Directors &Boards

The board's broader role in strategy: with more risks out there than ever imagined, and risks that have bigger impact than they had in the past, greater board involvement in strategy may be the best hope for staving off a disaster.(STRATEGY)(Cover Story)

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ONE OF THE PERENNIAL governance questions of the last decade has been, "What is the board's role in strategy?" Ten years ago in a governance seminar I was running at Wharton, Irving Shapiro, then recently retired as chairman of DuPont, said (only partly for effect), "The board has only one role: hire and fire the CEO--otherwise they should stay out of the way."

What a difference a decade makes! Most chief executives today involve their boards heavily in strategy. The board participates in an annual strategic retreat and discusses appropriate metrics for tracking progress and assessing the external environment. Directors also are frequently asked to review updates to the company strategy. Most CEOs welcome this involvement and the resulting discussions and advice.

All directors and chief executives I talk to (and there have been many in more than 30 governance courses I have run for directors over the last decade) agree that the board should not develop the strategy but should contribute to understanding the context for its development, evaluate management's suggested strategies, and monitor progress and impact. Strategy development is clearly management's responsibility, because the management team is closer to the market, the environment, and company capabilities than the directors are.

But there is danger lurking in the boardroom unless the definition of the board's role in strategy is broad. I believe the board has (at least) four major strategy roles:

* Short term: Ensure that the capabilities needed to execute the chosen strategy are world-class and provide differentiation and advantage.

* Medium term: Continue to reevaluate the strategy in light of competitive actions and changes in the external environment.

* Longer term: Periodically develop a "start from scratch" view of the world in a five-year time frame. What would the business look like if you were able to start it from scratch five years from now? If you don't do this, a competitor you don't even know today might.

* Always: Broaden your view of strategic risk to those things that have come to be lightning rods for destruction of shareholder value.

1. Assessing capabilities

A decade ago, leading strategy thinkers were talking about capabilities as strategic drivers. We saw more emphasis on IT, customer service, supply chain, lean manufacturing, rapid product development, and other mechanisms to change the rules of the game. Many companies have learned to use a broad range of capabilities to advantage, but there are others that have been slow to change or develop new capabilities. This difference is especially true in consolidating industries with a sudden break point, when winners and losers emerge suddenly from a fog. The airline industry and the shift to digital photography are two current examples.

As industries become more competitive, the real issue is that much more of what we once considered operational has become strategic. But operations is a differentiator only when we are so much like our competitors that we cannot find other ways to compete. Operational excellence is absolutely necessary as a capability, but if it is the only strategy it may be a sign that you have run out of ideas for the future.

2. Reevaluating the strategy

The annual strategy retreat worked well when we developed five-year plans, but competitive time frames are short and getting shorter. As a result, we have lapsed into two- to three-year plans with lots of mini-strategy updates. Conditions change, inside or outside, often beyond our control, and this means that the strategy may have to change in the short term.

This can even shift board focus from a high level to the nitty-gritty. There are times when this is appropriate because failure to get into the details could have strategic consequences. For example, consider the accompanying 10-year stock price chart of a $3.5 billion services company we'll call Service Corp. (see page 21). This company is the product of a number of mergers in a consolidating industry. If you believe in efficient capital markets, the stock price is a rough reflection of the performance of a company. On this basis, Service Corp. clearly went though a tough period as it tried to digest a large merger and regulatory problems. Its stock price was at rock bottom in 1998. What was the "strategy" at that point, and where did the board spend its time?

The strategy was survival--not an esoteric long-term vision of the future, but questions about whether the company would have enough cash to meet its obligations and why it could not collect receivables. This was not rocket science--the strategy, at least for a couple of years, had to be nitty-gritty operations. The management team and board concerned themselves with the fact that the company had 24 different billing systems, 120 days' receivables, and summary management and financial information that depended on integration via manual spreadsheets.

Once the operations issues were conquered, the company began to generate cash, the management team turned its attention back to the fact that the industry was consolidating, and the board began to focus on the longer term. The company went into acquisition mode and made more than 20 acquisitions over the next four years. The acquisitions went smoothly because of the discipline and operational competence built during the turnaround. In essence, an operations strategy became a platform that allowed acquisitions in a consolidating industry in which the lack of an ability to acquire and integrate would have made the company a target rather than an acquirer.

Strategic reevaluation is a constant board process. Sometimes no action is required and at times dramatic changes are in order, but the process should be on the agenda.

[ILLUSTRATION OMITTED]

3. Long-term view

The board also has a responsibility to come back to the longer-range question periodically and ask what the world will look like in five years or more. The capabilities required in that time frame may not be the ones you have now.

Strategy must be continually informed by the changes taking place in the external environment and how you will change the nature of the game. Are you changing the playing field (like Dell) or just competing on someone else's terms?

Your responsibility as a director is to worry about strategy in a very straightforward way. What should we be doing in light of the external environment? Do we have a vision as to how to change the game? Do we have the competencies necessary to play the game we need to play going forward?

Recent troubles at some companies that have had very long-run success are illustrative. Most would argue that Kodak did everything right for 100 years and yet has lost its position as the leader in its field. The problem is that it did everything right in a world that was not challenged by new technology for a century. Complacency with a leadership position and the extraordinary profits that accompanied such dominance made it hard for the board to question the strategy. Yet everyone knew digital photography was coming, and in fact Kodak was one of the innovators, with early patents in 1986. The problem was that no one wanted to admit that the cash cow (chemical-based imaging) would diminish. Even if they were willing to admit it, they did not want to take action until it was clear there was no other choice. Two of the most profitable and valued brands in the history of the world, Kodak and Coca-Cola, are in trouble for the same reason: They were so profitable for so long that the management teams and boards had trouble accepting the fact that the world had changed in ways they did not like.

4. Strategic risk definition

In today's world it is too easy to see examples of companies with sound businesses that find themselves with problems that destroy massive shareholder value. Tyco and HealthSouth are the prime examples. Both have strong operating businesses, but accounting and ethical missteps put both enterprises at risk.

Boards are learning a lot as they go through Sarbanes-Oxley Section 404 compliance, but the biggest lesson is that there are more risks out there than they ever imagined. Beyond the normal risks of execution, the board must consider that other things have the potential to seriously weaken a company and investor confidence. Some examples:

[GRAPHIC OMITTED]

* Financial structures that increase risk through exposure to events built into debt instruments (e.g., puts on bonds, loan calls, or term changes).

* Accounting/financial engineering issues that are not black and white, such as Fannie Mae's current struggle with treatment of its hedging transactions.

* IT systems that do not provide competitive capabilities, either reducing efficiency or exposing the company to a variety of risks (e.g., supply chain, fraud, lack of control, poor A/R).

* Succession planning or lack thereof, and the consequences in a crisis.

* Compensation issues that blow up when the worst-case scenario happens, such as the Ovitz/Disney lawsuit.

There are many other examples, and these kinds of risks have greater impact than they had in the past. Some problems occur through neglect as time passes and nothing is done (IT systems, succession). Others arise because no one imagined or thought through the worst case (compensation or financial structure).

Audit committees have broadened their view of risk over the years, but many of the risk reports I have seen from audit firms do not adequately cover the examples above. The board as a whole, on a regular basis, must review what constitutes risk in today's environment.

Value-added vs. meddling

Competitive strategy, technology strategy, customer acquisition/retention strategy, succession strategy, financing strategy, IT strategy, compliance strategy, revenue recognition strategy, and even legal strategy have all become fair game at a board level. I know--you think a lot of these are tactics in the implementation of the overall strategy and are places where the board should not be meddling. If you really believe that, you haven't been reading the papers.

What should you do to make sure your board's role is value-added when it comes to strategy? The obvious actions are to be a non-judgmental strategic sounding board for the CEO on a regular basis. The not-so-obvious roles involve looking broadly at risks, major trends, and implications; asking how you can change the nature of the competitive game; and really looking hard at whether the competencies you have are those required in a future environment rather than reflective of your past successes.

Just as important is your role in raising the flag and asking for a deeper discussion when you see unexpected moves from competitors, unexpected losses of customers or product strengths, employees' or customers' lack of understanding of the strategy, disruptive technologies, or declining margins with no apparent way out. The board is the last hope in some cases, as illustrated in my study of major management disasters (discussed in my recent book, Will Your Next Mistake Be Fatal?). Denial of obvious signals is a consistent first mistake that management teams make on the way to disaster.

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How does management recognize what we call a strategic mistake chain--a set of compounding, unchecked errors that threatens to bring a crisis to front-page status? It is neither easy nor exact, but there are clues that should set off some alarms for further investigation.

* Employees don't understand the strategy. Most organizations endure some sort of internal grousing about the direction of the business. Some of this is a failure to communicate on management's part, but do not dismiss these comments capriciously. They are often early indicators, from those on the front lines who are in a position to know, that things are not going as well as you might believe.

A colleague tells the story about a marketing executive who arrived for work at Kodak in the mid-1990s. The first meeting he went to was a shouting match about the future of digital photography. The hard-liners said digital cameras were never going to be in Kodak's future, while the new hires all battled for a digital vision of the future. The new executive said he knew within two weeks of arriving at Kodak that he had made a huge career mistake. Everyone was in denial about digital imaging. He was gone in exactly one year.

* "Surprise" competitive products, usually characterized by a sick feeling in the gut when you pick up a newspaper or trade journal and see that a competitor has announced a breakthrough product that you thought was beyond their competence. If Motorola owned the pager business at some point, why did RIM bring the BlackBerry to market? Did Motorola think there was no opportunity there, or did they ignore it because it was too small? For all of its history in radio, why doesn't Motorola have a position in satellite radio? Motorola did announce a chipset to improve sound quality in radios that receive existing AM and FM signals, but the press release sounds like a defense of why the company is not in the satellite radio market.

* "Surprise" competitors. This is similar to the surprise product problem, but it makes you feel even worse when you realize that a company you have never heard of or thought was insignificant is in your space stealing your customers. Is Kodak surprised to find Dell selling cameras? Probably not at this stage because everyone is moving into their space.

* Missed opportunities--another way to look at surprise products, pre-emptive market entry by others, technical breakthroughs you had on the shelf, and other forms of business humiliation.

* Looking outside for growth or technology because organic growth has become difficult if not impossible.

* Difficulty finding opportunities. Is it the people, the technology, or the market?

* Early to market, early to lose. Kodak was too early with Photo CD and too late with more broadly applicable products.

* Loss of pricing power on flat or declining volume--the first stage of commoditization.

* Indirect loss of pricing power (for example, more free add-ins), an indication of increased competitive pressure.

* No returns on R & D. Xerox might have said this about PARC at some point, but the answer depends on the time frame for evaluation.

* Feeling your competencies are undifferentiated. If you are really honest, are your competitors as good as you are in most respects?

* Declining price/earnings (P/E) and financials. Unfortunately, this is a look in the rearview mirror, not an early warning indicator. By the time you see this, you usually have very serious problems.

There are ways to deal with these signals when you see them, but the first step is to create a culture that is willing to ask questions about the preceding items and be honest about the answers.

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