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Engaging Boards in Corporate Direction-Setting: Strategic Scorecards

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Moves by regulators to drive governance reform have cascaded across the globe. The U.S. Sarbanes-Oxley Act and the U.K. Combined Code are leading examples. The article discusses how boards can contribute to strategic conversations and share responsibilities for strategic management with the CEO and top teams. We discuss how tools like balanced scorecards can align the focus of directors towards future opportunities and risks. It is suggested that boards adopt a strategic scorecard as implemented by CIMA [1] to engage in strategy. This holistic framework provides a common language and structure for top-level decision-making and leads to enhanced performance for stakeholders.

Keywords: Strategic planning, Scorecards, Boards of directors, Strategic decision-making, Board effectiveness, Corporate governance

Background

Calls for improved corporate governance and more effective oversight by boards have sounded for decades. Concerns with the failure of boards to be involved in strategic decisions arose in the 1980s and earlier (Tashakori *et al.*, 1983; Mace, 1971). Recently matters have come to a head with the sad litany of well known and previously respected companies that engaged in over-aggressive and fraudulent accounting practices. Few directors can now be unaware of the potential for litigation by activist shareholders and regulators. To address the situation, regulatory reform has cascaded across the globe with the U.S. Sarbanes-Oxley Act and the U.K. Combined Code as examples. However, critics of Sarbanes-Oxley identify very high costs and other damaging unintended consequences of this Act (Lawler and Finegold, 2005). New securities business has increasingly moved from U.S. Exchanges to the City of London and its more lenient regulatory environment.

Pressures for governance reform are now urgent. However, organizations of all types and sizes struggle to know how best to go about increasing the effectiveness of their boards. Change efforts typically focus on redefining responsibilities, new board structures and processes, new board appointments, and upgrading of knowledge and skills. But the issues of governance reform and how to define and measure board effectiveness are not simple (Allen *et al.*, 2004). Research by Pettigrew and McNulty (1995) showed that the power of independent and non-executive directors to influence management actions is shaped by a complex interaction of structural and contextual factors.

No plans for board reform can be successful unless barriers to change are addressed. CEO and senior management predictably resist dilution of powers they regard as their traditional prerogatives (Mace, 1971). Other barriers may be subtle, such as the reluctance of directors to appraise their own performance and needs for improvement (Stybel and Peabody, 2005). We believe that a powerful way to overcome barriers is to encourage boards to become more active in strategy conversations. This requires careful attention to redesign of strategy processes involving the board, and appropriate choice of methods for strategic planning. In this article we emphasize the importance of using the right tools for improving board effectiveness. We describe how strategic scorecards can be applied to facilitate better oversight and decision-making. This also necessitates supporting information systems and board education.

What Makes an Effective Board?

Forbes and Milliken (1999) identify two factors that distinguish effective boards from ineffective ones: board task performance, defined as the board's ability to perform its control and service tasks effectively, and the board's ability to continue working together, as evidenced by the cohesiveness of the board. Board task performance includes activities such as hiring, compensation and replacement of senior executives, approval of major initiatives proposed by management, and generating and analyzing strategic alternatives during board meetings. Sonnenfeld (2002) emphasizes the importance of boards as social systems and notes that board governance cannot be legislated and it must be built over time. Cultural factors influence the tolerance of constructive dissent and create a climate of trust. The human element creates a virtuous circle of respect, trust and candor.

After studying almost 100 organizations, Thomas *et al.* (2007) identified five basic practices of effective boards. Directors should be chosen based on their results orientation, strategic orientation, independence, and ability to collaborate. The chairman must be skilled in the same competencies as well as be able to coach and mentor. Succession planning must be the first priority. The board should focus on a few key agenda items. Directors must be able to review their collective and individual contributions.

There is evidence of a trend towards improving board effectiveness. In a longitudinal survey of Fortune 1000 companies, Lawler and Finegold (2005) found that between 1998 and 2003 the percentage of companies with formal governance guidelines increased from 64 to 87. This study also found a significant relationship between adoption of formal governance guidelines and improvements in board effectiveness.

There are further means for improving board effectiveness. Forbes and Milliken (1999) describe three board features that significantly affect organizational performance and which can be leveraged: effort norms, cognitive conflict, and the board's use of knowledge and skills. Effort norms are concerned with motivation of board members, the time dedicated to board tasks and doing their homework. Cognitive conflict can result in the consideration of a wider range of strategic alternatives and contribute to higher quality decision-making under certain circumstances (Eisenhardt *et al.*, 1997). Knowledge and skills must relate to important functional areas and specifics of the firm and industry.

We argue in this article that an effective board is one that, amongst other important activities, involves itself in strategic management and endeavours to use methods and tools that are appropriate to this task.

Why Boards Must be More Involved in Strategy-Making

Judge and Zeithaml (1992) observe three external pressures for greater board involvement in strategic change: directors have a growing exposure to legal action as a result of insufficient attention to strategic decisions, major institutions such as pension funds pressure boards to action, and the real and potential threats of hostile takeover and other market factors force boards to focus more on strategic issues. Gopinath *et al.* (1994) observe how certain landmark court decisions have helped enshrine the principle that boards are legally responsible for involvement in strategy and for answering to a broad group of stakeholders, not just to the top management and shareholders.

We suggest the multiple demands now being made upon boards to become more closely involved with enterprise risk management, improved non-financial reporting, operating and financial reviews, and quality assurance, also speak to a strong need for the board to be involved in the strategic decision processes that must support such activities.

Evidence Linking Board Attention to Strategy with firm Performance

Several research studies and surveys show a link between board attention to strategic activities and organizational performance.

Judge and Zeithaml (1992) investigated relationships between organizational and board characteristics and organizational performance in a study of 42 hospitals, biotechnology firms, textile firms, and large diversified Fortune 500 firms. A positive relationship between board involvement in the strategic decision-making process and an organization's financial performance was discovered. Siciliano (1993) studied 240 YMCA organizations and found a relationship between board participation in strategic planning and the organization's social performance. Golden and Zajac (2001) constructed a database of strategic changes from a sample of over 3000 hospitals. The attention that boards gave to strategy was found to be strongly and positively related to strategic change.