Leading from the Boardroom
by Jay W. Lorsch and Robert C. Clark

It’s no exaggeration to say that the governance of companies has moved from the inner sanctum of the boardroom to the white-hot spotlight of public discourse. More is demanded these days from independent directors: They’re expected to ensure their firms’ compliance with an ever-evolving set of regulations, head off executive wrongdoing at the pass, and appease shareholders’ and Wall Street’s never-ending hunger for positive short-term results.

Directors seem to be rising to this challenge. They’re more serious, they’re working harder, and in most cases governance reform appears to have given them real power to oversee management’s actions. As a result, corporate boards have taken big steps forward in the past decade. But having to operate in a post-Enron world has also produced some negative and unintended consequences for boards—the most critical one being directors’ inability to be leaders who focus on ensuring the long-term success of their companies.

Major public companies are important engines of economic prosperity, and boards have a paramount obligation to see that these national assets thrive. As historian Alfred D. Chandler, Jr., pointed out, the decline and ultimate failure of once-great companies has been a historical fact. But such decline is not inevitable. Rather, it results when corporate leaders (CEOs and directors alike) don’t anticipate and deal with the long-term threats facing their companies.

By necessity, boards are working overtime to comply with Sarbanes-Oxley and other relatively new reporting requirements. To keep pace, they’re overemphasizing committee work instead of harnessing the intellectual power of the whole board to deal with complex matters. Instead of working collaboratively with management, they’re creating or perpetuating dysfunctional relationships that cast directors as corporate police who enforce rules and trace managers’ missteps, rather than guides who help managers choose the right path.
Further, boards’ long-standing focus on quarterly results has intensified. This emphasis on the short term has repercussions. (See Robert H. Hayes and William J. Abernathy’s “Managing Our Way to Economic Decline,” HBR July–August 1980.) In March 2007 the U.S. Chamber of Commerce, one of the world’s largest business federations, with about 3 million members, even went so far as to recommend that companies move away from posting quarterly earnings guidance. The thinking was that such reports inevitably put the squeeze on boards and on CEOs—whose average tenures during the past decade have shrunk even as their pay packages have increased—to take the quickest route to results, not necessarily the path to long-term success. The knee-jerk reaction of most boards when confronted with corporate decline over several quarters has been to remove the CEO and search for a replacement—often from outside, since boards frequently fail to ensure internal management continuity.

Boards can and must do better at balancing their function as compliance officers with their function as shapers of the future. From their places around the table, directors must steer themselves and the company’s management team toward farsighted strategic and financial thinking and succession planning. Certainly it is management’s responsibility to develop and implement strategy, but the board must use a long-range lens when requesting and vetting senior leaders’ proposals—encouraging the top team to raise its game even when things are going well and challenging it to respond creatively when threats or problems emerge.

Independent directors cannot be expected to understand all the details of their companies’ performance successes or failures, but they can and should be able to stay focused on long-term trends and the impact of those trends on their companies. In short, they must learn to lead from the boardroom.

In the following pages, we’ll provide some advice for doing just that. We’ll explore the changed environment directors are operating in, what they need to do to regain control of their agendas, and what it looks like when directors take the lead in critical, forward-looking discussions about finance, strategy, and talent development.

**Coming Up Short**

Last year a board we’re familiar with created a strategy committee of the five directors who had the most knowledge about the company’s industry. The idea was that the committee would work closely with management to study the likely evolution of the industry and the company’s position in it. The team’s mandate was to come back to the full board with some long-term strategy recommendations, ones that management wholeheartedly supported. For six months, the members of the committee labored; they collected information and met frequently, by themselves and with senior leaders at the company. The result? A plan for containing costs and growing revenues—over a mere two years. Obviously, the plan was focused neither on significant changes in strategy nor...
on the long term, yet the full board did not seem particularly bothered by that fact. There are several reasons why this board and those of plenty of other struggling public companies are coming up short—or short-term, as the case may be.

More focus on compliance means longer agendas.

New regulations have increased directors’ workloads, yet the amount of time they have together to do their jobs hasn't changed. The average board, even at a very large company, meets only five or six times a year, for just over a day each time. Board agendas, meanwhile, are overflowing with governance matters—compliance, accounting, legal, and shareholder-related issues—all of them important, all clearly of concern at the board level, but none of them germane to leadership or strategy. Since the introduction of Sarbanes-Oxley, in 2002, for instance, the time required for audit committee meetings has at least doubled. This, in turn, has increased the time the whole board spends on accounting and financial-reporting matters.

Despite the added demands, most boards are stuck in a time warp, conducting their affairs pretty much as they always have: the same number and length of meetings, the same committees, and the same patterns of interaction among directors and between directors and management. Their response to new compliance requirements has been to stuff 10 pounds of content into a five-pound bag. The directors’ committee work usually cannot be completed in the allotted time, and their discussions often end up being truncated or spilling over into hastily arranged teleconferences. Agenda items that might address future concerns get short shrift. Directors put their heads down and push ahead; they do not step back and ask themselves how to change their processes and procedures to accomplish more.

Boards’ relationship with management has changed.

Directors typically have relied on senior management for most of their information about the company. After all, the directors aren’t—and don’t want to be—as immersed in the minutiae of their organizations as management is. From the directors’ perspective, the CEO and his or her team should have the latitude and responsibility to run the company the way they see fit, with the board providing high-level guidance. Because of their current focus on compliance, however, directors find themselves in the very role they have long tried to avoid—that of micromanager, probing the senior team’s actions, taking less for granted, looking more closely at proposals and reports to be certain that management’s behaviors are free of malfeasance and illegalities. To us, the irony here is that as directors have become more hands-on in the area of compliance, they’ve become more hands-off in the area of long-range planning, which exposes shareholders to another—potentially greater—kind of risk.
The pressure for immediate, measurable results is still there in spades.

The obsession with quarterly earnings impedes boards’ ability to plan for the long term. Some business leaders argue that all their companies need are short-term goals and results. After all, the long term is made up of a series of short-term accomplishments, they point out. We strongly disagree. We’ve been on boards where directors and management were so absorbed with quarterly earnings or fast-track product launches that they were slow to recognize trends that ultimately created problems for their organizations—disruptive technologies in their industries, for instance, or new competitors from emerging markets.

If companies are to succeed in the global economy, their directors and top executives need to have a clear view of where they want their organizations to be in five or 10 years. Most directors will say they squeeze some time into their meetings to discuss what they call “strategic matters.” In most cases, however, they’re actually talking tactics: They’re answering questions like “How did we do last quarter?” and “What do we need to do differently in the next three months?” The metrics considered are almost always financial, because that is a language that directors with different backgrounds share and can converse in knowledgeably. Strategic capabilities such as technology or marketing often get only limited attention. When the company’s ultimate destination is always just 90 days away, neither the board nor the senior managers will have the time or incentive to draft explicit and well-articulated long-term organizational goals.

Admittedly, today’s public companies are growing bigger and more complex—and it has become more of a challenge for directors to keep up with various facets of their businesses and industries. It may be unrealistic, for example, to expect the independent director of an automobile manufacturer to know the details of a new engine technology. But that director should be able to, say, understand the implications of the large pension and health care obligations of the company, or participate in talks about the company’s global brand strategies—should we expand in India, and if so, should we outsource or find a JV partner?—or conduct regular reviews of competitive intelligence. Directors similarly should be able to reasonably discuss issues of talent development and succession. Sadly, this is more the exception than the rule in most boardrooms.

**Taking the Long View**

In assuming leadership of their companies’ long-term destiny, boards first need to be clear with themselves and with management about the complementary roles each side must play. Each group must be realistic about what it has the time and knowledge to do on its own. Different boards and management teams will define their roles differently, of course, according to company circumstances. In general, however, the setup will look familiar—but with an emphasis on the long term: Management will develop
and propose long-range plans, and the board will react to these proposals and debate among itself (and with management) their validity and wisdom.

Second, since directors are forced by law and regulations to get into the weeds on compliance, they’ll have to be smarter about staying out of the weeds as much as possible when considering strategic issues. Instead of worrying about coming up to speed on the fine details of the business, they should exercise their broad knowledge and accumulated wisdom about a range of relevant business domains: finance, strategy, marketing, technology, and the like. It is precisely their 10,000-foot view that allows boards to more easily identify trends and threats on the horizon.

Third, directors must not only be intelligent, well-informed, highly interactive audiences for management but also push management to address the company’s future. Boards have the power to approve plans and proposals, they can change the top management of companies, and they are unavoidable—they must be reported to regularly. Boards, therefore, have an effective platform from which to evangelize for the long term—that is, to deliberately engage senior managers in discussions about critical future concerns and to signal that those issues are priorities.

And fourth, the directors must encourage leadership not just from the boardroom but within it. There has been a long-running debate in U.S. companies about whether the top executives at organizations should continue to assume the roles of both CEO and chairman of the board. It’s hard to argue with the premise that separating the jobs can strengthen independent leadership in the boardroom. But a survey we conducted in 2005 of directors of Fortune 200 companies suggests that boardroom effectiveness has less to do with formal structure than with the quality of the directors themselves and how they interact. (See the sidebar “The Real Signs of a Strong Board.”)

The Real Signs of a Strong Board

The intention of shareholder activism is to improve corporate governance, but in fact, it has very little effect on how well boards do their jobs. A survey we conducted in 2005 of directors of Fortune 200 companies suggests they do not believe that many criteria used by ISS Governance Services (formerly Institutional Shareholder Services) and other ratings agencies to assess board performance have much to do with board effectiveness.

We asked the directors their opinions about 52 of the so-called indicators of effective corporate governance favored by ratings agencies—which included many check-the-box factors such as the appointment of a lead or presiding director and compliance
with relatively new stock exchange requirements. The directors didn’t find much value in those factors. Instead, they gave more
credence to criteria that related to the quality of board composition, talents, and processes. Three of the most highly rated factors
centered the specific background, knowledge, and abilities of directors—“Is there understanding among board members on the
key drivers of the company’s business?” and “Is there understanding among board members on appropriate metrics of corporate
performance?” and “Is the mix of experience and backgrounds of directors appropriate to the company’s business(es)?”

Also among the highest-rated factors were specific activities or processes—for instance, did the board have manageable
agendas and allocate time appropriately at meetings, so management could present information but have adequate time left for
discussion and decision making? And did the board disseminate information to directors before meetings, so they could
consider the issues at hand and prepare ahead of time?

Among the less-favored factors were those related to publicly visible characteristics—whether the board was large, whether it
limited independent directors’ involvement to a small number of other boards, whether it separated the positions of chairman and
chief executive, whether it set a mandatory retirement age for directors, and whether it required director education programs.
Such indicators trumpeted by the ratings agencies were treated with great skepticism by the directors surveyed—yet the search
for talismanic indicators of quality continues.

Legally, boards are groups of peers, with collective rather than individual responsibility, but the most effective ones include multiple
directors willing to don the leadership mantle when it comes to particular issues, no matter what their titles are. Sometimes a
committee chair can be the catalyst for improvement. Sometimes a plain-vanilla director, seeing the need to get the ball rolling on
an issue, takes the initiative. In the case of the strategy committee we mentioned earlier, a director who wasn’t on the committee
pointed out the lack of long-term focus in the group’s proposal and the need for a more farsighted look. (What’s our plan for 10
years out, not just two?) Initially, the other board members ignored his comments, particularly the directors who had been on the
committee and worked so hard on the recommendations. But the dissident director persisted with his arguments, and eventually the
board concluded that a longer-term strategic plan was in order.

As the example suggests, it’s just as critical for individual directors to speak up and ask tough questions as it is for the board as a
collective. Yet such leadership is rarely realized because it poses an overt challenge to the board’s basic modus operandi and
because any conflict consumes a precious resource—the directors’ time together to discuss and reach decisions.
When the Board Reasserts Its Leadership

Once directors accept the need for more consideration of the long term, they can allocate their time more efficiently—meeting compliance standards but also buying back hours to go over future-focused concerns. Let’s take a closer look at what happens when the board assumes a more active leadership role.

Defining the long term.

This process has to start with a common understanding between directors and senior management about how far out the “long term” goes. All too often, boards will think their discussions about a discrete transaction—an acquisition or a divestiture, for instance—constitute consideration of the company’s long-term strategy and finances. In fact, that is rarely the case. An individual company’s definition of the long term will depend on how confident directors and management teams are in their ability to project several years into the future with reasonable accuracy. Industry activity may be a factor: It can be difficult to make far-reaching predictions in industries in which there are frequent technological or product innovations or low barriers to entry (for instance, internet-based businesses). Conversely, it may be easier to forecast events further into the future in industries where innovation is less frequent and dramatic and demand is tied to population growth (consumer products and household goods).

Taking the lead in finance discussions.

Once the time frame has been determined, the board and management must create a set of financial goals for the long term—for example, clearly articulated expectations for revenue and profit growth, returns on assets or investments, cash flows, and debt-to-equity ratios, as well as dividend and share-repurchase policies. Those measures will in turn help determine the company’s strategic direction. Such objectives will also reflect to the public how the board intends to allocate the wealth the company creates.

As we mentioned earlier, management in most instances will actually draft the financial goals and the means for achieving them. But boards must help determine whether the senior team is creating the right capital structure. The important point here is that directors should spend less time on quarterly earnings and more time on financial infrastructure—delving into questions about, say, the cost of capital or the debt-to-equity balance that the company is wrestling with.

Taking the lead in strategy discussions.
Once the board and management have crafted explicit financial goals, they need to turn their attention to how the company will hit those targets. Specifically, the directors must step back from fighting fires and consider how management’s view of the future squares with their own broader, higher-altitude views.

Board retreats provide a good setting for this. The board and management at Philips Electronics hold an annual two- to three-day retreat—uninterrupted time devoted to discussing the company’s direction for the next several years. There is time for management and the board to interact, certainly, but time is also set aside for director-only sessions, which encourage open and frank discussions and draw out knowledge and insights in an uninhibited way. It was such discussions, for example, that led Philips in 2006 to exit the semiconductor business, a segment in which it was losing ground, and focus more heavily on medical technology—in particular, on the quickly growing market for home health care.

Everyone involved in such retreats should understand that these getaways aren’t the only time to look ahead: “Strategy time” should be set aside at most, if not all, board meetings. Such time must remain sacrosanct, interrupted only for dire emergencies. The focus of management’s proposals and boardroom discussions should be on the long-term logic, not the short-term implications. The two parties must systematically examine the company’s competitive advantages and opportunities through several long-range lenses—industry trends, geographies, brands, IP, talent, labor contracts, and product and operational costs.

Any agreed-upon strategic plans should be reassessed regularly—not to fit management with a straitjacket but to help directors and senior executives understand whether factors have emerged that may require a shift in priorities or a move in another direction. Time should be reserved at each board meeting for such reassessments. The board of a software company we observed successfully followed this practice: The firm had acquired a smaller rival in the hopes of capitalizing on the former competitor’s promising new product. Within months of the acquisition, the product met with such enthusiastic customer response that the board pressed management to raise its revenue and profit goals for this new business over the next several years.

Like Rome, new strategies aren’t built in a day. We’ve found that shaping (or reshaping) strategies for the long term is a process that takes place over multiple board meetings. But we wonder how many directors have participated in such lengthy exercises—too few, we fear.

**Taking the lead in developing talent.**

Directors must also get serious about their role in ensuring the development of the next generation of senior leaders at their
organizations—that is, creating a deep bench of potential successors to the CEO and other top executives. When agendas become overcrowded, talent development and CEO succession are among the easiest topics to ignore or at least defer, even while directors recognize the importance of having the right people at the top.

A few years ago, a midsize company we observed had a successful CEO who was three years away from the mandatory retirement age. The directors began to discuss informally how to approach the situation and decided to put the process of identifying a successor on the board’s agenda. Unfortunately, when the time arrived to address this agenda item, the board and management were immersed in deliberations about a possible acquisition. Over the next 18 months, the succession issue was put on the agenda at each board meeting. Every time, a more pressing issue arose. With only a little over a year left until the CEO was slated to step down, the directors finally began active talks about this topic. By then, they had a severe problem: The CEO was an adamant supporter of an internal candidate for succession with whom the board felt uncomfortable. After a couple of hastily arranged discussions among themselves, the independent directors insisted that a search firm be retained to look outside. The CEO was opposed and continued to argue for his choice. Soon he began to insist that the succession decision was his alone, while the directors argued it was theirs. In the end, the board brought in an outsider, but the retiring CEO left in anger and frustration, which had a negative impact on the other members of the C-suite.

As this example illustrates, independent directors need to be particularly hands-on when it is time to select a new CEO. While most companies have a clear policy about the retirement age for their CEOs, the transition can still be a tricky one to navigate. CEOs, of course, don’t want directors to believe anyone can replace them; they may downplay internal candidates’ readiness to take over and overstate the lack of leadership talent available outside the organization. To counteract these tactics, boards must come to a firm agreement with their CEOs—from the earliest days of their relationship—about when the chief executive will step down and how and when the board will find a successor. Specifically, there must be a few directors who build trust with the CEO so they can talk candidly with him about his personal situation—what he is planning to do after his retirement, how he can best help his successor, and how he can exit gracefully. In some cases, a few of the directors themselves may have gone through a retirement process and can share their experiences with the CEO.

Directors often have only a superficial knowledge of the up-and-coming talent in their companies. Acquaintances are made at board dinners, and this social chitchat becomes the primary means by which directors are supposed to assess the strengths and weaknesses of the managers before them for promotion. This is hardly adequate. Directors need to devote more time to their companies’ emerging leaders. A good way to start is periodic on-site visits by the directors—something that is done by board
members at GE, where directors meet younger executives on their own turf and observe how they work with their subordinates. GE’s directors also meet with and address rising talent during development programs at the company’s Crotonville training facility and sometimes invite high potentials to make presentations at GE board meetings.

The board should also hold the CEO and the company’s human resources director accountable for at least an annual in-depth review of the company’s top management bench: What does the CEO think of these executives? How is this cadre of managers being developed, and are there potential successors for each of them? As they must do with their strategy and finance discussions, boards must carefully protect the time set aside to discuss talent—probably not at every meeting but often enough so that directors have some knowledge about the high potentials on the company roster.

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The basic argument for boards’ intense focus on compliance is to prevent the loss of shareholder value that corporate misdeeds create. But the argument for strong leadership from boards is even more compelling. Without it, there may be even greater destruction of shareholder value as companies go into decline. Obviously, whatever changes boards choose to make to achieve a longer-term perspective, they cannot abandon or even diminish their attention to compliance. Current laws and regulations require it, and shareholders and the public expect it—and will continue to demand it. But boards cannot afford to become so mired in it that they lose their way and fail to live up to their larger obligation: to help their companies grow and prosper, not just in the next quarter but in the next decade and beyond.

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