How you do it is less important than that you do it.

APPRAISING BOARDROOM PERFORMANCE

BY JAY A. CONGER, DAVID FINEGOLD, AND EDWARD E. LAWLER III

Rare is the company that does not periodically review the performance of its key contributors—whether they be individuals, work teams, business units, or senior managers. But one contributor usually escapes such review, and that one is arguably the single most important—the corporate board.

More than a few good reasons come to mind why companies should annually review the effectiveness of their boards, the most pressing of which is that influential investors—in particular, institutional investors—are beginning to demand it. A 1997 survey commissioned by Russell Reynolds Associates found that the quality of a company’s board has now become an important evaluation factor for institutional investors.
Other important reasons abound. Appraising a board’s performance can clarify the individual and collective roles and responsibilities of its directors, and better knowledge of what is expected of them can help boards become more effective. While no one can yet show a direct link between a board’s effectiveness and its company’s profits, few would be likely to disagree that improved board performance translates into better corporate governance. In fact, directors have told us that after they initiated board evaluations, their meetings went more smoothly, they got better information, they acquired greater influence, and they paid more attention to long-term corporate strategy.

Done properly, board appraisals may also improve the working relationship between a company’s board and its management—a powerful argument in itself for doing them. Directors have told us that the evaluation process encouraged greater candor in their dealings with the CEO and other senior managers. Formal appraisals of the board as a whole, and also of individual board members and the CEO, help ensure a healthy balance of power between the board and the chief executive. Furthermore, once in place, the appraisal process is difficult to dismantle. Thus an institutionalized review process makes it harder for a new CEO to dominate a board or avoid being held accountable for poor performance.

The changing roles and rewards for corporate directors create another compelling reason to review board performance regularly. As greater attention has focused on corporate governance, directorships that were once relatively low-paid and essentially honorary positions have become demanding and well compensated. Investors understandably want to know what they are getting for the millions of dollars in stock options and cash their companies are paying to directors.

Done properly, board appraisals may improve the relationship between a company’s board and its management.

The most obvious impediment to periodic board evaluations is that no one can perform them but the board itself. However, if the right evaluation process is in place, self-evaluation need not be self-serving evaluation. Nor need it be the kind of unpleasant, time-wasting event that makes performance appraisal nearly every manager’s least favorite activity.

Appraisals in the boardroom are a recent and not-yet-widespread phenomenon. A survey of directors at Fortune 1,000 companies conducted in 1996 by Korn/Ferry International indicates that even though roughly 70% of the largest U.S. companies have adopted a formal process for evaluating their CEOs, only one-quarter evaluate their boards’ performance. Evaluations of individual directors are even rarer and more controversial, occurring in just 16% of the companies surveyed. (See the table “What Companies Evaluate.”)

Over a two-year period, we interviewed and gathered written surveys from CEOs and board members at a dozen companies that are aggressive pioneers in performing and applying boardroom appraisals. Our research has allowed us to develop a set of best practices that represents a composite of the most effective techniques used by all these organizations.

Any discussion of performance appraisals must necessarily cover two broad areas—the what and the how. In the case of a board, what should be appraised is its ability first to define its responsi-

Jay A. Conger, David Finegold, and Edward E. Lawler III are professors at the University of Southern California’s Marshall School of Business in Los Angeles, where Conger directs the Leadership Institute and Lawler directs the Center for Effective Organizations. They are writing a book on the requirements for building an effective corporate board.

WHAT COMPANIES EVALUATE

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1996 Korn/Ferry survey
bilities and establish annual objectives in the context of those general responsibilities, and then its record in achieving those objectives. An appraisal must also look at the resources and capabilities the board needs and has available to perform its job. The how of board appraisal is, of course, the process the board uses to evaluate its own performance. We'll discuss the what first, then the how.

Activities and Responsibilities: What the Board Does

There's little argument about the modern board's responsibilities. First, it is responsible for business strategy development: not for setting strategy—that job falls to the chief executive and senior management team—but for ensuring that a strategic planning process is in place, is used, and produces sound choices. Further, the board must monitor the implementation of current strategic initiatives to assess whether they are on schedule, on budget, and producing effective results.

Second, a board is responsible for seeing that the company has the highest caliber CEO and executive team possible and that certain senior managers are being groomed to assume the CEO's responsibilities in the future.

Third, as the ultimate oversight body, the board must be sure that the company has adequate information, control, and audit systems in place to tell it and senior management whether the company is meeting its business objectives. And it is also the board's responsibility to ensure that the company

No one can evaluate a board but the board itself. Nevertheless, self-evaluation need not be self-serving evaluation.

complies with the legal and ethical standards imposed by law and by the company’s own statement of values. Finally, the board has responsibilities for preventing and managing crises—that is, for risk management.

Before a board can even begin to evaluate its performance in these broad areas of responsibility, it must articulate the specific actions that each of them implies. In other words, boards must set objectives for themselves within those broad categories against which they can eventually measure their performance. The boards of most of the companies we looked at create a set of objectives annually—generally speaking, at the beginning of the fiscal year—that reflects the directors' collective judgment about which aspects of the board's overall responsibilities need particular attention in the coming year.

The nominating or governance committee may design an initial set of objectives that it feels covers the essential responsibilities of an effective board. But it is vital that the full board and CEO then take time to discuss, debate, and agree to the final set of objectives and to establish priorities among them. Not until then can the board establish the criteria it will use to measure its own performance in meeting those objectives. For instance, as part of its role in developing business strategy, the board and the CEO may decide that the company will seek to become the leader in Latin America in its major product segments within three years. The board then specifies the evaluation criteria it will use to assess whether it is helping the company achieve that goal. Those criteria may include improving the board's knowledge of the region by adding a director who has Latin American expertise, facilitating the establishment of a partnership with the Venezuelan government, or holding a board meeting at the company's Latin American headquarters in Brazil in order to meet local managers.

Because of the many demands on a board's time, not every board responsibility need be evaluated every year. In a particular year, it is useful for the board to pick four to seven areas that it needs to improve. So, for example, a board might choose to focus one year on improving its evaluation of senior management talent at the divisional level, on identifying a system for tracking a strategic initiative, and on enhancing its CEO evaluation procedure. The choice of topics should reflect the areas the board feels are currently the most vital to the company, but all major areas of responsibility should be covered periodically. It is best if the board sets these developmental objectives in a meeting separate from the one at which the board appraises its performance during the past year.

Resources: What the Board Needs to Do an Effective Job

A board is a team of knowledge workers, and to do its job, the board needs the same resources and capabilities that any other successful team of
knowledge workers needs. Research done here at the Marshall School of Business's Center for Effective Organizations indicates that to do their jobs effectively, such groups need knowledge, information, power, motivation, and time.

Knowledge. The combined knowledge and experience of the board members absolutely must match the strategic demands facing the company. Because today's business environments are so complex, it is nearly impossible for a single person or even a small group of individuals to understand all the issues that come before a board. Such complexity argues for assembling a group of members whose skills and backgrounds are diverse and complement one another. Ideally, so that the board not grow unwieldy, each of its members should satisfy more than one need. Selecting directors for a single area of expertise or background characteristic can contribute to the creation of a board whose members focus only on their particular interests.

A performance evaluation that systematically assesses boardroom expertise and identifies current and future gaps is therefore critical to assuring that the board maintains the right mix of knowledge. A leading aerospace company uses a simple matrix highlighting the capabilities of its directors, making it easy to see if individuals representing the right mix of knowledge are on both its board and its various committees. The required capabilities are derived directly from the company's long-term business strategy. They include competencies in such areas as developing new technologies, doing business in the Pacific Rim, dealing with governments, and creating shareholder value.

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The CEO explains the matrix's purpose: "We use it to evaluate the disciplines we want to have on the board, the capabilities we currently have, the capa-

of experience. We try to move people around so that the capabilities we want to have on particular committees are covered. It's a chess game that gets played every year."

Information. To be effective, a board needs a broad range of information about the condition of its corporation. It needs, for example, up-to-date information on the competition, on key strategic issues, and on possible acquisition targets. And it needs that information presented clearly and concisely because its time is limited. Furthermore, the board needs to get its information from a broad range of sources such as outside stakeholders, customers, employees, and the directors themselves. An evaluation of board resources, therefore, must examine not only the kind of data a board gets but also their origins.

Power. An effective board needs authority—the authority to act as a governing body, surely, and to make key decisions—but also the power to see that senior management is accepting and implementing its decisions. One clear way to grant the board the independence it needs to exercise effective oversight of the CEO is for the board's chair to be someone other than the CEO, to be someone who represents the owners of the company. "This is the single most important factor in creating the right balance of power needed for effective governance," says Benjamin Rosen, chairman of Compaq Computer Corporation. "Our country has this separation of powers, why shouldn't companies?" The separation of chair and CEO is common in companies initially financed through venture capital. But it is unlikely to be widely adopted among large corporations in the United States because, Rosen says, "there is so much peer pressure on CEOs to keep the two roles together." Today only 3% of those chairing boards at large public companies in the United States are not current or former chief executives of the company.

Even when a single person is both the chair and the CEO, a company can take steps to achieve a balance of power between the board and chief executive. One step is to appoint a lead director, who represents the outside directors when setting agendas for meetings and who can take charge in a crisis. Instituting a formal evaluation of the CEO's performance also works to maintain a balance, as does making a portion of the CEO's compensation dependent on attaining targets agreed to by the board. (See the insert "Evaluating the CEO.") In addition, the board can schedule
EVALUATING THE CEO

Formal evaluations of a company's CEO by its board of directors are becoming increasingly commonplace. The process should involve three stages: establishing evaluation targets at the start of the fiscal year, reviewing performance at midyear, and assessing results at the end of the year.

Just before the start of the company's fiscal year, the CEO and his or her direct reports should work with the board to develop the annual strategic plan establishing the company's short-term and long-term objectives. Finding the right objectives is a critical part of the process. Many companies have built their CEO's objectives and compensation package around annual financial objectives and the performance of the company's stock. Although essential, such measures fail to take into account such important responsibilities as the CEO's plans for his or her own succession, lobbying efforts, involvement in trade associations, efforts at internal communications, leadership skills, and success in labor relations. The most telling evaluations, therefore, include both financial and nonfinancial objectives. Still, our best-practice companies kept their lists to between five and ten objectives. In addition, it is a good idea to define carefully at least three levels of performance for each objective - poor, acceptable, and outstanding. These levels become the benchmarks for differing pay packages.

A common problem we have found is that boards rely too much on the CEO's self-evaluation. Self-evaluation is an essential part of an effective performance appraisal, but it is by no means sufficient by itself. Clearly, individuals being judged on their performance may have many reasons to be biased in the way they rate themselves. For example, one CEO admitted to us that he purposely lowers his self-evaluation, preferring to be “pulled up” by his board's evaluation rather than be “put down.” We suspect that he is not alone. Self-assessment data must be balanced by other information. Ratings from customers and institutional investors, employee satisfaction surveys, and comparisons of the CEO's performance with that of leaders inside and outside the industry are all useful sources of information.

Once the objectives are defined, the CEO must translate them into a set of personal-performance targets and specify how his or her progress will be measured against each. The CEO then shares these targets and metrics with a committee of the board - normally, a compensation or a board governance committee that ideally consists solely of outside directors. This committee makes recommendations to the full board, resolving any differences between the perceptions of the CEO and the outside directors regarding objectives. This committee also establishes the financial rewards that will result from meeting the targets. Committee members must collaborate with the CEO to ensure that targets are realistic but challenging. When the CEO and committee members agree on objectives and measures, the committee presents them to the full board for discussion and final approval.

Next comes the midyear review — which, like any midyear employee review, is a chance for the board to assess whether the CEO is on a course to meet or exceed objectives and, if not, to determine where the problems lie. The midyear review encourages directors to act before minor problems become major ones and ensures that the objectives as originally framed are still relevant. Such reviews may need to occur more frequently than once a year in industries where products and market conditions change rapidly.

The final stage of the CEO's evaluation should take place at the end of the fiscal year, when the board's compensation committee compares the executive's actual performance against the targets and determines the compensation it will recommend to the full complement of outside directors. Typically, this stage starts with the CEO completing a written self-evaluation that gauges his or her performance over the year. Individual outside board members should also complete a short questionnaire assessing the CEO's performance. We strongly recommend that the questionnaire combine open-ended questions with those that use a rating scale. Rating scales make it easier to compare different board members' evaluations and highlight clearly where perceptions vary. Open-ended questions allow people the flexibility to consider factors that fixed scales and targets may overlook.

The committee should also collect and consider pertinent outside information, such as perceptions of the CEO by the investment community and by its most valued customers. Using all this material as background, the committee should then prepare its recommendation, and the outside directors should meet to discuss and approve a final compensation package.

In many companies, the response to all of this information from outside directors to the CEO is oral and informal. Our research and our analysis of the Korn/Ferry survey data, however, indicate that directors consider the evaluation process more effective when board members give the CEO written feedback as well. Committing thoughts to paper forces deeper reflection and greater clarity. It also gives CEOs something concrete that they can review at their leisure after the meeting. Written appraisals also ensure that every director is heard — not merely those who are the most vocal.
regular executive sessions at which only outside directors are present. These meetings would allow the board to discuss sensitive issues without raising alarms among senior managers.

A board's power is a function of the backgrounds of its members and the way they are chosen. It is crucial, then, that a committee of independent directors—and not the CEO—oversees the process of selecting new directors. Directors who have ties of business or family to the CEO and the company may have difficulty exercising independent judgment. They may be more easily swayed by the CEO's strong stance on an issue. Similarly, board members who sit on one another's boards create potential personal conflicts of interest.

It follows, then, that to assess the state of its own power, the board should in an appraisal ask such questions as: Do we have a healthy balance of power with our CEO? Is the board itself well led? Do we control the agenda of our own meetings? and, Can we act quickly to replace the CEO if necessary?

Motivation. The right incentives must be in place to align directors' interests with those of the individuals they are meant to represent: the shareholders and other stakeholders in the corporation (employees, customers, and the community, for example). Together with the process by which directors are selected, the reward system is a lever that companies can use to influence the motivation of board members.

A growing number of companies require directors to own shares, paying them partially or wholly in stock rather than offering pension plans or other perks. According to David Golub, managing director at Corporate Partners, which specializes in taking large equity positions in publicly traded companies, "The most important factor in determining if a board is effective is whether there is a small group of directors—it doesn't need to be every one—that has a substantial ownership stake in the company, enough so that it hurts them personally if the company is underperforming."

The board evaluation should take note of the requirements for owning stock and the degree to which directors' compensation is in stock rather than cash. It should also examine the mix of short-term versus long-term rewards. Although it makes sense to orient directors' compensation toward the long term—with, for instance, options that can be exercised only after several years or upon retirement—it is also important to remember that money may not be a director's primary motivation. As Harvard Business School professor Jay W. Lorsch has recently commented, "Directors, most of whom are highly compensated in their regular jobs, do not serve for financial rewards. Rather, they join boards because of the new ideas they gain and out of a sense that they have a responsibility to participate in the governance process." Thus having an evaluation process in place that focuses on identifying high-quality directors and encourages an open exchange of information may be as critical as establishing compensation policies intended to motivate some desired behavior.

Time. To make effective decisions, directors need sufficient, well-organized periods of time together as a group. Evaluations should note whether the frequency of meetings is adequate, whether there is sufficient time available to prepare for meetings and to deliberate on important decisions, and whether time spent in meetings is used efficiently. For instance, board members should not devote time in meetings to getting information from management that could have been communicated earlier. Rather, they should spend meeting time engaged in substantive discussion and decision making. Accordingly, an appraisal should consider whether board members are receiving the advance information they need in order to come to meetings prepared to debate crucial issues. It should also consider whether the meetings themselves are devoted to the right issues. Evaluating the way the board operates will not necessarily lead to the conclusion that it needs to meet more often. On the contrary, after appraising its own performance, one board we studied reduced the number of regular board sessions and instead delegated more work to committees and telephone conferences.

Because even the most efficient boards can run short of time for in-depth discussion of corporate strategy during regular meetings, some companies are scheduling annual strategy retreats. In some cases—for instance, in high-technology industries, where product life cycles can be less than a year long—meeting annually in such retreats is not enough. That's why Compaq devotes "a couple of
hours at every board session to some part of the business that is going to affect its strategy,” says outside director Ken Roman.

Dayton Hudson Corporation adopted a similar process after conducting an evaluation of its board. The directors concluded, says general counsel and corporate secretary Jim Hale, that “there’s too much strategic information for us to absorb all in one blast. Spread it out over the year, and give us the strategic issues affecting one operating division at each meeting.” The board evaluation process should help boards decide whether they currently have enough time to discuss strategy and what the optimum forum for strategy discussions should be.

Evaluation: How the Board Rates Itself

Whatever their individual advantages, all the approaches to board appraisal we observed were incomplete. Either they failed to gauge the adequacy of important board resources and capabilities or they failed to set clear performance objectives. We have therefore drawn on the strengths of several different approaches to synthesize a best-practice process that is both rigorous and comprehensive.

Self-evaluation is not an easy issue for any group to deal with. It is particularly difficult in the case of boards because it requires board members to make judgments and decisions about themselves and about issues that affect all stakeholders. The effectiveness of the evaluation very much depends on how the board structures the evaluation process. It should consist of three phases: The first—setting annual board objectives at the beginning of the fiscal year—we have discussed above. The process picks up again at the end of the year, when, in the second phase, the board secretary collects and disseminates information about the board’s activities. With that information in hand, in the third phase, board members can judge how close they came to meeting their objectives while also examining the adequacy of the resources available to them over the year.

Disseminating Information. The information disseminated to board members should come from both internal and external sources. It should include an analysis of how the board spent its time in meetings, breaking down the year’s activities and accomplishments according to how they contributed to each area specifically set out for evaluation in the annual objectives. For instance, board members should be able to scan a list of topics and issues that they addressed at meetings the previous year relating to business strategy development, and the list should be organized by the dates of each meeting and the length of time spent on each topic. Wherever possible, this information should be linked to tangible benefits to the board or the company that may have resulted from these activities. For example, the record of a decision by the board to expand the company’s markets in China should be connected to the opening of the company’s sales office in Beijing some two months later and to sales figures in the region for the appropriate period.

A careful examination of the topics covered at board meetings might also reveal that certain of the board’s objectives or portions of the company’s business were largely overlooked. Such an analysis might reveal, for example, a failure to hear from a member of the senior management team who is a prime candidate to succeed the CEO, or perhaps it might reveal a failure to review the company’s substantial real-estate holdings.

At the start of every fiscal year, Texaco’s board defines its general areas of responsibility (for instance, oversight of the company’s financial health, assuring adherence to corporate vision and values, planning for succession, and reviewing the CEO’s performance) and lists, according to their priority, objectives it creates for itself within each broad category. At the end of each year, the nominating committee then analyzes the minutes of all board meetings to determine how the board allocated its time relative to those priorities. Board members receive this information as the basis for a discussion of the board’s effectiveness. “We look back each year and ask how we did on each of these points and did we do enough,” observes Texaco’s corporate secretary,

An evaluation process identifying high-quality directors may be as critical as compensation policies that motivate behavior. Carl Davidson. What results is not a report card, he explains. “It is, rather, an objective listing of what we spent time on and a subjective assessment of how well we did in paying attention to our key responsibilities.” An element essential to the board evaluation process was missing from nearly all the companies we studied: data obtained from outside the corporation.
SHOULD INDIVIDUAL BOARD MEMBERS BE EVALUATED?

Perhaps the most controversial issue in the area of board appraisal is the question of whether to evaluate individual directors. A survey of corporate governance conducted by Russell Reynolds Associates in 1997 showed investors feel strongly that boards need to be more aggressive in weeding out underperforming directors. Yet until recently, formal appraisals of individual directors have been relatively rare. Recent surveys by Korn/Ferry International and the American Society of Corporate Secretaries indicate that approximately 15% of large corporations assess the performance of individual directors. In our interviews of board members, we found overwhelming opposition and several concerns.

First, a number of directors and CEOs felt that turning a spotlight on individual members might undermine boardroom collegiality. They worried that it might drive away good board members who feel they have already proved themselves—and that would be a significant problem when competition to attract top directors is heavy.

Second, it is difficult to determine who should evaluate a director. Peers are one possibility, but they often lack the information needed to make an accurate appraisal of other directors’ performance. Board members spend relatively little time together, and what occurs in the meetings may not be the best gauge of a director’s contribution. Says one corporate secretary, “A lot of people are quiet [in board meetings], but they are very effective. They operate in different ways. It’s what goes on in sidebar conversations, at dinners, during telephone calls between meetings, that kind of thing, that may really matter.”

Third, since each board member brings a different set of competencies to the board, it can be dangerous to establish blanket evaluation criteria, which might, for example, overlook the different ways members contribute. And, finally, research on team effectiveness clearly supports the idea that when individuals are interdependent, as they are on a board, it is important to place the main emphasis on evaluating and rewarding the effectiveness of the group as a whole. Otherwise, people tend to optimize their individual performance rather than contribute to the effectiveness of the team.

But despite the problems with individual appraisals, we believe there is a definite role for them as one component of an overall board-evaluation process. Certain issues relating to the group’s effectiveness simply cannot be addressed without evaluating individuals.

Although underperforming directors are relatively rare, it is a sound practice to identify them through formal assessments and to act quickly either to improve their performance or to remove them. As the average size of boards decreases and the demands and rewards for serving on boards increases, companies need more from directors than good attendance and perfunctory questions. Individual evaluation is a good way to make performance expectations clear. Support for this view comes from our analysis of the Korn/Ferry survey data, which show that directors rate their board’s overall effectiveness significantly higher in companies that do evaluate individual directors than in those that do not. (Even in those companies, however, evaluating the CEO and the entire board has a greater effect on directors’ impressions of how effective their boards are. See the table “How Effective Are Evaluations: The Directors’ View.”)

Directors at Motorola recently began assessing themselves in response to boardroom discussions stemming from their full-board evaluation. Prompted by the question, What does the board add to the management of the corporation? the discussion turned quite naturally to, What does each individual member add? That led to an annual self-assessment exercise. Motorola’s self-assessment questionnaire asks directors to indicate their degree of agreement (on a five-point scale) with 30 statements about their individual performance as directors such as, “I understand Motorola’s industry and markets,” and “I am fully prepared for board meetings.” The questionnaire is for the individual’s private use only and is not shared with any committee or other board member. It serves as a simple discipline and structure that directors can use to reflect on their own performance. It can also be used to start the transition to a peer-based evaluation.

Individual self-appraisal is not enough; individual biases reflected in self-appraisals should be balanced by the perceptions of others. One option is for the chair, the CEO, and the head of the board’s human resources committee to meet periodically to assess each director according to criteria similar to those Motorola uses. They should also use more objective criteria, such as the number of meetings the director has attended and the amount of the company’s stock he or she owns. The results of that assessment can be given to the individual but not to other board members. A company wishing to take a bolder—and potentially more effective—step could ask board members to evaluate one another anonymously. The most
A balanced approach is to combine anonymous peer evaluations with individual self-assessments and the evaluations by the CEO, board chair, or head of the human resources committee. The peer evaluations should be collected by a lead director, a trusted adviser, or an outsider who can provide board members with a summary of the comments and ratings of their peers. Keeping the source of all information anonymous, the adviser or outsider would then provide the full results to the committee charged with nominating directors to help it identify underperforming directors.

The results of individual appraisals are often the basis for developing a compensation program in which pay is tied to performance. In the case of directors, however, such programs are ill advised, as they pose too great a threat to board teamwork.

### HOW EFFECTIVE ARE EVALUATIONS: THE DIRECTORS’ VIEW

Directors’ View of the Impact of Various Evaluations on Their Board’s Effectiveness

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- **Governing, overall**
- **Shaping long-term strategy**
- **Bolstering the company’s image in the community**
- **Managing during a crisis**
- **Planning for top management succession**
- **Anticipating possible threats to company survival**
- **Balancing interests of different stakeholders**
- **Monitoring strategy implementation**
- **Building networks with strategic partners**
- **Enhancing government relations**
Information derived solely from internal sources may have inherent biases that distort the reality of the company’s competitive or financial position. Outside data are particularly pertinent when assessing a board’s performance relative to that of its competitors. Institutional investors, market analysts, regulatory bodies, the press, and academic journals are all potential sources of outside information. Evidence suggests that institutional investors, in particular, want to be asked for their views of board performance. Our analysis of the Korn/Ferry survey indicates that directors also view the evaluation process as significantly more effective when boards receive feedback from company stakeholders.

**Evaluating the Board’s Effectiveness.** After board members have had time to review the information provided to them, a lead director, the head of the committee overseeing the evaluation, or a respected and trusted outsider (such as the corporate counsel) should survey all board members confidentially to collect their views on the board’s performance relative to the objectives it had set for itself and to examine the nature and adequacy of the available

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**HOW MOTOROLA POLLS ITS BOARD MEMBERS**

The following is the first page of a five-page survey that Motorola uses to evaluate its board of directors. The complete form includes 27 multiple-choice questions and 7 open-ended questions.

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The following survey is a tool to help you think about the performance of the Board of Directors as a group. It is intended to enhance the Board’s overall effectiveness. The results will be discussed at a future Board meeting. Please indicate to what extent you agree with the following statements concerning the functioning of the Board of Directors as a whole. Circle one response for each item.

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**THE FOLLOWING QUESTIONS REFER TO THE BOARD OF DIRECTORS.**

**The board of directors:**

1. has an appropriate level of involvement in CEO succession
   - NEITHER AGREE NOR DISAGREE
   - STRONGLY DISAGREE
   - STRONGLY AGREE
   - AGREE
   - DISAGREE

2. has in place appropriate processes to assess the CEO
   - NEITHER AGREE NOR DISAGREE
   - STRONGLY DISAGREE
   - STRONGLY AGREE
   - AGREE
   - DISAGREE

3. has sufficient information for CEO evaluation
   - NEITHER AGREE NOR DISAGREE
   - STRONGLY DISAGREE
   - STRONGLY AGREE
   - AGREE
   - DISAGREE

4. spends an appropriate amount of time discussing the long-range future of the company
   - NEITHER AGREE NOR DISAGREE
   - STRONGLY DISAGREE
   - STRONGLY AGREE
   - AGREE
   - DISAGREE

5. proposes changes in company direction
   - NEITHER AGREE NOR DISAGREE
   - STRONGLY DISAGREE
   - STRONGLY AGREE
   - AGREE
   - DISAGREE

6. has a vision and a mission that is understood by all Board members
   - NEITHER AGREE NOR DISAGREE
   - STRONGLY DISAGREE
   - STRONGLY AGREE
   - AGREE
   - DISAGREE

7. is prepared to deal with unforeseen corporate crises
   - NEITHER AGREE NOR DISAGREE
   - STRONGLY DISAGREE
   - STRONGLY AGREE
   - AGREE
   - DISAGREE

8. has appropriate structures and processes to help evaluate company strategy and objectives
   - NEITHER AGREE NOR DISAGREE
   - STRONGLY DISAGREE
   - STRONGLY AGREE
   - AGREE
   - DISAGREE

9. effectively inquires into major performance deficiencies
   - NEITHER AGREE NOR DISAGREE
   - STRONGLY DISAGREE
   - STRONGLY AGREE
   - AGREE
   - DISAGREE
resources. The survey should use a mix of open-ended questions and numerically scored multiple-choice items that remain consistent from year to year, thus allowing the board to track its performance over time.

Amoco Corporation and Motorola take two different approaches that are both quite effective. Each uses a four-page questionnaire. Motorola's asks board members to indicate degrees of agreement or disagreement with 27 specific statements, such as: "The board of directors is prepared to deal with unforeseen corporate crises." It then poses five open-ended questions, one of which, for instance, asks: "Does the board have an appropriate mix of overview and approval activities? If not, what should be different?" (For a sample of Motorola's questionnaire, see the exhibit "How Motorola polls its Board Members.")

The Amoco questionnaire summarizes the board's responsibilities in each of six categories ("succession, planning, and selection," for instance) and asks directors to judge the board's performance in each as "excellent," "satisfactory," or "needs improvement." In each category, there is also space for comment. Two open-ended questions at the end of the survey ask directors how they would rate the board's overall performance and solicit suggestions for improvements. At other companies, an individual member of the board—frequently, the chair of the nominating, governance, or compensation committee—conducts interviews with each director in person or over the telephone using open-ended questions. Written questionnaires yield more consistent information, and we believe they are equally effective as long as they include an option allowing directors to schedule an interview with the chair of the appropriate committee, if they wish.

The committee responsible for corporate governance should analyze and discuss the results generated by the evaluation data. At Honeywell, that's the nominating committee, which reviews the written questionnaires and comments from all board members. As at most of the companies we studied, the committee does so after the directors' names have been removed. Results are compiled into a single report showing nearly verbatim responses to each question, identifying where the board has met its objectives, and indicating where it needs improvement.

Finally, the committee's findings are presented to the entire board in summary form. The board discusses the areas identified for improvement and creates appropriate action plans. Not only is the content of the presentation to the board important but so is its tone. The presentation of appraisal results must be balanced, highlighting the areas where ratings or viewpoints diverge and preserving the anonymity of individual members unless individuals specifically ask that their names be used. The most effective presenters are those who are good listeners and are trusted by board members.

Evidence suggests that institutional investors, in particular, want to be asked for their views on board performance. They must be seen to be independent of the CEO and senior management. Lead directors are often a good choice. When the board has not appointed a lead director, a good choice is the outside director who heads the committee responsible for corporate governance.

Conducting an appraisal in this way has several advantages. First, the scores on the questionnaires help the board members rank themselves objectively along a series of dimensions. Directors can also see where their viewpoints differ. But boards should also consider an additional technique that we never observed, even in our best-practice companies—having independent experts on group process observe some board meetings and contribute advice on how the board's performance might be improved. With little or no vested interest and an understanding of group-process issues, outside experts are better positioned to recognize dysfunctional team dynamics. They can also draw attention to implicit rules of behavior that may be interfering with the amount and candor of information flowing among board members.

Keeping the Process Effective

Once an effective board-appraisal process is in place and running, it is a good idea to reexamine it regularly to see how it can be improved or varied to avoid growing stale. When Dayton Hudson, for instance, began evaluating its board 15 years ago, it used a very formal process. Every year, board members reviewed each description of the board's responsibilities, as well as those for each committee,
paragraph by paragraph, to determine whether they were meeting their obligations. "There was a point in our history when that was useful and productive," recalls the general counsel, Jim Hale. "But over time, it got stilted, and we felt that it was more important that we have good communication than that we have a specific format." Rather than serving as a forum meant to foster rich discussion and debate, a board evaluation that takes too detailed an approach can eventually turn into a mechanical process in which accomplishments are merely checked off. What's more, reviewing the same dimensions repeatedly over many years will, at best, begin to yield merely incremental improvements and, over time, may discourage innovative challenges to established boardroom procedures. Using the same dimensions over and over again can also cause the board to lose sight of other areas it may need to review.

Throughout the last decade, Dayton Hudson's board has set aside a block of time each year to review its governance procedures and to evaluate their effectiveness, experimenting with a variety of different formats. Ideally, a board's governance committee will conduct a thorough review and critique of the board evaluation procedures, actively seeking input from all board members in the process. For example, during the takeover boom in the 1980s, members of Dayton Hudson's board did a case study to learn how the board of another company that had been through a hostile takeover dealt with that process. In other years, they have sent out written surveys to the directors, similar to the Amoco survey, asking them to assess the information the board was given and to suggest how the process could be improved. Last year, they circulated their extensive, publicly available, corporate-governance guidelines and asked the board whether any amendments were needed.

As the pressure mounts on publicly owned companies to improve their corporate governance practices, we are likely to see more of them adopting formal board evaluations. A few will take the bolder step of formally evaluating the performance of individual directors. (See the insert "Should Individual Board Members Be Evaluated?") But formal board evaluations are no panacea, particularly if companies are simply going through the motions to satisfy the investment community. The chair of one company that recently instituted processes for evaluating both its board and its individual board members admitted that he didn't believe it was important. "It's important to others, but it's not important to good corporate governance," he maintained. "It's just that people conduct best-practice surveys of corporate governance, and we wanted to have the evaluations on our checklist."

Even when employed at companies that do take them seriously, evaluations are no guarantee against trouble. Texaco's board has been a leader in the adoption of best practices in corporate governance, and yet these practices did not help it avoid a well-publicized incident suggesting corporate racism. On the other side of the coin, Business Week and Chief Executive magazines, for instance, consistently rate the Walt Disney Company as having one of the worst boards, as measured by governance procedure standards, and yet under Michael Eisner's leadership, Disney has produced exceptional returns to shareholders.

But if done correctly, evaluations create a way for the board and the CEO to hold each other accountable to clearly defined performance expectations while avoiding the dangers of getting the board involved in day-to-day management. Evaluations can also improve the operations of the board, clarify the respective roles of the board and the CEO, and ensure that both consistently focus on their responsibilities. Perhaps the clearest and most consistent benefit we've observed in those companies that have adopted board appraisals is a commitment by directors and the CEO to devote more time and attention to long-term strategy—and that by itself is an outcome significant enough to justify their implementation.

In a way, boards are like fire departments: they aren't needed every day, but they have to perform effectively when called upon. One chair observed that in good times corporate governance is largely irrelevant, but in bad times it is crucial. Formal, periodic board appraisals can help ensure that when the board is needed, all the right processes, procedures, members, and relationships are in place and ready to go.

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HARVARD BUSINESS REVIEW January–February 1998
How do boards draw the line between monitoring performance and managing the company?

CEO

Empowering the Board

by Jay W. Lorsch

CHAIRMAN

LEAD DIRECTOR

DIRECTOR

CHAIR OF THE AUDIT COMMITTEE

SECRETARY

CHAIR OF THE COMPENSATION COMMITTEE

CHAIR OF THE NOMINATING COMMITTEE

If the 1980s were the decade when the movement to empower U.S. factory and office workers took root, the 1990s are the decade when empowerment is sweeping corporate boardrooms. Empowerment means that outside directors have the capability and independence to monitor the performance of top management and the company; to influence management to change the strategic direction of the company if its performance does not meet the board’s expectations; and, in the most extreme cases, to change corporate leadership.

Because the chief executive is also the board chair in more than 80% of the country's publicly held corporations, it is not surprising that most chief executives view board empowerment with trepidation. Traditionally, corporate leaders have considered a powerful, active board to be a nuisance at best and a force that could improperly interfere in the management of the company at worst. They have preferred directors who are content to offer counsel when asked and to support management in times of crisis.

Chief executives who resist empowered boards must change their attitude. If they do not, they and their companies will be the losers because the empowered board is here to stay. If CEOs resist the trend, pressures to empower directors are likely to grow outside the boardroom, which will make the change adversarial and may lead to boardroom practices that will interfere unduly with management. But if CEOs recognize that empowered directors can help them and their companies, and if they encourage this trend, board empowerment can be achieved with minimal fuss and maximum benefit to CEOs, shareholders, and the U.S. economy.

This rosy scenario, however, means that outside directors and the chief executive must redefine

The Progress of Board Empowerment

<table>
<thead>
<tr>
<th>Company</th>
<th>Innovation</th>
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<tr>
<td>Dayton Hudson Corporation</td>
<td>Requires the outside directors to conduct an annual evaluation of the CEO.</td>
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<tr>
<td>Medtronic</td>
<td>Solicits opinions on board procedures by requiring all directors to complete</td>
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<td></td>
<td>a questionnaire; then the full board reviews the results at an annual meeting</td>
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<tr>
<td></td>
<td>and tries to make improvements.</td>
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<tr>
<td>Stanhome</td>
<td>Developed a formal document that specifies the board’s purpose, size,</td>
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<td></td>
<td>proportion of outside directors, annual calendar, and expectations of</td>
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<td></td>
<td>directors and management.</td>
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<tr>
<td>Mallinckrodt</td>
<td>Separated the roles of chair and CEO.</td>
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<tr>
<td>Lukens</td>
<td>Formed a committee of outside directors to study a major acquisition proposal,</td>
</tr>
<tr>
<td></td>
<td>hold discussions with management, and recommend action to the full board.</td>
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<tr>
<td>Campbell Soup Company</td>
<td>Designated a lead director with the title of vice chairman.</td>
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<td>Monsanto</td>
<td>Increased the proportion of the board’s time that would be focused on</td>
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<td></td>
<td>strategic direction and considered specific capital proposals within that</td>
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<td>framework.</td>
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<td>General Motors</td>
<td>Developed an explicit set of guidelines that outline how the board</td>
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<td>will function and be structured.</td>
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Note: The companies are listed in the chronological order in which they made significant moves toward empowerment. The innovation listed is only one of several changes each board has made. Members of the American Society of Corporate Secretaries provided some of these examples.

their relationship. The CEO must understand clearly the power and responsibility of the board. Outside directors must recognize and respect the boundary between monitoring management and actually managing the company. What is required is a new form of teamwork in which directors and top-level managers understand one another’s roles and responsibilities and collaborate effectively to achieve corporate success. Their newly defined relationship will strengthen the board’s ability to advise management and to monitor corporate performance. The CEO will retain the power to lead the company while obtaining the guidance of informed and active directors as long as corporate performance is satisfactory.

Pressures for Empowerment

There are several driving forces to empower outside directors. First, most institutional investors do not want to sit on boards and play a direct role in governing companies, but they have become more willing to pressure boards to challenge management and have been effective in getting the media to do the same. Recently, representatives of union pension funds, such as the Teamsters, have joined the ranks of shareholder activists. And changes in Securities and Exchange Commission regulations that make it easier for institutional shareholders to communicate with one another about corporate governance issues have increased the clout of those shareholders.

Second, the recent performance difficulties of many major companies and the removal of their CEOs have generated more public interest in active boards. Third, government competitiveness councils have stressed the link between corporate governance and competitive success, as has Chancellor William T. Allen of the Delaware Court of Chancery, in whose state more than half of U.S. public companies are incorporated.

Finally, the move to empower directors has been fueled by the controversy about CEO compensation – or, more precisely, by the perception that many CEOs are substantially overpaid relative to their companies’ performance. Richard C. Breeden,
BOARD EMPOWERMENT

who was chairman of the SEC from 1989 to 1993, believed that one way of tackling the issue was to make outside directors more accountable for top managers' pay. To that end, he and his fellow commissioners required companies to provide more details in their proxies about executive compensation, including how it was determined and how it related to the company's performance.

Several organizations have led the way in empowering their boards. (See the exhibit, "The Progress of Board Empowerment.") Most of them—including Campbell Soup Company, Mallinckrodt, and Stanhome—have done so not because of outside pressure or poor company performance but because they believed it was the right thing to do. But too many CEOs still seem to view calls for board empowerment with alarm.

Invalid Assumptions About Empowering Directors

Many CEOs and others with reservations about empowering outside directors proceed from incorrect premises about power and the boardroom. Power is zero-sum. This is a serious misconception. As U.S. factories and offices illustrate, one party (employees) can gain power without the other party (management) losing it. The same is true in the boardroom. In companies such as Dayton Hudson Corporation and Medtronic, where directors have long been empowered to monitor corporate and management performance, there is no evidence that the CEO and other top-level managers have found their power to lead the company diminished. What they have found is that directors are better informed, communicate their ideas more effectively, and enthusiastic. The CEO commented that as a result of the process, the full board had become more active, involved, and communicative and that the change in procedure had been valuable.

Advising and monitoring are in conflict. Advice is what CEOs want most from outside directors, and many chief executives worry that if directors become more forceful monitors, their usefulness as advisers will diminish. That concern is misguided because directors require the same two ingredients to perform both roles: access to useful information and the time to discuss it with one another and with management. In fact, directors on empowered boards are likely to be more knowledgeable and involved than those on traditional boards and therefore to be better advisers. It is true, of course, that if top management consistently disregards the directors' advice, an empowered board is more likely to be forceful in expressing its opinions. While such forthrightness may be uncomfortable to managers at first, it should lead to better decisions if directors and managers are working together effectively.

There is no need to act unless a crisis strikes. The assumption that boards can safely remain passive until there is a crisis implies that directors are like firefighters who sit around the station playing checkers until there is a fire and then spring into action. Firefighters must practice in order to cope with an emergency, and so must directors. Directors who passively await a crisis will have neither the necessary information nor the decision-making and communication mechanisms they need to resolve issues quickly if one does strike.

Moreover, as the events at such companies as General Motors and IBM have illustrated, the most difficult crises confronting boards occur gradually. Boards that do not actively monitor performance, even in apparently good times, are likely to have great difficulty spotting and understanding problems in a timely fashion. An important virtue of board empowerment is that it enables directors to prevent crises. By being active monitors, they can encourage and support their CEO in making the changes necessary to keep small difficulties from turning into large ones. In fact, in organizations whose boards removed CEOs because of poor corporate performance, the boards themselves usually had failed to monitor management and company performance in the years before the crisis.

One size fits all companies. Many managers incorrectly assume that empowerment should entail identical procedures and processes in all boards.
While there are certain essential activities in which any board should engage—as I will explain below—the specifics of how the board should carry out those activities and, more broadly, act as advisers and monitors must depend on the company’s particular circumstances.

At least three factors influence the processes and procedures that outside directors should use. First is the confidence the directors have in the CEO and the nature of the relationship between them. If the CEO is new and the directors do not have a good understanding of his or her ideas, they may want to monitor those ideas and the CEO’s actions more frequently and carefully. If the CEO has been leading the company successfully for several years, directors can be effective monitors with less detailed, annual assessments. In the latter situation, however, outside directors must satisfy themselves that neither they nor the CEO is overlooking significant changes in the circumstances facing the company.

A second factor that affects the way a board should think about empowerment is the company’s performance. If a company has been having problems, the directors will clearly want to be more involved in understanding management’s thinking and decisions than if the company has not. Again, at the least, the directors should feel sure that they and management are anticipating the future and not overlooking potential problems.

The board’s role as monitor will also depend on the complexity of the decisions facing managers and directors. Beyond problems with company performance, the factor that most influences such complexity is the diversity of the company’s businesses—in other words, the number of different products and markets and also the number of countries in which the company operates. For example, the board of a company such as Procter & Gamble, which operates different businesses all over the world, has more complexity to deal with than the board of Lukens, which basically is in only one business and operates in only one country.

Some would argue that a company’s size is also a determinant of the complexity of the decisions it faces. While that argument has some merit, size alone has less of an effect on complexity than diversity does. In essence, a bigger company has to make bigger decisions about the same issues, but if a company engages in a greater number of businesses, that means more and different issues for the board.

Another factor that affects the complexity of decisions is the rate of market and technological change in the company’s businesses. Clearly, a company such as IBM, which not only has multiple

Like firefighters, directors must practice to cope with emergencies and resolve issues.
businesses operating globally but also deals with constant and rapid technological and market changes, faces immense complexity. The task of keeping abreast of those changes is enormous.

Complexity as determined by such factors presents a serious challenge. The more complexity a company faces, the more difficult it is for directors to be effective monitors, because they constantly must be alert to changes, especially ones that are hard to anticipate.

What monitoring involves in a given company will change over time, as conditions change. Directors must have the information they need to focus on the right issues and use their time together productively. The effectiveness of the group is the true source of their empowerment. To understand why, let's consider the sources and limits of outside directors' power.

**The Sources and Limits of Directors’ Power**

In theory, the directors’ mandate to govern a company comes from the laws of the state in which it is incorporated. To the layman, those definitions of the board's role are surprisingly vague and broad. For example, according to Delaware law, “The business and affairs of every corporation organized under this charter shall be managed by or under the direction of a board of directors.” Directors usually delegate the responsibility of operating the company to management. In carrying out their residual responsibility of overseeing management, they are expected to demonstrate care and loyalty (have no conflicts of interest) and to exercise business judgment. Laws defining directors’ powers in other states generally follow those of Delaware.

Of course, these broad duties have been interpreted and refined by court decisions in the individual states and especially in Delaware. In addition, the stock exchanges and the Securities and Exchange Commission have developed rules and regulations that further define directors’ duties. For example, the exchanges require audit committees to be composed of outside directors, and the SEC has prescribed how compensation committees should report top management's pay to shareholders.

While such actions enhance a board's ability to govern, the broader legal framework really does little more than provide a board with legitimacy to govern. Its real power and ability depend on two other sources: the knowledge that directors have and their cohesion as a group. Each source must be considered in relation to the CEO, because a board's real power depends on its relationship with the CEO and with other top executives.

One important factor is that directors are part-timers and the CEO is a full-time employee whose entire career may have been with the company. Not

**Given the experience and ability of directors on most boards, only a stubborn and arrogant CEO would resist a unified board.**

surprisingly, CEOs have knowledge about their companies that directors do not. From the directors' perspective, it is not an exaggeration to say that a primary purpose of board meetings is to learn about the organization from the CEO. Directors may obtain any data they want, but such information must be converted into useful knowledge through the prism of a broader understanding of the company and its markets and operations—information that inevitably must come from management at board meetings. The financial and written data tell only part of the story, and directors usually come to meetings armed with many questions: Why are revenues up or down? What are customers and dealers doing? Why are manufacturing costs declining? What is the status of a new product in a test market? Why are negotiations on a proposed acquisition taking so long?

Superior knowledge about such matters provides even the most well-intentioned CEO with a real power advantage over the outside directors. If we add to this advantage the fact that the CEO usually determines the board’s agenda and leads its meetings, it is clear why CEOs must be convinced of the value of empowered directors. If they resist the idea, they can easily inhibit progress.

Directors, however, have a critical source of power that they can use to their advantage: their solidarity as a group. Given the experience and ability of the directors on most boards, only a stubborn and arrogant CEO would resist a unified board. As we have seen in the past few years, when a united board decides that it's time for a change in corporate direction or leadership, it prevails. Previously, the process of building such consensus may have taken too long because boardroom norms inhibited directors from communicating freely with one an-
Essentially, directors are part-timers and CEOs full-timers whose entire careers may have been with the company.

other. An empowered board, however, can facilitate the necessary dialogue and build solidarity among its members.

What Makes an Empowered Board?

Much has been said and written lately about the characteristics of an empowered board. These characteristics, which are being adopted to varying degrees in different boardrooms, can be summarized as follows:

- Most of the directors come from outside the company and have no other relationship with it.
- The board is small enough to be a cohesive group. Its members understand their common objectives and are willing to dedicate the time to accomplish them. They recognize that their primary obligation is to monitor the company's management and performance, not to manage the company.
- Members represent a range of business and leadership experiences, which are pertinent to understanding the issues the company faces.
- Members communicate freely with one another in both committee meetings and board meetings and outside such settings—with and without management.
- If the CEO is also chair of the board, the outside directors select a leader from among themselves. This person leads their deliberations when they meet without management and works closely with the CEO to plan board activities.

Committees are made up entirely of outside directors. While management is consulted on matters discussed within the committees, they also meet regularly without management.

Members receive information about the company's financial and product-market performance in a format that is intelligible and enables them to understand their company's performance relative to the competition's.

Such characteristics are the foundation on which board empowerment is being built, but the critical and less explored issues are what empowered boards should do differently as they monitor and advise, and how they should carry out their activities without interfering with management's duty and capacity to run the company.

Empowered boards should not interfere with management's capacity to run the company.

Three activities are crucial if the board is to be an effective monitor: ensuring legal and ethical conduct by the corporation's officers and employees; approving the company's strategic direction and evaluating its progress; selecting, evaluating, rewarding, and if necessary removing the CEO, and ensuring that appropriate top-management succession plans are in place.
For years, directors have identified those three activities as their most important responsibilities. The first is the one with the longest history and the one that is accomplished most uniformly across the broad spectrum of U.S. companies. Audit committees made up of outside directors in all public companies ensure that financial reports are accurate, that accounting rules are followed, and that assets are not misappropriated. Many audit committees also review officers’ and employees’ compliance with other rules and standards of conduct. While some boards have failed in handling this responsibility, most notably in some commercial banks and in the savings and loan industry, this is not generally an area that needs substantial improvement.

To monitor effectively, boards must also use their greater power to review and approve corporate strategy and to evaluate CEO performance and succession planning at least annually. A brief review of how most boards have been carrying out those two responsibilities will illustrate why they are the areas requiring the greatest change.

At AT&T, directors and senior officers use strategic retreats for no-holds-barred discussions of changes in their industry.

Traditionally, boards become involved in thinking about strategic direction when they approve specific capital or acquisition proposals. During the past decade, in a growing number of companies, boards have held one- or two-day strategic retreats. While that development is commendable, what happens at the retreats varies considerably. In some companies—for example, General Mills—managers inform directors of their intended strategy either through briefing books provided in advance or through oral presentations made at the retreat. Directors share their reactions and concerns at the retreat or later in private discussions with the CEO. Alternatively—for example, at AT&T—strategic retreats have been used for directors and senior officers to have an open, no-holds-barred discussion of changes in their industry.

While such approaches to involving board members represent an advance over the traditional practice of simply asking them to approve major projects individually, they do not go far enough. What is needed is for more boards to approve explicitly the strategic directions proposed by management and to review progress annually. Today only a few leading-edge boards take that approach.

The practice of evaluating the CEO realistically has also, until recently, been restricted to a few companies. The acknowledged pioneer has been Dayton Hudson Corporation, and its directors and managers have gradually spread the gospel around the Twin Cities and beyond—for example, to companies such as Hannaford Brothers and Medtronic. Outside the Dayton Hudson orbit, a few other companies, such as Alcoa and Stanhome, have also developed explicit CEO reviews. But in most companies, the traditional practice has been a casual conversation between the chair of the compensation committee and the CEO about the latter’s compensation and how it relates to his or her and the company’s performance. More and more companies need a thorough evaluation process if the board’s monitoring is to succeed.

A final aspect of the board’s monitoring work is implementing a schedule of planning and review for the board and management. Such calendars guide meeting agendas in organizations like Dayton Hudson, Medtronic, and Stanhome. The calendars designate specific board meetings for strategic planning and review, for reviewing CEO performance, and for reviewing management succession plans. Not only do such schedules organize and focus the board’s work, but they also emphasize for directors and management alike the interconnectedness of the key facets of the directors’ role as monitors.

Effective Empowerment

While empowered directors have many concerns, they are now focusing much of their attention on CEO performance evaluation and corporate strategy. They hope that by doing a better job on these matters, they will avoid the problems that plagued many major companies in the past decade, when both directors and managers failed to recognize changes in technology and markets that adversely affected their companies.

Evaluating the CEO annually is central to effective monitoring for several reasons. Fundamentally, it is a major step toward empowering the board because it delivers a clear message to both the CEO and the directors that the former is accountable to the latter. It also provides outside directors with an impetus to engage in an open and frank discussion.
about the CEO’s and the company’s performances at least once a year. As a result, they will understand their company and its leader better and will be more effective monitors. A director who has served on two boards that have conducted CEO evaluations says that on most boards without careful CEO reviews, the outside directors don’t have much opportunity to talk to one another. On the two boards with such evaluations, directors don’t necessarily want to criticize the CEO, but they find it useful to converse openly about issues they may not want to bring up in front of the CEO. The director adds that such discussions allow directors to learn more about the organization and provide a forum for addressing concerns.

Finally, an evaluation benefits the CEO personally by directly communicating the directors’ concerns and suggestions for improvement, as well as their praise. If it is done properly, it also allows the CEO to discuss his or her reactions with the directors. All corporate leaders realize that such feedback and dialogue are invaluable but all too rare.

As the list of companies whose boards evaluate the CEO has grown to include Alcoa, Brunswick, General Motors, Honeywell, and the St. Paul Companies, among others, unique approaches to such evaluations have been developed. However, certain criteria are essential to an effective evaluation:

- It should be conducted at least annually.
- It should assess the company’s annual and long-term performance in comparison with that of similar organizations.
- The CEO’s accomplishments should be judged against individual goals as well as against the goals for the company’s performance. The CEO’s individual goals should cover initiatives like starting a major quality-improvement program or making an acquisition. While such goals will vary from year to year, the CEO should continuously plan for top-management succession.
- The CEO should provide an assessment of his or her own performance.
- The outside directors should make their assessments individually. Their judgments should be combined by one director, a committee of directors, or an independent party so that they indicate the general tenor of the directors’ assessments as well as the range of their views. This feedback should be transmitted to the CEO confidentially.
- The CEO should discuss the evaluation face-to-face with one or more outside directors and should have the opportunity to discuss his or her reactions to the review with all the directors.

Once a board and its CEO have implemented such a review, the roles of each party are quite clear. The CEO will set his or her objectives and do a self-appraisal, and the directors will assess and communicate how well they think the CEO is performing. Once the CEO and the board agree that such a process is desirable, there should be little dispute about the division of responsibility between CEOs and directors.

The related question of when and how deeply the board should become involved in strategic matters is less clear and likely to remain more controversial. A long-standing concern of both managers and directors is where to draw the line that separates management and board prerogatives. An outside director at Lukens who was actively involved in developing strategy said there is a fine line between having a director contribute ideas to the company’s strategic direction and having that director try to manage the company. Once a director crosses that line, the board has real problems, because directors should not run the company. The director suggested that in such cases, maybe management should hold back information at board meetings.

Withholding information from the board is certainly not a good solution to the problem, but the question about where to draw the line is important. A senior executive at Lukens was clear about the distinction between directors and managers: "As each side moves closer to the dividing line, the responsibilities of each begin to look the same. But they are not the same, so the line needs to be drawn in such a way to ensure that managers manage and the board approves. You cannot have the whole group managing and approving together."

At a minimum, directors should approve corporate strategy and review and evaluate its results. How involved they should become in specific strategic decisions depends on specific circumstances. For example, at Lukens, the chairman and CEO asked the committee of outside directors to become involved in an acquisition proposal because the de-
Decision was of great importance to the future of the company, whose performance had been lagging. Furthermore, the CEO was new and wanted to be certain that the directors supported the initiative. In such circumstances, it is prudent for directors to become more deeply involved in strategic decisions.

Even in companies that have established CEOs and are performing well, some decisions may be of such magnitude that management seeks or the board desires involvement. For example, at AT&T, the chairman and CEO held a strategic retreat with the board to discuss the impact of wireless communication on the company. The purpose of such informal meetings is for the CEO to get the directors' advice as well as to prepare the directors for a possible major decision. At AT&T, these discussions seem to have prepared the company for the McCaw acquisition more than a year later.

While in both examples, management invited the board's involvement in strategy, the legal responsibility to determine where to draw the line between the board's monitoring and management's development and implementation of strategy belongs to the board. Monitoring will not work if directors and top management have not agreed on their respective roles. One of the tenets of American democracy has always been that the government rules with the consent of the governed. In a different sense, the same must be true as boards become empowered. Corporate leaders, who are the governed, must believe that the means the board has chosen to monitor strategy are reasonable and visible, and do not interfere with management's prerogatives. For that reason, both CEOs and directors must have a means of reviewing and adjusting the line between the board's and management's prerogatives. I shall return to this point, but first let's consider the major factor in how effective directors can be as monitors: the knowledge they need to carry out their activities.

Directors' Knowledge

To contribute effectively to discussions of corporate strategy and to evaluate CEO performance competently, directors obviously need adequate knowledge. Knowledge is the appropriate word here instead of the more frequently used information because the directors' real problem is not lack of information but its content and context. One director says that most boards spend too much time watching presentations when what they really need is to understand the material presented so they can participate more effectively. In the 1989 survey of boards for Pawns or Potentates, the book I co-authored with Elizabeth Macrver, and in subsequent interviews with many directors, very few directors expressed a concern about adequate information. Their real concern was having too much information to digest in the time they had available. Under the U.S. system of governance, outside directors are part-timers. No matter how diligent they want to be, there is a limit to how much time they can devote to a particular board.

Directors receive information in two ways. The first is written reports. Typically, they contain information about the company's financial results as well as about specific proposals to be discussed at a particular meeting. The second is oral presentations by managers; especially important is the CEO's report, which is a central feature of most board meetings. While the specific content may vary from one boardroom to another, the CEO's remarks about the state of the company and events affecting it since the previous meeting are an important source of knowledge for directors.

In general, directors absorbed all those data over many years of service and gradually converted them into knowledge about the company. In many boardrooms of the past, such a gradual approach to building knowledge was adequate. However, in companies faced with long-term decline because of rapidly changing market and technological conditions, this approach proved inadequate. Directors were no more aware of the significance of external events than were top-level managers. One reason for the myopia may have been that managers were the providers of information to the board. But another may have been that directors are long on financial knowledge and short on knowledge about changing markets and technology. It is not that management willfully withheld information about products and markets but that, traditionally, such data were not judged to be within the board's purview.

If boards are to be effective in evaluating the CEO and approving corporate strategy, they need to develop knowledge not only about the company's financial results, which are an indication of past per-
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formance, but also about the company's progress in accomplishing its strategy. That means understanding progress in developing new technology and new products and services, and in entering new markets. It means understanding changing customer requirements and what competitors are doing. Similarly, directors need the data to build knowledge about the organizational health of the company. In essence, they need their own version of the "balanced scorecard," which Robert S. Kaplan and David P. Norton recommend for managers in "Putting the Balanced Scorecard to Work" (HBR, September-October 1993).

As in other aspects of a board's work, directors and managers must decide what mix of knowledge is appropriate to the company's circumstances. Again, there are certain minimal requirements. The data must be balanced between financial and strategic issues and focused on future prospects as well as past performance. Information must be grounded in strategic objectives and competitive demands, and it must paint a broad picture of the conditions the company is facing. The data should also shed light on the CEO's progress toward achieving his or her individual goals.

The challenge for directors is to take what may be a greater quantity and a broader array of information and turn it into useful knowledge quickly. Some boards, such as Monsanto Company's, deal with this challenge by increasing the capital limits of projects requiring board approval, thus freeing up time to devote to broader strategic issues.

Another practice followed by Monsanto's and Alcoa's boards is to ask directors periodically for their assessment of the information they receive. This practice encourages directors to provide one another and management with an explicit review of information and discourages the company from sup-

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plying the same types of data because "we have always done it that way." Another solution to the problem of more information is to ensure that data are organized efficiently and provide a concise but comprehensive overview of the company's strategic progress. Data should be sent to the directors in advance so they can study them, formulate questions, and identify issues they would like to dis-

cuss at board meetings. Directors should have the option of meeting alone to develop their collective understanding of the company's situation and to decide which questions and issues they want to discuss with management. A growing number of boards—for example, Alcoa's, General Motors', and Medtronic's—are now doing that.

Such steps should enable directors to keep up with events in a rapidly changing world so they can make informed approvals of specific strategic issues and in-depth judgments about the CEO's accomplishments and goals. Those steps are essential to the board's role as an effective monitor.

Self-Monitoring

In this dynamic world, no set of board activities is likely to constitute effective monitoring for very long. Conditions facing the company will change, as will the membership of the board. The inevitability of change and the fact that even the most talented and well-motivated directors and managers will find that their best-laid plans do not always work mean that an empowered board must periodically monitor its own performance. Boards at AlliedSignal, General Motors, Honeywell, Medtronic, and Texaco already monitor themselves. At some companies, such as Medtronic, the outside directors use an annual questionnaire to solicit opinions from themselves and from managers, and then review the results of the survey to find opportunities for improvement. At other companies, directors simply devote part of a meeting, usually annually, to a discussion of how well the board has been conducting its affairs and how its performance can be improved.

The idea of the entire board's reviewing its own activities annually is sound because it enables all directors, both insiders and outsiders, to contribute their ideas for improvement and thus be committed to any changes in process. Regardless of the specific process used, how well a board is conducting its duties must be assessed in light of the conditions the directors are confronting: What is their relationship with the CEO, and how much confidence do they have in him or her? How well has the company been performing? How complex are the issues facing the directors?

In the context of the circumstances, directors need to assess how well they are understanding and monitoring the company's strategy. How well is the process of CEO evaluation working? How effective-
ly do the directors use their time together? How well are board committees functioning? Are directors getting the appropriate information, and is it well organized? Those are some of the major concerns that should be addressed to make boards more effective monitors.

The review of procedures will be conducted most efficiently if the directors have designed in advance an explicit set of principles about how they intend to function as a board, as General Motors' board did in the company's 1994 guidelines. Creating such guidelines, while time consuming, causes directors to reason together about what changes they may want to make. Once such principles have been established, they also provide directors with a clear framework against which to judge their performance. In addition to reviewing their processes and procedures, a few boards are conducting explicit reviews of individual directors. For example, AlliedSignal has established a process whereby individual directors are reviewed at the time of their renomination.

This suggests that while the full board can be involved in both aspects of evaluation, the board's committees can also play a role in monitoring the board's work. The compensation committee can focus on the CEO review process. The audit committee, already familiar with the company's information system, is an ideal group to monitor and improve the information directors are receiving. The nominating committee, in addition to evaluating individual directors, can orchestrate the annual review of the board's activities by the full board. Each committee thus makes a unique contribution to the board's oversight of its own functioning.

In the past decade, employee empowerment has improved productivity and quality, allowing many U.S. companies to be more competitive in the global marketplace. Empowering directors will enable them and their organizations to deal more successfully with the turbulence and demands of the future. U.S. companies today face more challenges and uncertainty than at any time since the end of World War II. The continuing growth of the world's marketplace, with customers and competition in Asia, Eastern Europe, and South America, as well as the shift in the domestic economy caused by the decline in defense spending and changes in the health care system, among other factors, present U.S. companies with unprecedented challenges and opportunities. Empowered boards are most likely to contribute to meeting them if their growing power is developed in collaboration with that of the managers they oversee. That means both groups must work together to establish and understand the role of empowered directors.

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