



The view from the **boardroom**

A McKinsey survey of directors shows that they're tired of playing defense.

**Robert F. Felton and
Pamela Keenan Fritz**

New energy is stirring in corporate boards. After years when accounting scandals and charges of inadequate governance put them on the defensive, they are looking to step up their engagement with core areas of corporate performance and value creation. The principal finding of a *McKinsey Quarterly* survey of more than 1,000 directors (see sidebar, “How the survey was done,” on the next spread) is that having focused for a time on accounting-compliance issues, they are now determined to play an active role in setting the strategy, assessing the risks, developing the leaders, and monitoring the long-term health of their companies.

At one level, our survey underlines the way the US Sarbanes-Oxley Act is holding boards—not only in the United States, but also around the world—more responsible for meeting high standards in reporting and controlling the financial affairs of their companies. Yet the implications for governance are even more far reaching. To achieve as much involvement as directors say they want, they will have to use their time in meetings more effectively and develop a new understanding of their roles and responsibilities; otherwise, they will give management the impression that they intend to take on day-to-day roles. Moreover, the composition and culture of boards, as well as the agendas of board meetings, will require fresh thinking.

A changing role

Directors want to be more actively involved in three areas: what we call a company's health (its ability to survive and develop over the longer term) and its short-term financial performance, its strategy and assessment of risk, and its leadership.

Performance and health

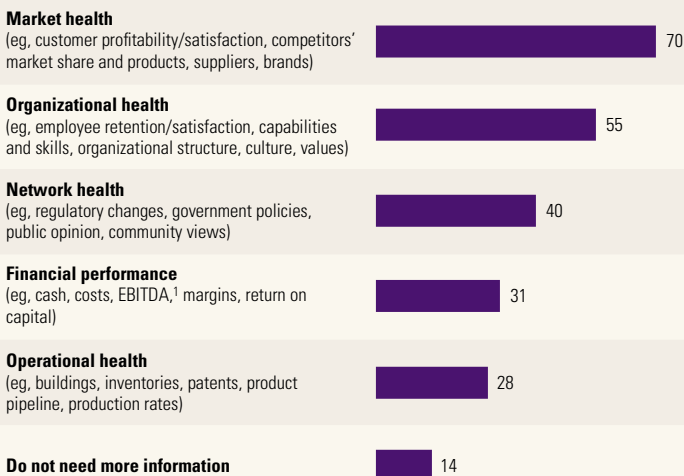
Although the survey shows that directors focus primarily on financial matters reflecting short-term corporate performance, they wish to expand their reach into issues that shed light on the longer-term health of their companies (Exhibit 1). Indeed, fully 70 percent of the directors want to know more about customers, competitors, suppliers, the likes and dislikes of consumers, market share, brand strength, levels of satisfaction with products, and so forth. Upward of half want to know more about the state of the organization, including the skills and capabilities needed to realize the corporate business strategy, both now and in the future. Two in five respondents are eager for insights into external networks, such as the nature and level of regulatory and government risk, as well as public, media, and community attitudes toward the business.

EXHIBIT 1

Directors want to know

% of respondents

As a director, I would like to know more about the following areas pertaining to the performance and long-term health of my company:



¹Earnings before interest, taxes, depreciation, and amortization.

Source: Jan 2005 McKinsey Quarterly survey of 1,016 corporate directors

How the survey was done

Our survey, conducted in late 2004 and early 2005, went to 4,200 directors of public companies around the world. The response rate was 24 percent, and the 1,016 respondents were fairly evenly spread out among the different parts of the world as well as among countries at different levels of economic development (exhibit).

These respondents work for a mix of service and manufacturing businesses of every size, as measured by their turnover and the number of people they employ. One-third of our respondents come from countries with corporate-governance structures that are under development. Some of these countries, such as South Korea and Taiwan, are relatively advanced economically but less advanced in their corporate governance. The remaining respondents come from countries with more established structures.

Some differences are noteworthy. The smaller the company, for instance, the less well CEO successions appear to work. Directors of companies in the Asia-Pacific region and in emerging markets seem to be even keener to receive additional information than are their counterparts in Europe and North America. And more CEOs lead the succession process in North America (where more CEOs also act as chairman of the board) than elsewhere.

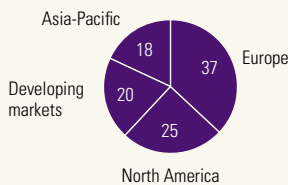
Given the variety of our respondents, we found the results to be remarkably consistent by region and company size. The data that accompany this article reflect this consistency. With some noted exceptions, we are providing the full data set, covering all respondents.

EXHIBIT

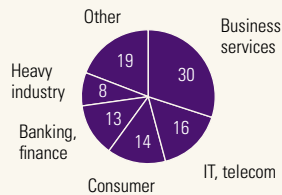
About the research

% of respondents (n = 1,016)

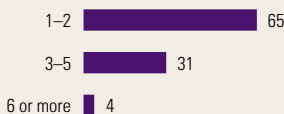
By region¹



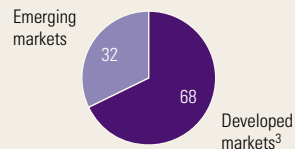
By industry²



By number of boards



By level of corporate-governance development



¹North America: Bermuda, Canada, and United States; Asia-Pacific: Australia, Hong Kong, Japan, New Zealand, Singapore, South Korea, and Taiwan.

²**Banking, finance:** asset management, banking, financial services, insurance, private equity; **business services:** construction, consultancy, engineering, legal, real-estate management; **consumer:** agriculture, consumer packaged goods, health care, media/entertainment, pharmaceuticals, retail, travel/logistics; **heavy industry:** automotive, chemicals, manufacturing, metals/mining; **IT, telecom:** computers and technology, IT services, software, telecommunications; and **other:** academia, nonprofits, public sector, among others.

³Developed markets: Australia, Canada, European Union 15 (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom), New Zealand, Norway, Singapore, United States.

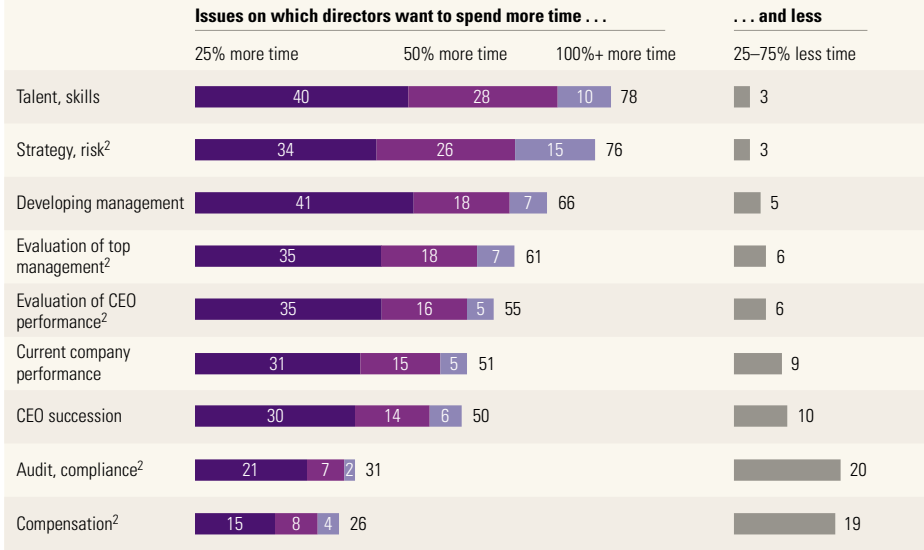
Source: Jan 2005 *McKinsey Quarterly* survey of 1,016 corporate directors

EXHIBIT 2

More time, please

% of respondents¹

How would you change the amount of time your board is spending on addressing the following issues?



¹Figures do not sum to 100%, because respondents who don't want to change the amount of time they spend on these activities are not shown.

²Figures do not sum to total, because of rounding.

Source: Jan 2005 McKinsey Quarterly survey of 1,016 corporate directors

But directors don't want to spend significantly less time on their current activities (Exhibit 2). The main exceptions are auditing and compliance and the compensation of top management. About one-fifth of the directors feel that they spend too much time on those issues.

To understand the long-term health of a company, directors should monitor not only its current financials but also a broader range of indicators (Exhibit 3): market performance, network positioning, organizational performance, and operational performance. Risk—including credit, market, regulatory, organizational, and operational risk—plays an important part in each dimension. Without this knowledge, directors will have only a partial understanding of a company.

Developing the right perspective on the balance between short- and long-term performance is important. The board of one leading North American industrial company, for instance, focused on its excellent quarterly financial figures. The company's performance appeared to be strong: its

margins and return on capital were rising and costs were falling. Yet capital investment was falling as well, the value of the company’s brands was eroding, a major product recall was under way, and the morale of employees had sunk so low that 20 percent of them acknowledged getting treatment for stress. Had the board and management focused on longer-term health indicators, these uncomfortable facts would have received scrutiny.

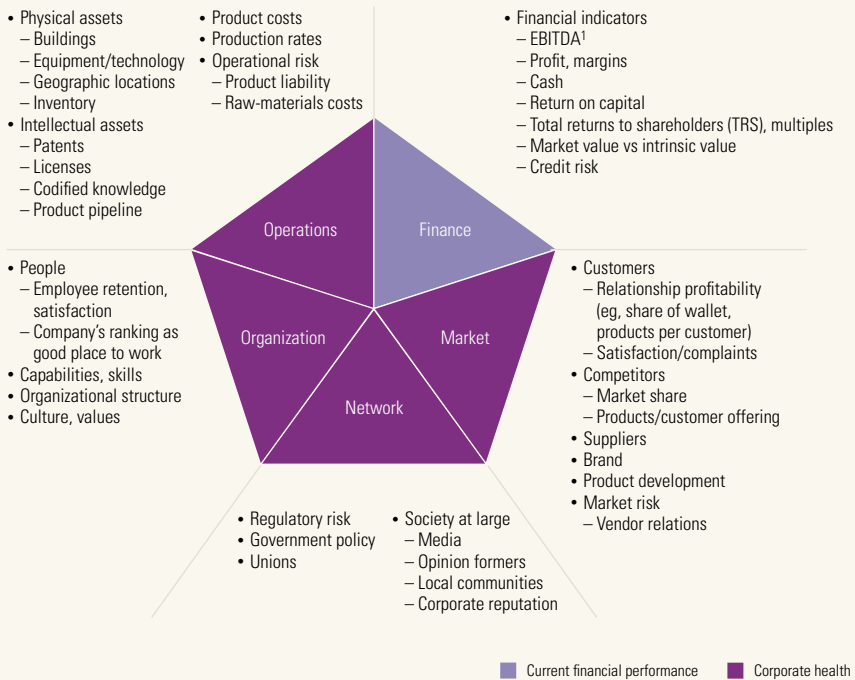
In seeking to balance short- and long-term performance, boards might start by agreeing on a core set of metrics tailored to the specifics of a company’s industry, maturity, culture, and current situation. For example, two oil companies—one focusing on operational efficiency, the other on exploration—might choose quite different metrics. Similarly, companies pursuing a fast turnaround might, understandably, be less focused on their long-term health.

For many companies, monitoring a robust set of metrics will probably involve little additional work: those the board might want are likely to be a

EXHIBIT 3

Five ways to thrive

Dimensions of corporate health, performance (lists not exhaustive)



¹Earnings before interest, taxes, depreciation, and amortization.

Source: Jan 2005 *McKinsey Quarterly* survey of 1,016 corporate directors

subset of the data already available to management. If they are not, it may take time to identify them, but companies should plug such a serious gap anyway to ensure the long-term health of the business.

Strategy and risk

More than 75 percent of the directors say that they want to spend more time on strategy and risk. This refocusing seems to reflect three forces at work among boards: a shortfall of knowledge about the current and future strategy of their companies, a certain lack of confidence in management, and a desire to assume a more active overall role.

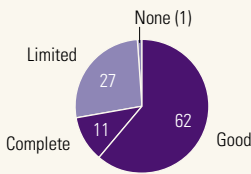
Surprisingly, more than a quarter of the directors have, at best, a limited understanding of the current strategy of their companies (Exhibit 4). Only 11 percent claim to have a complete understanding. More than half say that they have a limited or no clear sense of their companies' prospects five to ten years down the road. Only 4 percent say that they fully understand their companies' long-term position. More than half indicate that they have little or no understanding of the five to ten key initiatives that their companies need in order to secure the long-term future.

EXHIBIT 4

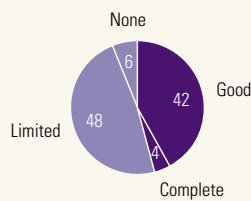
Troubling

% of respondents¹ (n = 1,016)

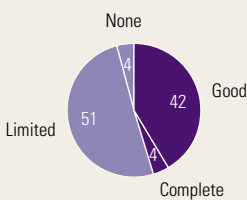
How would you describe your board's understanding of the company's current strategy?



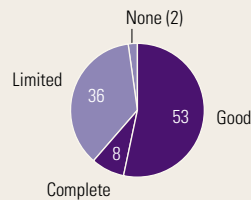
How would you describe your board's understanding of where long-term objectives will position the company in 5-10 years?



How would you describe your board's understanding of 5-10 key initiatives needed to achieve long-term objectives?



How would you describe management's understanding of 5-10 key initiatives needed to achieve long-term objectives?



¹Figures do not sum to 100%, because of rounding.

Source: Jan 2005 McKinsey Quarterly survey of 1,016 corporate directors

Similar gaps emerged on the question of risk. Only 11 percent of the directors claim to have a complete understanding of the risks their companies currently bear, while 23 percent have a limited understanding or none. When it comes to long-term risks, just 8 percent claim to have a complete understanding, and 37 percent say they have little or none. Likewise, since more than half of the directors admit that they have no way of tracking changes in risks over time, boards are vulnerable to unforeseen shifts.

The survey also highlighted a lack of confidence in executives. Only 8 percent of the directors feel that management fully understands the key initiatives required by strategies for the future, while 38 percent say that it has, at most, a limited understanding.



If directors want to become more involved in developing strategy and assessing risk, they will have to start by working with management to grasp the current strategic position more clearly. In turn, management should draw up and propose a number of different long-term strategies. Boards should test and challenge them before choosing, with management, the most appropriate ones.

Management could then develop a detailed plan that the directors should also test and challenge before it receives final approval. In our experience, the process typically unfolds over several board meetings. One key point: board members should have enough time to probe strategic issues—does the company really have the ability to execute in a particular area, for example, and has it scoped out ways of gaining access to the markets it wants to enter?

Finally, the board can play an important role in tracking the progress of the plan and changes in any risks it involves. We find that a board works best on this charge when it devotes its limited time to five or so key strategic initiatives, tracking their progress and any change in the accompanying risks. Management, by contrast, must deal with all aspects of the strategic plan. Of course, once accepted, the strategy will evolve over time and require an ongoing dialogue between the board and management.

To see how these ideas work in the real world, consider the story of a leading North American industrial company that repositioned itself in a major turnaround. The company had been far from world class in any area, from product development to operating margins; focused too much on the US market; and lacked significant service revenues and international experience.

Yet management, convinced that this \$5 billion business could be a world leader in its industry segment, joined with the board to develop a strategy that highlighted five initiatives: developing low-cost operations, building operations in Europe and Asia so that half of all revenue would come from outside the United States, creating a strong M&A capability, forging a large service component, and shaping an efficient global organization with appropriate skills and leadership.

The board, assisted by management, focused on monitoring these initiatives. Its role in helping to identify and articulate them—and in tracking their progress and changes in the risks they involved—was crucial. With strong support from the board, management succeeded in driving the long-term strategy of the business while allocating expenditures in a way that adequately maintained its short-term financial performance.

Leadership

Most directors, as our survey indicates, want to devote more attention to developing the talents and skills of the people who work for their companies. That interest isn't limited to hiring and developing the CEO; it extends to the top-management team and even to the broader company.

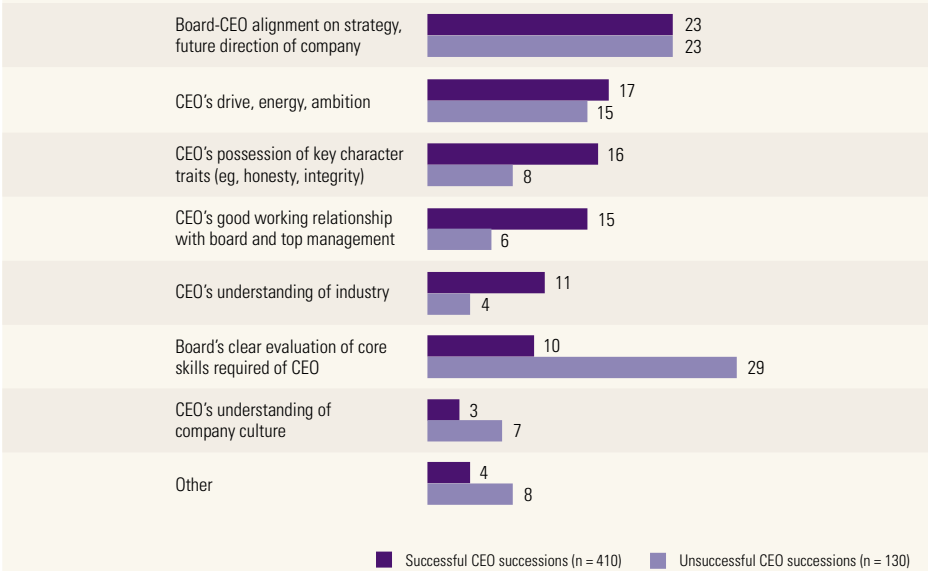
Directors already appear to be taking the lead in CEO successions, to judge by the 41 percent who say that they and their colleagues on the board led the most recent CEO search. That is good news. As former Sara Lee Corporation CEO John Bryan commented, the most significant task for the board is to decide who gets “to run the place.”¹ This responsibility is particularly important today: research shows that 71 percent of all US CEOs leave their posts involuntarily.² Leaving the succession to the incumbent CEO is therefore a high-risk strategy.

The board's involvement in the process does not, however, guarantee a favorable outcome. In our survey, nearly one-quarter of the directors report that the most recent CEO succession at their companies had failed. When we probed for the reasons, the response was intriguing. According to the directors, CEO successions that work well and those that don't can be explained, in many cases, by the presence or absence of the same things: alignment between the board and the CEO on the company's strategy and future direction; finding a CEO with sufficient drive, energy, and ambition; the CEO's honesty and integrity; and a core skill set that includes

¹ John A. Byrne, Richard A. Melcher, and Jennifer Reingold, “Wanted: A few good CEOs,” *Business Week*, August 11, 1997.

² Margarethe Wiersema, “Holes at the top: Why CEO firings backfire,” *Harvard Business Review*, December 1, 2002, Volume 80, Number 12, pp. 70–7.

EXHIBIT 5

Succession stories% of respondents¹*For CEO succession, what was the most important consideration leading to success or failure?*¹Figures do not sum to 100%, because of rounding.Source: Jan 2005 *McKinsey Quarterly* survey of 1,016 corporate directors

investor relations and M&A (Exhibit 5). The absence of appropriate core skills is the most important factor in abortive successions, but their presence is less important in good ones.

Building these insights into succession plans can help boards to improve the odds. The essential first step, before candidates begin to appear, is for the directors as a group to agree on the professional skills and personal characteristics that match the company's strategy and culture. Once the board has decided which core skills and qualities are needed, it should ask the incumbent CEO for a list of internal candidates and ensure that they get regular exposure to the directors. In parallel, the directors should develop their own list of external prospects, bearing in mind that while external hires often appear more attractive, the fit with the company's business strategy and culture may be less good.

The next stage is for the directors to evaluate candidates against the agreed-upon criteria—in particular, by probing into their views about the company's strategy and future direction. Alignment between the board

and the CEO on these issues is crucial to success, and its absence leads to trouble. After a thorough discussion, the board is then ready to choose a new CEO. The full process can take time: according to outside observers, GE’s board and CEO, for example, identified the attributes they wanted from the next CEO six years before Jeffrey Immelt replaced Jack Welch.³ This approach gave the board enough time to assess the skills of the candidates at running their businesses, developing strategies, and managing external affairs. A corporate succession is no one-off event; boards should focus on it continually, since the average length of a CEO’s tenure goes on trending downward. As a new CEO takes office, the board should begin looking for a worthy successor.

And the process doesn’t end with the selection. As one chairman observed, “You don’t just hand [the new CEO] the keys and say ‘call us in June.’” The board must be substantially involved in coaching the candidate it chooses, especially in the first months. Finally, it has to agree on how it will evaluate the CEO going forward.

In practice, this kind of involvement seems to be rare. Our survey showed that more than 50 percent of boards have little or no formal process for evaluating the performance of CEOs, despite the huge responsibility

EXHIBIT 6

A willingness to change

Median of all respondents, %

On a percentage basis, how important is each of the following factors when you evaluate your CEO’s performance? How important should they be?



Source: Jan 2005 McKinsey Quarterly survey of 1,016 corporate directors

³Geoffrey Colvin, “Changing of the guard,” *Fortune*, January 8, 2001.

entrusted to them. Boards that do tend to focus on short-term business goals, which, according to the directors, account for the largest part of the assessment: 35 percent. Longer-term goals play a smaller role, as do other metrics, such as the ability to lead people and manage stakeholders, as well as professional ethical behavior. The short-term bias is even more pronounced in the realm of CEO compensation: twice as many directors say that short-term factors are the main underpinnings of their decisions than rely primarily on long-term factors.

Fortunately, directors are keen to change this mind-set. When they were asked how the CEO's performance *should* be measured, long-term goals outranked short-term goals, and leadership too was more important than it is in today's actual succession process (Exhibit 6). Directors apparently know that they should evaluate the CEO's ability to promote the long-term health of the company and not just its recent financial results.

A more active evaluation of the CEO has an added benefit: it prepares the board for the next succession process and forces directors to think about important issues and skills. Many directors have little or no experience selecting a CEO. Their involvement in rigorous annual evaluations will leave them better prepared to judge candidates when the time comes.

The selection and evaluation of a CEO isn't the board's only human-resources task. Our survey showed that more than 60 percent of the directors are also eager to spend more time developing and evaluating top management and that 78 percent want to spend more time developing the skills and capabilities of the company as a whole. This

finding augurs well for the future.

*Directors apparently know that they should **evaluate** the CEO's ability to promote the company's long-term health, not just recent results*

Although talents, skills, and capabilities play a crucial role in helping a business make good on its strategy, in our experience management teams and boards often overlook the importance of

assessing them and spotting the gaps. As a result, companies often need "quick-fix" responses to shortages of talent and skills—shortages that often result from poor planning, which can be costly if labor markets tighten suddenly. One large industrial company based in Asia, for example, identified a need for 670 managers, in addition to its current roster of 960, to meet the challenges resulting from the introduction of a new strategy. But when the company assessed its current managers, only 150 of them turned out to have the right skills. The resulting gap of 1,480 managers was significant enough to raise questions about the viability of the company's new course.

Early on, boards should recognize and discuss any new strategy's ramifications for talent and skills. Directors can not only contribute their own experiences but also provide a longer-term perspective that challenges management to think about the sustainability of the company's recruitment program.

Wider implications for the board

The survey results show clearly that boards want to engage more actively with management teams. Such a relationship can prove fruitful, but it will also be more complex than the present one. Making it work will require effort from both sides.



First, to cover this wider range of issues, boards will have to become more efficient, particularly since their time has already been stretched in recent years: the average commitment of a director of a US listed company increased from 13 hours a month in 2001 to 19 hours in 2003 (and then fell to 18 hours in 2004), according to a 2004 Korn/Ferry survey. Boards can conduct their meetings more efficiently if the directors receive clear, concise, and focused information in a regular format, but nearly a third of our respondents say that the information they receive is formatted inconsistently from meeting to meeting. Eighteen percent feel they receive too much information. Second, directors and

executives should understand when and how a board's role changes. Above all, both sides must know whether the changes mean that management can or can't expect the board to become involved with a particular issue.

The world of private equity offers a glimpse of the new role that corporate boards could play—and of the payoffs that might accrue to shareholders. Research indicates that partners in the highest-performing private equity funds often spend 15 days a month with a company during the first 100 days after gaining control of it, to assess its management, pull together a strategy, and set appropriate performance metrics.⁴ Only after the end of this initial burst of activity will the partners' involvement fall back to around 2 days a month—oddly enough, about the same amount of time that directors of public companies now devote to them. Important differences obviously separate private buyouts from the governance of

⁴Joachim Heel and Conor Kehoe, "Why some private equity firms do better than others," *The McKinsey Quarterly*, 2005 Number 1, pp. 24–6 (www.mckinseyquarterly.com/links/16475).

public companies, but investing time early on to develop a value creation strategy will probably serve boards well anyway. Boards might consider ways of using this up-front time to implement their plans, which they could then monitor with about the same level of effort they now devote to that task.

Corporate boards seem eager to shake off the perception that they are defensive and lethargic. So far they have responded satisfactorily to the call for higher standards and strong compliance with the new accounting rules. Now they apparently want to become more active in core areas of the companies they govern. Boards and management alike can benefit from such a new relationship, but only if both understand its complexity and mitigate the tensions it is sure to create. *Q*

Bob Felton is a director and **Pam Keenan Fritz** is a consultant in McKinsey's Pacific Northwest office. Copyright © 2005 McKinsey & Company. All rights reserved.

Appendix

The McKinsey Global Survey of Corporate Directors

Many of the principal findings of the January 2005 *McKinsey Quarterly* survey of corporate directors from around the world appear in the article “The view from the boardroom,” beginning on page 48 of this issue; information about the respondents can be found in the sidebar, “How the survey was done,” on page 51. In the following pages, readers wishing to explore the results in greater depth will find additional data: comparisons between the way directors from countries where corporate governance is well developed and those from the rest of the world want to spend their time; a look at the differences between the way CEOs and nonexecutive directors approach strategy and risk, as well as an industry-specific look at risk; and views on the evaluation and succession of CEOs from a range of perspectives, including industry, company size, and whether the director in question was a CEO or a nonexecutive director.

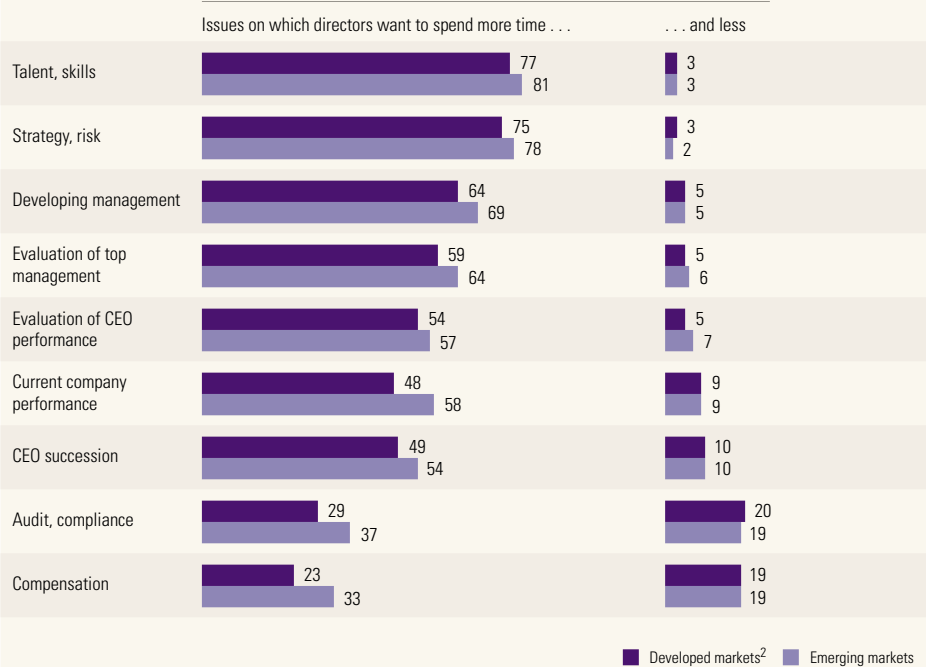
Performance, corporate health, and the allocation of time

Economic development and the development of corporate governance don't always go hand in hand. In this section, we separated the responses of directors of companies based in the 21 countries where corporate governance is well developed from those of directors of companies based in other countries, where it is still developing.

How would you change the amount of time your board is spending on addressing the following issues?

% of respondents¹

By level of corporate-governance development



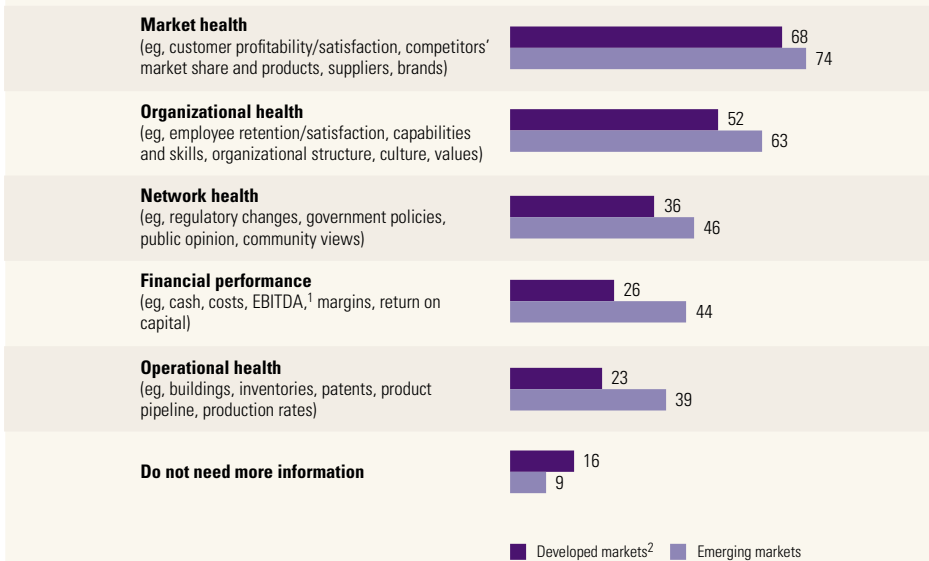
¹ Figures do not sum to 100%, because respondents who don't want to change the amount of time they spend on these activities are not shown.

² Developed markets: Australia, Canada, European Union 15 (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom), New Zealand, Norway, Singapore, United States.

Source: Jan 2005 McKinsey Quarterly survey of 1,016 corporate directors

As a director, I would like to know more about the following areas pertaining to the performance and long-term health of my company:

% of respondents



¹Earnings before interest, taxes, depreciation, and amortization.

²Developed markets: Australia, Canada, European Union 15 (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom), New Zealand, Norway, Singapore, United States.

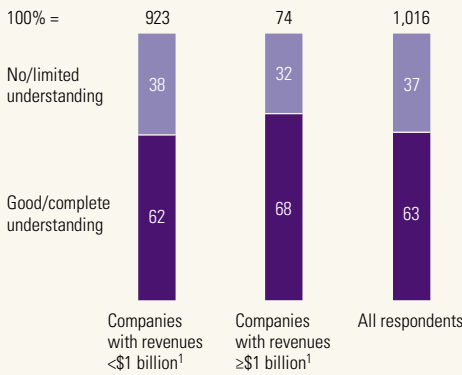
Source: Jan 2005 *McKinsey Quarterly* survey of 1,016 corporate directors

Strategy and risk

To guide a company effectively, boards need to understand an organization’s strategy and its risks. In this section, we look at how well directors understand them, both at large companies as compared with small ones and at companies in different industries. We also highlight the differences in the way CEOs and nonexecutive directors perceive the board’s understanding of strategy.

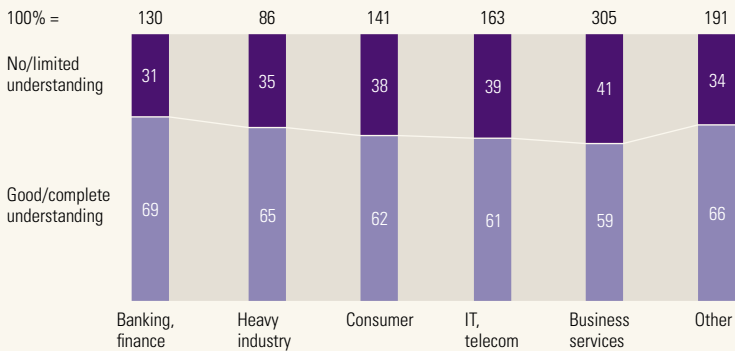
How would you describe your understanding of key risks in long-term strategy for your company?

% of respondents



By industry²

% of respondents



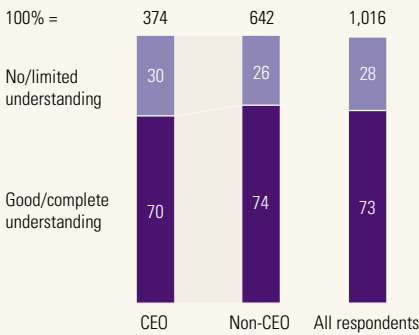
¹Excludes respondents who reported no revenue or for whom data were unavailable.

²**Banking, finance:** asset management, banking, financial services, insurance, private equity; **business services:** construction, consultancy, engineering, legal, real-estate management; **consumer:** agriculture, consumer packaged goods, health care, media/entertainment, pharmaceuticals, retail, travel/logistics; **heavy industry:** automotive, chemicals, manufacturing, metals/mining; **IT, telecom:** computers and technology, IT services, software, telecommunications; and **other:** academia, nonprofits, public sector, among others.

Source: Jan 2005 McKinsey Quarterly survey of 1,016 corporate directors

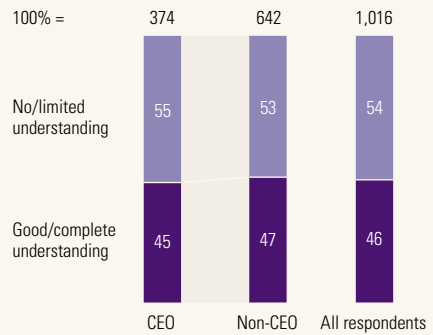
How would you describe your board's understanding of the company's current strategy?

% of respondents¹



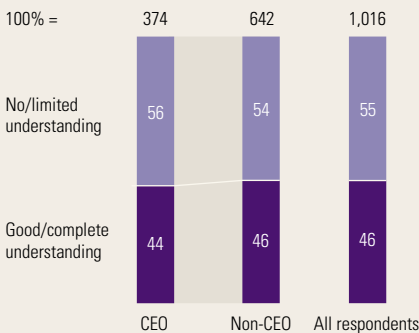
How would you describe your board's understanding of where long-term objectives will position the company in 5-10 years?

% of respondents



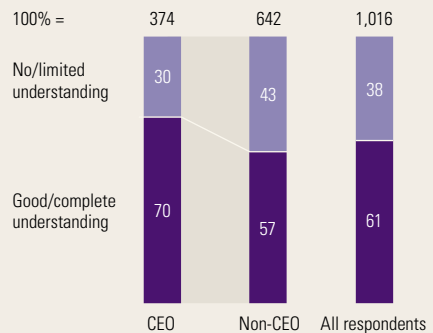
How would you describe your board's understanding of 5-10 key initiatives needed to achieve long-term objectives?

% of respondents¹



How would you describe management's understanding of 5-10 key initiatives needed to achieve long-term objectives?

% of respondents¹



¹Figures do not sum to 100%, because of rounding.

Source: Jan 2005 McKinsey Quarterly survey of 1,016 corporate directors

Leadership

For a board of directors, the evaluation and succession of the CEO are two of the most important functions. This section presents the views of directors, overall and by industry, about who should lead the succession process. We also investigated how many corporations have a formal evaluation process for the CEO, including the differences between large and small companies and between CEOs themselves and nonexecutive directors.



Who should lead the CEO-succession process?

By industry¹

% of respondents²

| | IT, telecom | Consumer | Business services | Banking, finance | Heavy industry | Other | All respondents |
|--------------------|-------------|----------|-------------------|------------------|----------------|-------|-----------------|
| CEO and board | 52 | 50 | 46 | 45 | 45 | 50 | 48 |
| Board | 29 | 30 | 33 | 30 | 38 | 31 | 32 |
| Specific committee | 14 | 13 | 14 | 19 | 10 | 15 | 14 |
| CEO | 4 | 4 | 4 | 4 | 3 | 2 | 3 |
| Other | 1 | 2 | 3 | 2 | 2 | 3 | 2 |

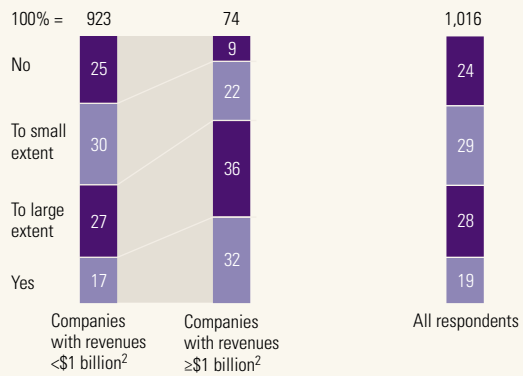
¹**Banking, finance:** asset management, banking, financial services, insurance, private equity; **business services:** construction, consultancy, engineering, legal, real-estate management; **consumer:** agriculture, consumer packaged goods, health care, media/entertainment, pharmaceuticals, retail, travel/logistics; **heavy industry:** automotive, chemicals, manufacturing, metals/mining; **IT, telecom:** computers and technology, IT services, software, telecommunications; and **other:** academia, nonprofits, public sector, among others.

²Figures do not sum to 100%, because of rounding.

Source: Jan 2005 McKinsey Quarterly survey of 1,016 corporate directors

Does your company evaluate the CEO using a formal process based on agreed-upon goals?

% of respondents¹



¹Figures do not sum to 100%, because of rounding.

²Excludes respondents who reported no revenue or for whom data were unavailable.

Source: Jan 2005 *McKinsey Quarterly* survey of 1,016 corporate directors