer “share of mind” in a consolidating industry; strategy was left to executive discretion.

- The board of a privately held parts manufacturer aspired to an enduring 15 percent return on equity, noting its openness to alterations in the business model to get it.

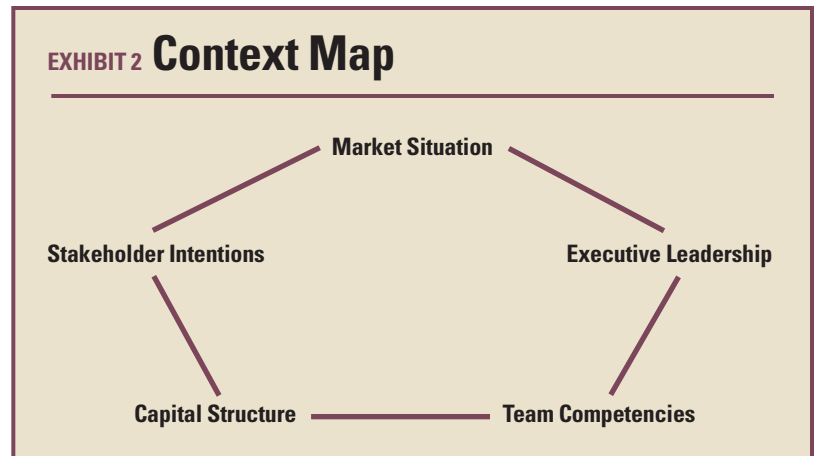
- Trustees of an industrial products firm sought to attain the status of a Fortune 500 firm, setting the table for a decade of acquisitions and organic growth

- A supplier to municipal utilities was directed by its board to grow its business to at least 15 percent of corporate turnover in the interest of achieving “material significance” within the portfolio.

Board members should also be aware of the potential for “contaminating” their perspective with their personal risk profile. The long-tenured retail executive may have wonderful insights for the software firm selling into his space but a vastly

different point of view on the risks and rewards appropriate to the industry in which he now exercises governance.

Tuning a board’s perspective to the right channel is *the* job description of the chair. In this regard, directors are a bit like meteors circling the organizational planet: Too far above it all and they are likely to float off to a ceremonial distance until cri-



sis brings them down; too deep and they burn up in the atmosphere, dissipating their well-intentioned energy in a spate of micromanagement.

One last test

Once in place, strategy should pass the test of yet another set of tough questions:

- Have we got the capacity to *execute* on our best intentions?
- Is the *talent* available for key initiatives without de-focusing our baseline?
- Are our *systems* and *infrastructure* robust enough to carry the shift?
- Are the *interests of management* aligned with the *interests of ownership*?
- What’s the *earliest evidence* that will validate our chosen course?
- How will we *measure success* ... and make *course corrections*?

On this last, the board should always have strategic matters on its standing agenda: readings on the “dashboard,” progress in key initiatives, and changes in the “context map” for the business.

Regardless of sector or corporate structure, governance is indeed a form of ownership; for owners, the development and governance of strategy should always be given equal-or-better billing with compliance and oversight. ■

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