

The Board Perspective

A collection of McKinsey insights focusing on boards of directors

Number 2, March 2018



McKinsey Board Services supports CEOs and boards of directors to improve board effectiveness and unleash the value-creation potential from good corporate governance. Our solutions are tailored, integrated, and supported by deep industry, functional, and board expertise.

The Board Perspective is a publication written by board experts and practitioners at McKinsey as well as McKinsey affiliates.

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Introduction

Welcome to the second edition of *The Board Perspective: A collection of McKinsey insights focusing on boards of directors*.

Expectations placed on boards continue to expand, with topics such as cybersecurity, talent and culture, and geopolitical risks increasingly requiring directors' attention. Prioritizing where to invest time in order to maximize the value the board delivers to the company's strategic priorities is a perennial struggle.

Over the past two years, we have focused our research on how major trends affect the role of the board of directors, including the push for more diversity in the boardroom, the increasing role of activist investors, and the challenge of dealing with rapid technology shifts.

This year's compendium presents a selection of recent insights from McKinsey experts and board practitioners. The research draws on interviews with successful chairs, global surveys of board directors, our work with boards around the globe, and the deep experience of our subject-matter experts.

We have organized the contents into three sections:

- **The role of the board:** Which activities should the board engage in, and how?
- **Board structure and foundations:** What mix of capabilities and experiences do you need to deliver on the increasing expectations from stakeholders?
- **Board effectiveness:** How can you increase the overall impact of your board?

The compendium is a selection of perspectives, not a comprehensive analysis of what it takes to develop an effective board of directors. We would, however, welcome your input on what this would require.

We hope you enjoy this compendium, that you find the insights useful, and that they trigger interesting discussions on further enhancing the value of your board.

Please direct comments or questions to us or any of the authors at McKinsey_Board_Services@McKinsey.com.

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THE ROLE OF THE BOARD

A close-up, low-angle shot of a person's hand holding a microphone. The hand is in the foreground, holding the microphone horizontally. The background is blurred, showing a stage or event with warm lighting and a blue screen. The overall mood is professional and focused.

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How activist investors are transforming the role of public-company boards

Collaboration between activists and traditional asset managers is changing the boardroom. Here's how.

David R. Beatty

Like it or not, hedge-fund activism has become a characteristic of the corporate landscape. In 2015 alone, activists made public demands of some 637 companies worldwide.¹ In 2016, they'd already made demands of 625 companies by the end of October.² And these are just the campaigns that are made public: there are probably at least as many that are never covered by the press because of a quiet settlement between the activist and the target company's board.

What constitutes an activist and the definition of embedded funds does vary. But combined, there appear to be around 550 "active activists" around the globe,³ controlling more than \$180 billion in embedded capital—up from \$51 billion in 2011.⁴ Most are centered in the United States, but new firms have also sprouted up in Australia, Canada, Europe, and Hong Kong. And to magnify their clout, they are increasingly attracting the interest of asset and

pension-fund managers and collaborating in transformative campaigns.⁵ Working together, they could mobilize trillions of dollars to challenge the strategies and performance of publicly traded companies.

Whether you see hedge-fund activists as a catalyst for beneficial changes in governance and strategy or short-term opportunists detrimental to long-term value creation, this much is clear: the growing influence of activists on global capital markets will fundamentally transform how public-company boards interact with investors. This includes the role of the board in investor relations, the importance of outside voices, and more transparent relationships between directors and company managers.

Boards must now be directly involved in investor relations

All medium and large public companies have investor-relations (IR) departments that report

regularly to the board about shareholding levels and shareholder concerns. But traditionally, few, if any, directors would actually visit a shareholder to discern his or her view. Most boards would meet with their largest and most interested shareholders at the annual general meeting. But beyond that, reports from IR were more than likely deemed sufficient to understand the views of investors. Even now, some companies still have explicit policies that preclude directors from communicating with investors.

Today, as a direct consequence of shareholder activism, boards and executives frequently review lists of the largest shareholders in order of percentage of holdings. They then decide on a consultation strategy that may well include a visit from an independent director without any management being present. Mary Jo White, the current chair of the US Securities and Exchange Commission, has even publicly stated that shareholder relations are now a board duty: “The board of directors is—or ought to be—a central player in shareholder engagement.”⁶

Public examples abound. Among companies, Andy Bryant, the independent chair of the board at Intel, meets with four of the company’s largest shareholders each quarter. Sometimes CEO Brian Krzanich or other senior managers are present, and sometimes other independent directors join in. Among asset managers, Larry Fink, CEO of BlackRock (with an estimated \$5.1 trillion in assets under management), wrote an April 2015 letter to all S&P 500 CEOs, urging them to have “consistent and sustained engagement” with their shareholders.⁷ And Bill McNabb, CEO of Vanguard Group (with an estimated \$3.5 trillion in assets under management), has encouraged boards to promote communication with shareholders through, for example, a new “shareholder liaison committee” or other structures.⁸ The board of Tempur Sealy International has now created a Stockholder Liaison

Committee.⁹ A new industry of advisory organizations has already sprung up to help boards cope with these new shareholder-relations responsibilities.

Corporate strategy must consider alternate perspectives

In most, if not all, corporations, senior managers lead an annual strategy meeting to examine where the company is headed with respect to its competitive context. Typically, these are two- or three-day occasions, held off-site, with the agendas carefully planned to maximize the likelihood of developing a coherent and insightful strategic plan.

In fact, according to a recent McKinsey survey,¹⁰ boards have significantly increased the time they spend on strategy. This is not surprising given the ever-increasing complexity of the global and digital world we live in. Corporate strategy is tougher to hone and of shorter duration than ever before. An increasing number of companies now insist that strategy be on the agenda of each and every board meeting, so that the directors can be assured that they are investing their time in the most important function: helping to figure out and navigate the way ahead.

When it comes to the traditional off-site, there is a real chance to go back to the basic roots of company competitiveness and to reexamine assumptions and past approaches. This is almost always led by the C-suite team, but it can include external speakers with specific company knowledge. If you, as a director thinking about the next strategic review, were reasonably certain that activists were closely examining your company, why not actively invite their insights?

Given current norms and expectations, asking activists to report their view of alternate corporate strategies to the board may be awkward, or even threatening. But failure to understand alternate strategies to maximize corporate

performance might well lead to an open proxy fight. To look at the matter in a less threatening way, instead of having to spend millions on a consulting review, you could get one for free from would-be activist investors.

Board relationships with management must become more transparent

Relationships between a company's directors and its CEO and C-suite executives depend upon many things, especially the trust between the chair (or lead director) and the CEO. These relationships have always evolved over time, as companies progressed or failed to progress and as CEOs grew into their positions. But the basic operating norm in the past would be to let the managers get on with running the business and fundamentally trust in their strategy for doing so.

Today, the presence of activists in the market have further transformed these relationships. Questions about performance and strategy have never been absent from board meetings, but with this level of activist interest, they are now always front and center. Directors—who are fundamentally dependent on management for information and data—must constantly be aware that activists and institutional investors are also closely examining their performance. And boards that don't understand alternative points of view on corporate strategy or bring them to the top management team for consideration can never be fully confident that the management's view of the world is the right one. The

outcome can be bitter. Failure to find out who is interested in your company and who might have a different twist on the strategy can quickly lead to damaging hostilities that could be lethal to the company, its employees, and its customers.

One meaningful step toward greater transparency internally would be to appoint CFOs to companies' boards of directors. As directors, they could be charged with discerning where activist investors are proposing different approaches—and with purposefully representing any alternate asset-deployment strategies. Since CFOs don't "own" capital investments the way operating executives and the CEO might, they can afford to be dispassionate third-party evaluators of investment flows and alternate investment strategies. This is a long-standing practice in the United Kingdom, recognizing the CFO's knowledge of a company's assets, the returns on those assets, and often a profound viewpoint on the likelihood of a performance improvement.



Activist funds allied with asset and pension-fund managers have transformed the landscape of shareholder involvement. By embracing the three principles outlined above, directors will be better prepared for what's ahead. ■

Questions about performance and strategy have never been absent from board meetings, but with this level of activist interest, they are now always front and center.

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- ¹ *Activist Insight Monthly: Half-year review*, a joint report from Activist Insight and Olshan Frome Wolosky, July 2016, Volume 5, Issue 6, activistinsight.com.
- ² "Big is over," *Activist Insight Monthly*, November 2016, Volume 5, Issue 10.
- ³ Ibid.
- ⁴ *The activist revolution*, JPMorgan Chase, January 2015, jpmorgan.com.
- ⁵ David Benoit and Kirsten Grind, "Activist investors' secret ally: Big mutual funds," *Wall Street Journal*, August 9, 2015, wsj.com.
- ⁶ Remarks at the 10th annual Transatlantic Corporate Governance Dialogue, speech by chair Mary Jo White, US Securities and Exchange Commission, December 3, 2013, sec.gov.
- ⁷ *BlackRock Blog* and *Business Insider*, "BlackRock CEO Larry Fink tells the world's biggest business leaders to stop worrying about short-term results," blog entry by Larry Fink, April 14, 2015, businessinsider.com.
- ⁸ F. William McNabb III, Vanguard proxy voting CEO letter, February 27, 2015, about.vanguard.com.
- ⁹ "Tempur Sealy announces leadership and board changes," Tempur Sealy press release, May 11, 2015, tempursealy.com.
- ¹⁰ "Toward a value-creating board," February 2016, McKinsey.com.

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How CFOs can better support board directors—and vice versa

Governing boards face increasing pressure and greater scrutiny from investors. Here is how CFOs can reinforce their stewardship.

Frithjof Lund, Justin Sanders, and Ishaan Seth

Has there ever been a time when boards of directors were more in need of the sharp, fact-based counsel of a value-savvy CFO? With market forces intensifying, technology creating broad-scale digital disruption, and systemic threats looming in the form of cyber and geopolitical shifts, even the best-positioned board directors can benefit from a strong relationship with the head of finance. That is even truer for directors selected more for their industry, product, or technical expertise, for example, than their financial acumen.

Fortunately, CFOs at most large companies are more than up to the task and go well beyond the traditional role of helping boards ensure regulatory compliance. Yet we still see CFOs—typically those who are new to the role—who are unpracticed at engaging their board directors effectively. While our experience in the United States is the primary basis for this finding, the differences between com-

panies in any given country can be just as substantial as the differences between countries. It all comes down to the individual CFO, CEO, and board.

Regardless of where they sit, many CFOs should spend more time helping board directors understand a company's strategy and defining value creation in the context of both the financial outcomes of the past and forecasts of future performance. The lessons go both ways: CFOs can benefit from effective relationships with board directors—particularly with the chair of the audit committee, who can share external perspectives and act as a thought leader and sparring partner. CFOs should be more assertive in anticipating questions from the board and providing the needed information to connect data to strategic and operating decisions. And CFOs should more actively collaborate with the CEO and other executives to present a unified perspective to the board. As our research suggests, improved

board effectiveness can also result in better financial performance (see sidebar, “Understanding the link between board effectiveness and financial performance”).

Define value creation in context

The traditional role of the CFO is to go through the results with the board, explain what happened, and look at the variances versus the prior period. It takes a very historical view on what the company just did, which in and of itself does not add a lot of insight with respect to potential future value creation. This inward-looking view focuses on the company and its results without comparisons to the market and how peers and competitors are performing, and it does not help the board understand what is good or bad. A board might celebrate organically growing 8 percent in a given year, for example, and then watch in dismay as the share price drops because the company’s peers all grew at 20 percent.

The biggest opportunity for a CFO’s relationship with the board often hinges on being able to put together an objective view on what a business’s performance has been, how it compares with the market and other businesses in a company’s portfolio, and what the board should expect of future performance. The CFO’s input is especially important for creating clarity on resource allocation to higher-growth businesses within the portfolio, the value potential of increasing the drive toward digital transformation, the value from M&A (and other big-ticket investments), and the impact of broad-based performance transformations.

That input need not reflect the most-sophisticated analyses. In some cases, qualitative observations can suffice. Often, CFOs have the best read on what investors care about and should therefore influence how companies frame, measure, and communicate their value-creation plans. CFOs spend more time than most other executives on investor

road shows and facing questions from analysts, and they know which issues can complicate or derail an investor story. They have also seen firsthand which metrics resonate best with investors and how investors will react. For example, after meeting with multiple investors, the CFO at one financial-services company realized that the market was demanding a different way of dealing with and reporting on the company’s major investments in growth. As the CFO discussed this dynamic with the board, they all recognized they had communicated up-front investments in growth in a manner that appeared more like separate, one-off restructuring charges. This board-level engagement by the CFO helped push the company to separate its communication of growth investments from cost-focused restructuring charges. More important, the dialogue helped the board better appreciate that the nature of the company’s growth objectives would require material investment in data architecture, analytics, and automation.

In other cases, strategic assessment of a company’s performance relative to peers can be helpful, whether it involves simple metrics such as share-price performance or more-nuanced metrics such as organic growth or margin expansion. Those types of contextual insights—the result of close collaboration with the rest of the executive team—can tee up the questions that the board needs to ask regarding value creation and strategy. They can help board directors understand the areas they should watch to reveal the company’s potential advantages or weak spots. The impact can be striking.

Consider, for example, how the CFO of a natural-resources company helped the board understand its returns relative to peers. The overall benchmarks were all similar-size companies but lacked specifics on the individual businesses with different exposures to energy and commodity cycles. Without that detail, board directors were concerned that the company’s performance had been relatively

Understanding the link between board effectiveness and financial performance

Findings from McKinsey's global board survey point to benefits from good dynamics between directors and C-suite executives.

It has always been one of the more tantalizing questions in corporate governance: What effect does the board of directors have on financial performance? In a survey of more than 1,100 directors,¹ we attempted to test the link between the quality of board operations and boards' effectiveness at core activities with self-reported financial performance relative to peers.²

We considered three core variables of board operations: dynamics within the board, dynamics between directors and C-suite executives, and board processes. The results suggest that boards with better overall operations, as well as those that execute core activities more effectively, report stronger financial performance at the companies they serve.

For instance, at boards with top-quartile operations, 59 percent of directors report financial outperformance relative to their industry peers—compared with 43 percent who say the same at bottom-quartile boards.³ Further, the bottom-quartile directors are nearly twice as likely to report weaker relative financial performance. According to the results, the operational practices that contribute most to outperformance are when the board has a long-term succession plan for itself, sufficient induction training for new directors, and an appropriate mix of skills and backgrounds.

The results suggest an equally strong connection between directors' effectiveness at core board activities and financial performance relative to peers: nearly 60 percent of directors at boards in the top-quartile for effectiveness say their respective organizations have significantly outperformed peers. In contrast, just 32 percent of those at the bottom-quartile boards say the same. Among the activities linked most closely with outperformance are setting a comprehensive strategy framework for the organization, assessing management's understanding of value creation in the organization and the industry, and debating strategic alternatives within the board and with the CEO.⁴

These findings emerge at a time when, across the corporate landscape, board responsibilities are growing. Directors are expected to go beyond traditional oversight and get involved with critical issues such as strategy, digitization, talent and succession planning, and risk.⁵ CFOs, CEOs, and other C-suite leaders have a big role to play in ensuring that directors can manage these growing expectations. They could, for instance, support induction training programs by supplying relevant insights and materials that new directors can use to acquire a foundational understanding of the organization and the industry. Additionally, they

could engage in regular, formal dialogues with board directors. By preparing concise reports on key issues and establishing clear operational processes with the board, CFOs and other executives in the C-suite can help directors meet their oversight responsibilities and create greater value for their organizations.

The contributors to the development and analysis of the survey include **Martin Hirt**, a senior partner in McKinsey's Taipei office; **Frithjof Lund**, a partner in the Oslo office; and **Nina Spielmann**, a specialist in the Zurich office.

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- ¹ The online survey was in the field from April 18 to April 28, 2017, and garnered responses from 1,126 board directors representing the full range of regions, industries, company sizes, and board roles; 31 percent of respondents are either board chairs or lead independent directors, and we asked respondents to answer all questions with respect to the single board with which they are most familiar. We excluded responses from directors on not-for-profit boards, since the financial-performance results are more relevant to private-sector boards. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.
- ² Financial performance is measured as self-reported organic revenue growth, profitability, and change in market share relative to industry peers in the past three years. To control for potential biases (for example, board chairs tending to report better financial performance than other respondents do), we defined two control variables: the respondent's job title and his or her role on the board—for example chair, vice chair, or lead independent director. Before running the financial-performance analysis, we confirmed that the best- and worst-performing companies have an equal distribution of job titles and board roles across all quartiles. The outperformers are those companies that, according to respondents, reported to perform on average across all three reported performance measures—profitability, organic revenue growth, and growth in market share—higher or much higher than their industry peers in the past three years.
- ³ With respect to dynamics and processes, the “top-quartile boards” are those where respondents agree with eight or more of the 14 statements we asked about, and respondents at the “bottom-quartile boards” agree with only three or fewer.
- ⁴ The survey asked about 42 different board activities related to strategy, performance management, investments and M&A, risk management, shareholder and stakeholder management, and organizational structure, culture, and talent management. With respect to board activities, the “top-quartile boards” are those where respondents are effective or very effective at 26 or more of the 42 activities we asked about, and respondents at the “bottom-quartile boards” are effective or very effective at 13 or fewer activities.
- ⁵ “The CEO guide to boards,” *McKinsey Quarterly*, September 2016, McKinsey.com.

poor. Coordinating with the CEO, the CFO reminded the board that an underperforming business in the down side of a cycle will also benefit when the market recovers. Instead of presenting a current snapshot of performance, he led board directors in a discussion about what performance in two years might look like—and provided a set of historical financial analyses to gauge how much of the company's future returns would likely come from a recovery. The dialogue changed the board's focus from a question of whether the company should restructure or shut down to one defined by performance: given a certain measure of performance, when should they start investing again to make the most of the market's recovery?

That example is not the CFO presenting a business case for operational restructuring or recommending specific strategic actions. It is a case of the CFO going beyond pure financial reporting to put the company's performance in the context of its strategic direction and peers with the right level of detail so that board directors could see for themselves what they needed to do.

Proactively engage with the board

The more CFOs engage with boards, the better they can anticipate boards' questions—and the better they can keep boards informed ahead of potential surprises. CFOs can also expect to receive valuable support and advice in return. These relationships

are most effective when CFOs have active roles in making presentations in every board meeting and are present for most of the discussion. Such involvement allows a CFO to understand board dynamics (and therefore engage more productively with board directors), answer follow-up questions, and track the context from prior meetings. This practice, of course, also requires the CEO to be open to the CFO's more inclusive participation.

When the board of a multi-industrial business was weighing its acquisition priorities, for example, the discussion eventually came back to a question of how the company created the most value. Would the company do better to trade off assets through M&A deals or grow its business organically? Having joined that board meeting, the CFO was better able to follow up in subsequent board meetings by adding several analyses to his reports to the board. Those included an overview of the company's organic growth relevant to its markets, some pre- and post-acquisition data on some of its businesses, and highlights of the company's strengths and weaknesses with respect to organic growth.

That input led the board into a more nuanced discussion. Instead of an "either/or" focus on dealmaking or organic growth, it considered the businesses in which it would or would not want to pursue acquisitions, whether the company had established the right assets and capabilities to

execute those acquisitions, and whether it should pursue certain operational priorities before jumping into an active set of acquisition choices.

The importance of proactive behavior in a CFO's board interactions spans industries. The mechanisms for capital reallocation at banks or other financial institutions do look different from those at an industrial company. But a CFO's role looks nearly identical when it comes to identifying where to shift resources to create more value. In one instance, the CFO of a financial-services company observed that the company had allocated so much capital to high-priority growth areas that it had underinvested in lower-growth businesses with higher, faster returns. That is the same growth-versus-returns dilemma that industrial companies face and leads to the same predictably lower returns. Proactively raising the issue with the board enabled the company to adjust its capital-allocation rules and make relatively small adjustments that would improve returns without sacrificing new growth opportunities.

Manage board interactions as a team

Taking a more proactive role is not something a CFO can do alone; the CEO formally governs the CFO's relationship with the board. As head of the management team, CEOs are in the best position to judge how—and how often—their senior managers interact with boards. In our experience, reshap-

Managing interactions between the senior-management team and the board is generally most effective when it is some form of team effort.

ing the interaction typically happens only when a new CEO either redefines the current CFO's role or brings on a new CFO explicitly tasked with developing a refreshed level of engagement with the board.

From there, managing interactions between the senior-management team and the board is generally most effective when it is some form of team effort. The CEO, often in consultation with the board chair, leads the effort. But the CEO's success comes not just from knowing the facts and sharing perspectives but also from understanding the questions on board directors' minds, the context in which they are asking those questions, their own personal histories as board directors and executives, and the interactions between board directors. Who among the directors in the room will ask questions? Who will hold back? Who will be the doubters? And who will be open to providing support and advice to the CFO?

As a trusted source of facts and data as well as a strategic adviser, often alongside a chief of strategy or operations, the CFO is usually a lieutenant to the CEO in making successful board interactions happen. The team's efforts can allow the CEO to focus more mental energy on managing the discussion, understanding the way the board engages, and ensuring that the board is heading to the right outcome.

At a minimum, CFOs should think of their role as improving the way boards and senior management teams work together by identifying, surfacing, and answering questions about different decisions well in advance of the formal meetings during which votes will occur. That effort helps avoid putting board directors on the spot and asking them to vote with limited information. It also helps ensure that if there are points of contention, there are facts on the table when boards engage in a formal setting.

A CFO should be especially mindful of his or her relationship with the audit committee chair. Audit committee chairs are often the board's biggest advocates for value creation, cash protection, and the board's fiduciary responsibility. Here, too, the relationship varies from company to company. But the one constant is that the audit committee chair is typically very engaged and often asks questions regarding value creation, the company's use of cash, payments back to shareholders, and the investors' perspectives.

The CFO's relationship with the audit committee chair can also be an important driver of talent development and succession planning. For instance, the CFO and audit committee chair may schedule private sessions to identify strong candidates for senior finance positions. We have seen several instances in which the audit committee chair has offered coaching and mentoring to members of the finance team—particularly those in line for the CFO role. These high-potentials may be invited to audit committee meetings to make presentations on special projects and initiatives, giving them some exposure to board directors. We have also seen CFOs invite audit committee chairs to meetings of the finance function to help inform important discussions—for instance, changes required as a result of new accounting standards.

The way that CFOs should communicate with audit committee chairs will depend on the governance within a given board. In some situations, it might be most effective to establish a continuous dialogue between the CFO and the audit committee chair so they can jointly prepare for board meetings: the audit committee chair would have ample opportunity to review the issues at hand and provide relevant information ahead of full board discussions. Indeed, the audit committee chair can serve as a powerful ally for the CFO—holding board directors to task on financial discussions, translating complex concepts for the group, and reinforcing

points that the CFO had previously been unable to make on his own.



As demands on board directors grow, CFOs will be increasingly important as resources to support them. Our experience suggests that the CFOs who can define value creation in context and proactively anticipate boards' needs will excel. Those CFOs can also accelerate their own development by working more closely with board directors and taking in their insights and experiences. Defining their relationships with the board in the context of the rest of senior management is critical. ■

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Are you prepared for a corporate crisis?

No one can predict when disaster will strike—but knowing what to expect if it does will buy precious time.

Sanjay Kalavar, Detlev Mohr, and Mihir Mysore

Imagine yourself as a top executive in a company hit by a major crisis within the last 72 hours. First, and most importantly, there may have been serious damage to the community in which you operate. Your customers may have suffered, people's livelihoods destroyed. The environment may be irretrievably damaged. Some of your employees and contractors may be injured, or worse. Your investors will be livid, and the board looking to assign blame. By the end of the first week, chances are your organization will be facing dozens of lawsuits, some set to become class actions over time.

Very likely, at this early stage, you will realize that verifiable facts are few and far between. Opinions and rumors abound. You will have little or no idea of the extent of any physical or financial damage or the extent to which the organization was complicit in the event. You don't even know which of your top team members you can count on. Some of them may be implicated; others may be operationally inexperienced, unfamiliar with the political

realities, or temperamentally unsuited to the new situation—filled with good intentions but uncertain what role to play.

The crisis will be manna from heaven for your organization's natural antagonists, who will seek to take advantage of your misfortune. Competitors will try to lure customers and poach employees. Activist investors may plot a takeover. Hackers may target your systems. The media will dig up every past error the company may have made.

Much of the anger, by the way, is directed at you. And it's personal. Parody Twitter accounts may appear in your name, trashing your reputation. Your family may be targeted online. Reporters may be camping outside your home at odd hours of the day and night.

In the middle of all this chaos, what exactly do you do? Do you hold a press conference? If so, what do you say when you have so few facts? Do you admit wrongdoing, or do you say that what happened is not the fault of the company? Do you point to the cap

on your legal liability, or do you promise to make everything right, no matter the cost? What do you tell regulators that are themselves under pressure, and demanding explanations?

The issues just described are not hypothetical. They are all real examples of experiences that organizational leaders we know have faced in multiple crises in recent years. What’s really troubling is that these experiences are now far more frequent, and far more devastating, than they have been in the past.

Every crisis has its own unique character, rooted in specific organizational, regulatory, legal, and business realities. But after helping around 150 companies cope with a range of corporate

disasters, we have seen some clear patterns. These can teach companies some simple best practices they can follow to prepare for a better response, in case the worst happens.

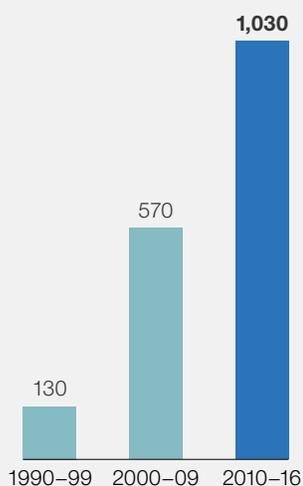
The threat is growing

Many incidents inside companies never hit the headlines, but recent evidence suggests that more are turning into full-blown corporate crises (exhibit). The total amount paid out by corporations on account of US regulatory infractions has grown by over five times, to almost \$60 billion per year, from 2010 to 2015. Globally, this number is in excess of \$100 billion. Between 2010 and 2017, headlines with the word “crisis” and the name of one of the top 100 companies as listed by Forbes appeared 80 percent

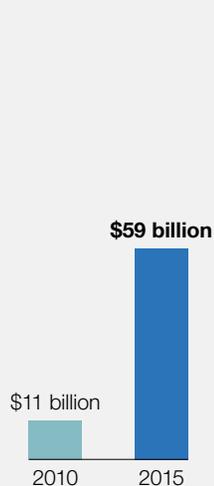
Exhibit

Many company incidents remain hidden—but recent evidence suggests that more are turning into full-blown corporate crises.

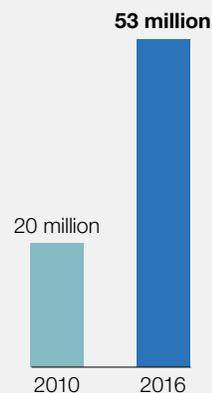
Average number of headlines signaling corporate reputation risk¹



Major penalties² paid by corporations for US regulatory infractions



Recalled vehicles in US auto industry



¹ Reflects headlines with word “crisis” and name of one of top 100 companies in 2015 Forbes Global 2000 list.

² Major penalties defined as those exceeding \$20 million.

Source: Factiva; National Highway Traffic Safety Administration; goodjobsfirst.org/violation-tracker

more often than in the previous decade.¹ Most industries have had their casualties. For instance, the US auto industry recalled a total of around 53 million vehicles in 2016, up from about 20 million in 2010, while the US Food and Drug Administration sent out nearly 15,000 warning letters to non-compliant organizations in 2016, up from just north of 1,700 in 2011.

Why is this a bigger problem now than it has been in the past? First is the growing complexity of products and organizations. A new pickup truck today includes computer controls programmed with more than 150 million lines of computer code, while the average deepwater well is the height of seven Eiffel Towers. Goods travel thousands of miles and move through supply chains that comprise multiple intermediaries and multiple jurisdictions. A second reason for the significance of the problem is a higher level of stakeholder expectations. Customers, often in response to messages on social media, are more willing to sue or shun a company they believe is unethical. Governments are more willing to seek redress from companies they believe are breaking the law, and shareholder activism is on the rise. Third, the changing social contract is driving anxieties and mistrust in institutions, making irreversible knee-jerk reactions more likely. Finally, the raw speed of business operations—from rapid communications to shorter product-development timelines—makes crises more likely.

Understandably, companies spend more time trying to prevent crises than preparing for them. However, crisis readiness has become at least as important as risk management, takeover readiness, and vigilance over safety.

Underpreparedness has consequences and helps explain why companies engulfed by a large crisis initially underestimate the ultimate cost by five to ten times.² Senior executives are frequently shocked by how quickly a problem can turn from

a minor nuisance into an event that consumes and defines the company for years to come.

Five parallel paths to resolution

In our experience, it helps to think of a crisis in terms of “primary threats” (the interrelated legal, technical, operational, and financial challenges that form the core of the crisis) and “secondary threats” (reactions by key stakeholders to primary threats). Ultimately, the organization will not begin its recovery until the primary threats are addressed, but addressing the secondary threats early on will help the organization buy time.

When a crisis hits (or is about to hit), one of the first actions should be to create a cross-functional team to construct a detailed scenario of the main primary and secondary threats, allowing the company to form early judgments about which path the crisis may travel. This helps the organization set out major decisions it needs to make quickly and is the first step toward wresting back control—improving the headlines of tomorrow, rather than merely reacting to the headlines of today.

While it is rare to get everything right at this stage, it is equally rare to get most of the second-order effects wrong. People are innately overoptimistic, of course, as we know from work on cognitive biases, but even being half right about how things will unfold is valuable at this early stage. It will provide a strong basis for tackling the five broad issues we see as critical to the outcome of a crisis: controlling the organization, stabilizing stakeholders, resolving the immediate primary threats, repairing the root causes of the crisis, and restoring the organization over time. While all five need to be started early, they will likely require different levels of emphasis at different stages.

Control the organization

Normal rules for how the organization operates get torn up quickly in a crisis. Informal networks

Are you prepared for the worst?

Twenty-five questions executives should ask themselves now

Understanding threats

- What are the organization's top ten risks and, relative to these, what are the top five "black swan" threats that could destabilize the organization?
- For each black-swan threat, how might the crisis evolve, including second-order effects by stakeholders and assessments of maximum exposure?

Organization and leadership

- What will the crisis organization look like for each threat (in particular, is there a crisis-response leader with the right temperament, values, experience, and reputation), and when will that organization be activated?
- What will be your organization's governing values and guiding principles if any of the black swans hit?
- Have you defined the blueprint for a central crisis nerve center staffed by top executives, with division of roles?
- Do you have a crisis governance structure that involves the board, drives decision making, and isolates the rest of the business?
- Do you have a succession plan in case some of your mission-critical leaders need to step down because of the crisis?

Stakeholder stabilization

- Have you defined key stakeholders, including competitors and influencers, and tested how they might act in a crisis?
- Have you invested in understanding and establishing relationships with regulators and government stakeholders?
- Do you have a plan to protect employees and reduce attrition of your most talented employees?
- Have you established the portfolio of actions to stabilize stakeholders in the event of each scenario, beyond public relations?

Operational and technical

- Which critical operations can keep going, and which ones may need to slow or stop?
- Is there a blueprint for an operational or technical war room staffed with the right team and adequate peer review?
- Have you defined ways to monitor and reduce cyberthreats, including dark web scans, during a crisis?

Investigation and governance

- How will you scope an investigation, and what level of transparency might you need to provide?
- Do you have a set of options for large governance changes you may need to make after a crisis?

Marketing, brand, and communications

- Have you established a basic communications process, tools, roles, and plan to drive key messages with stakeholders?
- Have you thought how to protect your brand during the crisis and help it recover afterward?

Financial and liquidity

- Are there financial protocols to provide crisis funding, protect liquidity, and maintain the business?
- Have you defined the broad scope of root-cause investigations and how they will be governed?

Legal, third party, and other

- Does the crisis team have a working knowledge of relevant legal provisions, case law, and protocols?
- Have you preidentified battle-tested third parties, such as law firms, crisis communications firms, coordination, and business decision making?
- Do you have a sense, based on case law, what the overall legal pathways may be to resolve the black-swan event?
- Have you identified critical suppliers and considered how existing terms and conditions will affect you adversely in a crisis?

Readiness

- Have you rehearsed and critiqued all of your biggest crisis scenarios at least once in the past 12 months and implemented improvements to processes or other changes arising from these exercises?

founded on trust and the calling in of favors can dominate over formal organizational reporting structures. Those previously opposed to the status quo can quickly become vocal, sparking a turf war and delaying action. Some key executives may themselves be implicated and unable to lead the response. Managers may start executing an uncoordinated set of actions with the best of intentions but incomplete or inaccurate information. No longer able to build consensus, they end up with unwieldy organizational structures that have dozens of decision makers around a table, with the result that the effort becomes dispersed and disconnected.

All this explains why an effective crisis team is central to mounting a satisfactory response. The best crisis organizations are relatively small, with

light approval processes, a full-time senior leader, and very high levels of funding and decision-making authority. The team should be able to make and implement decisions within hours rather than days, draw a wall of confidentiality around the people who are responding, and protect those not involved from distraction in their day-to-day activities.

A common error is to choose an external expert as leader of the company's crisis response. External hires typically struggle to motivate and organize the company in a crisis situation. The right leader usually will be internal, well known, and well regarded by the C-suite; will have served in an operational capacity within the industry; and will enjoy strong informal networks at multiple levels in the company. He or she should possess a strong set of values, have a resilient temperament,

and demonstrate independence of thought to gain credibility and trust both internally and externally.

The ideal crisis organization includes a set of small, cross-functional teams, typically covering planning and intelligence gathering, stakeholder stabilization, technical or operational resolution, recovery, investigation, and governance.

Stabilize stakeholders

In the first phase of a crisis, it's rare for technical, legal, or operational issues to be resolved. At this stage, the most pressing concern will likely be to reduce the anger and extreme reactions of some stakeholders while buying time for the legal and technical resolution teams to complete their work.

For instance, an emergency financial package may be necessary to ease pressure from suppliers, business partners, or customers. Goodwill payments to consumers may be the only way to stop them from defecting to other brands. Business partners might require a financial injection or operational support to remain motivated or even viable. It may be necessary to respond urgently to the concerns of regulators.

It's tempting and sometimes desirable to make big moves, but it is tough to design interventions that yield a tangible positive outcome, from either a business or a legal standpoint. What usually works is to define total exposure and milestones stakeholder by stakeholder, then design specific interventions that reduce the exposure.

Resolve the central technical and operational challenges

Many crises (vaccines in pandemics, oil wells during blowouts, recalls in advanced industries) have a technical or operational challenge at their core. But the magnitude, scope, and facts behind these issues are rarely clear when a crisis erupts. At a time

of intense pressure, therefore, the organization will enter a period of discovery that urgently needs to be completed. Frequently, however, companies underestimate how long the discovery process and its resolution will take.

Companies' initial solutions simply may not work. One manufacturer had to reset several self-imposed deadlines for resolving the technical issue it faced, significantly affecting its ability to negotiate. Another company in a high-hazard environment made multiple attempts to correct a process-safety issue, all of which failed very publicly and damaged its credibility.

It's best, if possible, to avoid overpromising on timelines and instead to allow the technical or operational team to "slow down in order to speed up." This means giving the team enough time and space to assess the magnitude of the problem, define potential solutions, and test them systematically.

Another frequent problem is that the technical solution, mostly due to its complexity, ends up becoming a black box. To avoid this, technical and operational war rooms should have an appropriate level of peer review and a "challenge culture" that maintains checks and balances without bureaucratic hurdles.

Repair the root causes

The root causes of major corporate crises are seldom technical; more often, they involve people issues (culture, decision rights, and capabilities, for example), processes (risk governance, performance management, and standards setting), and systems and tools (maintenance procedures). They may span the organization, affecting hundreds or even thousands of frontline leaders, workers, and decision makers. Tackling these is not made any easier by the likely circumstances at the time: retrenchment, cost cutting, attrition of top talent, and strategy reformulation.

For all these reasons and more, repairing the root cause of any crisis is usually a multiyear exercise, sometimes requiring large changes to the fabric of an organization. It's important to signal seriousness of intent early on, while setting up the large-scale transformation program that may be necessary to restore the company to full health. Hiring fresh and objective talent onto the board is one tried and tested approach. Other initiatives we've seen work include the creation of a powerful new oversight capability, the redesign of core risk processes, increased powers for the risk-management function, changes to the company's ongoing organizational structures, and work to foster a new culture and mindset around risk mitigation.

Restore the organization

Some companies spend years of top-management time on a crisis, only to discover that when they emerge, they have lost their competitiveness. A large part of why this happens is that they wait until the dust has settled before turning their attention to the next strategic foothold and refreshing their value proposition. By this stage, it is usually too late. The seeds for a full recovery need to be sown as early as possible, even immediately after initial stabilization. This allows the organization to consider and evaluate possible big moves that will enable future recovery, and to ensure it has the resources and talent to capitalize on them.

Be prepared

Much of the training top executives receive around crisis management is little more than training in crisis communications—only one part of the broader crisis-response picture. The sidebar (see “Are you prepared for the worst?”) lays out the sort of questions about preparedness that companies should be asking themselves.

Companies—and boards—should consider clearly defining the main “black swan” threats that may hit them, by conducting regular and thorough risk-identification exercises and by examining large crises in other industries as well as in their own. Once they do this, they should lay out, for each threat, what the trigger may be and how a hypothetical scenario for a crisis might unfold, based on patterns of previous crises. This allows the company to examine critically areas of weakness across the organization, and to consider what actions could offset them. For instance, should the company consider revisiting terms and conditions for key suppliers and building in a “cooling period,” rather than being forced to change the terms of accounts receivable in the heat of the moment? What other measures would provide short-term liquidity and steady the ship financially? Should the company invest in an activist-investor teardown exercise to assess key vulnerabilities that may surface in the midst of a crisis?

Companies — and boards — should consider clearly defining the main “black swan” threats that may hit them, by conducting regular and thorough risk-identification exercises and by examining large crises in other industries as well as in their own.

Once such an assessment is complete, the company should train key managers at multiple levels on what to expect and enable them to feel the pressures and emotions in a simulated environment. Doing this repeatedly and in a richer way each time will significantly improve the company's response capabilities in a real crisis situation, even though the crisis may not be precisely the one for which managers have been trained. They will also be valuable learning exercises in their own right.



Risk prevention remains a critical part of a company's defense against corporate disaster, but it is no longer enough. The realities of doing business today have become more complex, and the odds of having to confront a crisis are greater than ever. Armed with the lessons of the past, companies can prepare in advance and stand ready to mount a robust response if the worst happens. ■

¹ Factiva; McKinsey Crisis Response analysis; top 100 based on the 2015 Forbes Global 2000 list.

² McKinsey Crisis Response analysis: ratio of initial company and analyst expectations in multiple crises (as measured by initial drop in market cap) to final cost.

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The four questions to ask when serving on a nonprofit board

Directors need to probe, nudge, and prod to make sure the organization achieves its full potential.

William F. Meehan III and Kim Starkey Jonker

Sooner or later, you may follow in the footsteps of countless business leaders onto the board of one or more nonprofit organizations. Maybe it's the board of a local institution you care about personally, such as a small-scale theater, public radio station, or your child's school. It also could be a national or even global organization—an international development group, a major university, or the like.

Whatever the board, it's an opportunity to make a difference, provided you're prepared. Some of that opportunity stems from the growing potential of these organizations to generate social impact. Even as the cash-strapped public sector retrenches, nonprofits are poised to enjoy new sources of financial support: some \$59 trillion will move from US households into other hands between 2007 and 2061, according to one estimate. Nonprofits also can leverage new sets of tools, including robust digital infrastructure.

The nature of the opportunity runs deeper, though. Our research, as well as that of others, shows that

a great many nonprofit boards are underdelivering. A majority of respondents to a 2015 survey on nonprofit governance, conducted by researchers at Stanford University, said they did not believe that their fellow board members were very experienced or very engaged in their work. More than two-thirds of directors said their organization had faced one or more serious governance-related problems over the years—a finding reinforced by a survey we conducted with more than 3,000 stakeholders in the nonprofit sector, 56 percent of whom indicated that their organizations struggled with board governance.

If you know how to probe, nudge, and prod, you can help your board perform better. Doing so starts with courage. In our experience, nonprofit board members are often reluctant to contribute actively to discussions for fear that they will appear uninformed or cause an embarrassing ruckus. To be effective, you must overcome that fear. And then you must ask questions. Ask all your questions, even ones you fear might seem stupid, and keep asking

Nonprofits need a crystal-clear mission statement that can unite stakeholders with different—and often competing—goals and expectations.

them until you figure out what the smart questions are. Then demand answers to the smart questions. If you don't get good answers to your smart questions, or if you don't get support from your fellow board members when you ask those questions, then resign.

While many questions will be specific to your organization, there are four crucial ones that apply to all nonprofits. We'll lay those out in this article, which builds on a model of strategic nonprofit leadership we've distilled our book, *Engine of Impact: Essentials of Strategic Leadership in the Nonprofit Sector*. As we show in the book, board effectiveness is a critical enabler of all the components that, collectively, are indispensable to the achievement of a nonprofit's potential. Happily, it's one that you can start helping with the moment you get on a board.

Question 1: Are we succumbing to mission creep?

Companies in the private sector have a built-in sense of focus: they exist to maximize shareholder value. Because nonprofits lack that clarity of purpose, they need a crystal-clear mission statement that can unite stakeholders with different—and often competing—goals and expectations. When a mission statement is clearly formulated, it guides decisions about which programs and projects to undertake, which to avoid, and which to exit.

In too many cases, though, nonprofits develop mission statements that are vague or too lofty. In

fact, many board members do not know or fully understand their organization's mission. When BoardSource asked nonprofit board members and CEOs to “grade your board's performance in understanding your organization's mission,” only 50 percent of respondents gave their board an A.

An unintended consequence of such fuzziness is mission creep, a debilitating virus that takes nonprofits far beyond their core competencies. It's worth remembering that a fundamental axiom of strategy in the corporate sector is that more focused strategies outperform less focused ones. If a for-profit bakery decided to begin making not just bread and pastry but also tennis rackets, software, and pianos, people would raise an eyebrow. When that kind of expansion happens in the nonprofit sector, no one blinks. Often mission creep arises from a compelling funding opportunity. For example, a neighborhood after-school tutoring organization that decides to offer midnight basketball can invariably trace that decision to a top donor's special enthusiasm for midnight basketball.

Helping an organization avoid such problems is one of the main duties of a nonprofit board. Too often, board members just accept that a nonprofit's mission “is what it is.” Even in cases where an organization has a clear and well-focused mission statement, board members and senior staff should thoroughly review that statement every three to five years. In doing so, they will sharpen both their understanding of the mission and their commitment to maintaining it.

The board of Helen Keller International (HKI) periodically reviews its mission in this way as part of its strategic planning. According to its mission statement, HKI “saves and improves the sight and lives of the world’s most vulnerable by combating the causes and consequences of blindness, poor health and malnutrition.” (The interventions are linked; malnutrition is a leading cause of blindness.) President and CEO Kathy Spahn says the organization requires board members to visit programs in Africa and Asia at least once every three years, allowing them “to come back not only inspired and passionate about our mission, but also with a deep understanding of what is involved in executing on that mission.” That approach has paid off. When a devastating cyclone struck in Bangladesh, for example, the HKI board ensured that the organization limited its role to helping villagers reestablish home gardens and did not attempt to provide emergency food supplies. Emergency relief is not HKI’s mission or core competency.

Question 2: How is our ‘theory of change’ informing our strategy?

Board members who are used to robust strategy formulation in the private sector are often surprised by how nonprofit organizations struggle to translate their mission into a concrete plan for marshaling and deploying resources. In many cases, boards themselves are part of the problem. Only 20 percent of respondents in the BoardSource survey said that they would give an A to their board’s ability to adopt and follow a strategic plan.

One way to make the strategic conversation more concrete is to probe on a nonprofit’s “theory of change.” A theory of change is a rigorous description of exactly how an organization’s work—its portfolio of initiatives and interventions—will help achieve the given mission. Often discussed in the nonprofit world, but infrequently employed as a tool for ensuring strategic coherence, a theory of change is a step-by-step outline, ideally informed by empirical

evidence, of how organizational activity will translate into impact for beneficiaries.

When reviewing any proposed activity, you should ask the executives and program officers of the nonprofit, “How does this activity align with a logical, achievable theory of change?” When you are clear on the answer to that question, you can do a better job of assessing that individual initiative. You are also better able to have a coherent conversation about big-picture strategic issues that may be rumbling beneath the surface, such as the degree to which your strategy incorporates a clear-eyed view of potential competitors and collaborators, or the sustainability of your revenue model. These are critical issues that a business leader naturally would ask about in a corporate setting but that can seem out of place unless they are integrated with a theory of change.

Landesa, an organization that has worked in more than 50 countries to obtain land rights for the rural poor, consciously divides its theory of change into five discrete steps, each of which is informed by empirical evidence. Here, for example, is how it articulates the final step: “A small group of focused professionals working collaboratively with governments and other stakeholders can help to change and implement laws and policies that provide opportunity to the world’s poorest women and men.” Landesa also developed a graphical picture of its theory of change that uses arrows depicting causality to delineate specific goals, activities, outcomes, and impact.

For Landesa, as for most organizations, the process of developing and obtaining stakeholder agreement on its theory of change has been as important as the end product. Tim Hanstad, former president and CEO of Landesa, who is now a special adviser to the organization, explains: “Some of our richest discussions as an organization—with management, staff, board members, and donors—have occurred during the process of developing . . . our theory

of change. . . . We are forced to ask ourselves as a group, ‘What evidence do we have that our intervention will bring about the intended results?’” Landesa not only has a sound theory of change; it also uses that tool. “We have an internal process—called the Project Life Cycle process—that requires every new project concept and design to be justified by our theory of change,” Hanstad says.

Question 3: How are we evaluating our impact?

Corporate boards enjoy the benefit of a range of financial metrics, including a company’s share price, to help them evaluate their performance. Without them, nonprofit boards unsurprisingly tend to fall short in this area: in the 2015 BoardSource survey, for example, only 13 percent of respondents gave their board an A for monitoring organizational performance and impact, and 38 percent gave their board a C or worse.

If you are serious about helping your nonprofit achieve its mission, you need to insist on regular impact measurement, not as a pro forma obligation but as part of a dynamic feedback loop that helps drive organizational strategy. Far from being a mere box to tick, evaluation can drive a virtuous cycle in which an organization tests its theory of change and strategy and then improves its programs in response to what it learns.

In recent years, randomized controlled trials (RCTs)—studies that test an intervention against a counterfactual case in which it is not in effect—have emerged as a powerful way to demonstrate whether a nonprofit intervention actually works. Boards should encourage this approach. Pratham, an organization that works to improve learning outcomes among children in India, has embraced RCTs with the full support of its directors. Over a 12-year period, the organization completed 11 such evaluations. “The RCT process is expensive, but the value is enormous because it builds internal capacity,” said Madhav Chavan, Pratham’s founder. “After we started doing the RCTs, our entire organization started understanding data much better, and we acquired down the line a better understanding of how to think of impact.” Through its investment in this approach, Pratham has shown a definitive, causal link between its program and the impact on beneficiaries—and in turn this has helped unlock millions of dollars in funding.

Question 4: Do we have the right ‘fuel’ to drive our organization?

A nonprofit is more than its mission, strategy, and impact. It’s also a living, breathing organism that requires “fuel”—great people, an effective organization, sufficient funding, and the like—to operate. As a nonprofit board member, you need to check your organization’s “fuel gauges” on a regular basis.

This should start with a clear-eyed view of the board itself. Significant mismatches between a nonprofit’s mission and the composition of its board are common. An egregious example arose on the board of an international poverty-alleviation organization that, for more nearly a decade, consisted only of a handful of the founders’ childhood friends, all of whom were based in the United States and none of whom had any substantive experience or relevant professional expertise in international poverty



alleviation. How could such a board operate as anything other than a rubber stamp for the decisions of the organization’s executives?

If you find yourself on a board like this, you have a duty to speak up, and to vote with your feet if you don’t see progress. You may be surprised at the receptiveness of your fellow directors, whose time is valuable and who may be harboring similar feelings but remaining quiet out of politeness or habit. As you work through these issues, heed the venerable principle of the three Ws: work, wisdom, and wealth. You and your fellow board members should ask, “Do we have members who offer their time, energy, and insight to committee work, fund-raising events, outreach to donors, and the like? Do we have members whose special talent or area of expertise will help us achieve our mission? And do we have members who can and will support the organization financially?” While this last topic may be uncomfortable, helping your organization to raise money—whether through direct giving, providing introductions to prospective donors, or continually examining your organization’s overall approach to fund-raising—is the only way to sustain its impact.

Keeping an eye on the fuel gauge also means regularly asking at board meetings, “Does our organization have the people needed to achieve our mission?” Board members have a special duty to insist on both paying highly effective executives appropriately, so they can be retained, and ensuring that underperforming employees move on. The latter is an area where nonprofits particularly struggle. In our Stanford survey, only about half of nonprofit executives, staff, and board members agreed with the assertion that underperforming employees “do not stay for long in my organization.” But as every manager in the

for-profit sector knows, removing laggards, when done responsibly, not only improves organizational efficiency but sends a powerful signal about organizational values.



Serving on a nonprofit board in the years ahead represents an extraordinary opportunity for impact on society, and on the nonprofit itself. But if you want to be an effective strategic leader, you can’t settle for a regimen of reading board books and showing up for quarterly meetings. You must engage fully on your organization’s mission; seize opportunities to observe frontline work; and, at each board meeting, take every chance to confront the big, long-term issues by asking tough questions. The best quip that we ever heard on this subject conveys a vital truth: “I have no objection to a good discussion breaking out in the middle of a board meeting.” ■

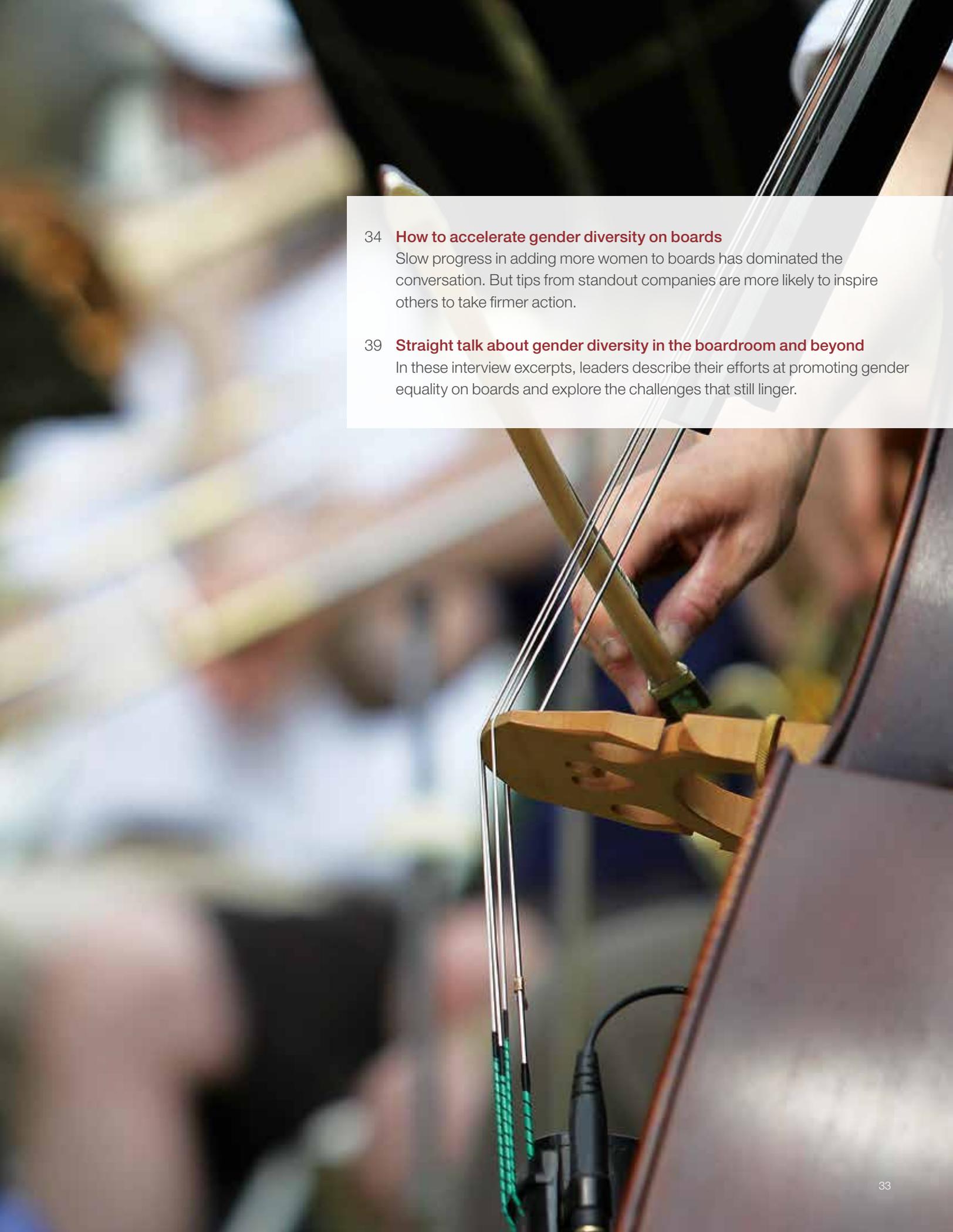
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BOARD STRUCTURE AND FOUNDATION



34 **How to accelerate gender diversity on boards**

Slow progress in adding more women to boards has dominated the conversation. But tips from standout companies are more likely to inspire others to take firmer action.

39 **Straight talk about gender diversity in the boardroom and beyond**

In these interview excerpts, leaders describe their efforts at promoting gender equality on boards and explore the challenges that still linger.



How to accelerate gender diversity on boards

Slow progress in adding more women to boards has dominated the conversation. But tips from standout companies are more likely to inspire others to take firmer action.

Celia Huber and Sara O'Rourke

The tone of much public discourse on the issue of women's representation on boards has been pessimistic of late, and understandably so, given the crawl toward gender parity in the United States. Women currently hold 19 percent of board positions there, while in European countries such as France, Norway, and Sweden, where legislative or voluntary targets are in place, they hold more than 30 percent.

That said, some progressive companies are taking the lead, looking for female board members in new places and bringing them on board in new ways. Many feel they still have a long way to go, but their experiences are salutary for those that are lagging behind and want to better understand how to make change happen.

We recently conducted an analysis of companies in the S&P 500 to identify top performers in board diversity, defined as those with the highest percentage of women on their boards as of August 2016 (see Exhibit 1 for the top 25). It showed that women occupied at least 33 percent of board seats among

the top 50 companies (up to nearly 60 percent for the highest percentage). In all, female representation on those boards has increased on average by 24 percentage points since 2005. We then conducted a series of interviews with the CEOs and board chairs from a number of those standout companies, as well as some European businesses that have made similar progress. (For in-depth insights from executives at some of these companies, see "Straight talk about gender diversity in the boardroom and beyond," on McKinsey.com.) Our goal was to hear directly from them about their gender-diversity journeys—the challenges they've faced, the best practices they've adopted, and the benefits that they continue to reap from increased representation of women, as well as other minorities, on their boards. What follows is a set of best practices, although by no means an exhaustive one (Exhibit 2).

Change the mind-set

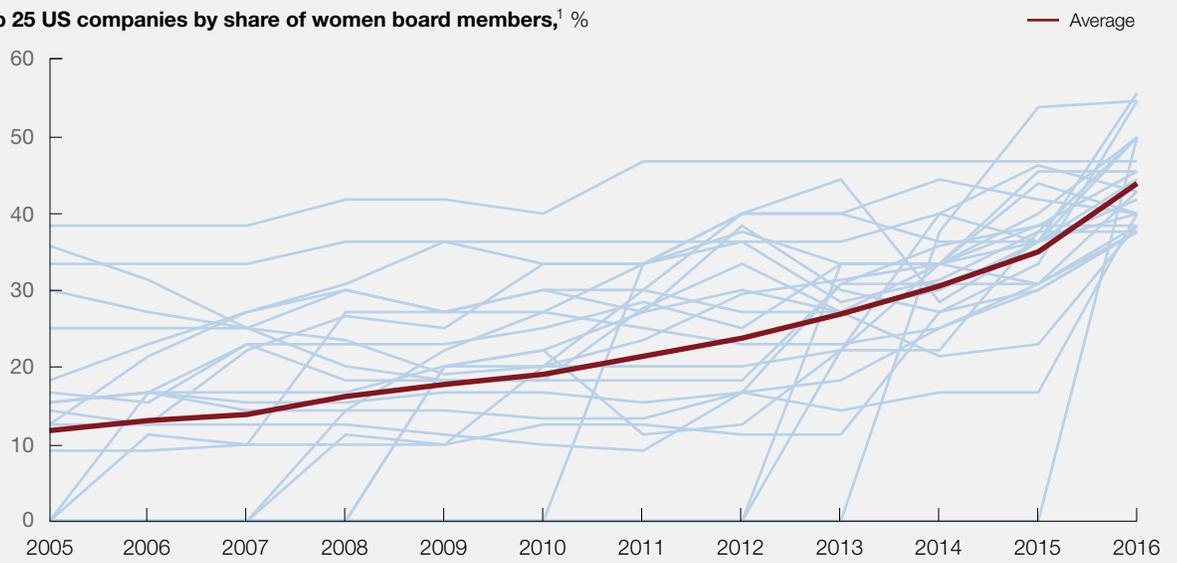
Even laggards acknowledge that increasing the percentage of women in the workforce and on boards is the right thing to do. But general conviction isn't

sufficient. What's too often missing, says Fabrizio Freda, president and CEO of the Estée Lauder Companies, is a sense of urgency: "People believe we are going to get there eventually. But that is not enough; it's too slow. The real obstacle is the lack of urgency." Freda was one of many executives we interviewed who insisted that meaningful change will come only when executives make fewer excuses and work together quickly. What's needed

are purpose and intention—a set of goals and motivations that will underpin decision making. For some, that has meant establishing a target number of board positions for women, while others take care to ensure that the list of candidates is diverse from the beginning, without adherence to a static quota. As Mary Dillon, CEO of Ulta, explains, "To maintain or expand diversity on our board, we continue to make an active effort to make sure

Exhibit 1 **Among the top 25 US companies, representation of women on boards is steadily converging toward parity.**

Top 25 US companies by share of women board members,¹ %



Accenture	General Motors	Signet Jewelers
Alaska Airlines	Hewlett-Packard	Tegna
Alliant Energy	Hologic	Texas Instruments
American Water Works	IPG	Ulta
Ameriprise Financial	Kellogg	Viacom
Best Buy	Macy's	Wells Fargo
Dollar General	Michael Kors	Williams Companies
Dr Pepper Snapple	Navient	
Estée Lauder Companies	Patterson Companies	

¹ As of August 2016.

Source: BoardEx database, 2005–16

Exhibit 2



Best practices to improve gender diversity on boards

Change your mind-set	Make a visible commitment to diversity with sustained action throughout the organization
	Set new principles for decision making (eg, include women on every candidate slate)
Expand your criteria	Look beyond current CEOs and other members of the C-suite
	Consider candidates with the right expertise, not just those with prior board experience
Maintain an active pipeline	Expand your network to include more women and explicitly ask search firms for female candidates
	Cultivate long-term relationships with prospective candidates

that the slate is diverse. Just the act of being cognizant, and having it top of mind that every slate has to have diversity, will drive action.” Leaders at both Genpact and Microsoft underscored the importance of flexibility, recounting how their searches to fill one board seat yielded two highly qualified women, so they just decided to bring both of them on board.

Expand your criteria

Despite their best efforts, some companies cite the small pool of female executives as a continuing

challenge. And they add that specific criteria for expertise in areas such as digital technology narrows the field even further.

Overcoming this reality of unequal numbers requires openness to creative solutions. One is to move beyond the standard practice of focusing a search on executives with prior board experience. Dan McCarthy, president and CEO of Frontier Communications, notes that many of the women on his board were first-time directors. “We were

willing to take risks on individuals—we look for someone who has the ability to move from the tactical to the strategic—and it has turned out to be great.”

This approach can be particularly helpful for small- and mid-cap companies that struggle to compete with large corporations for high-profile candidates. Genpact president and CEO Tiger Tyagarajan observes that “some people may prefer to join the board of a mid-cap company, where they can actually be more engaged and have an impact on the company’s strategy, versus a large company, where more time may be spent on general governance issues.” Leaders also tell us that looking beyond current or former CEOs and C-suite executives for candidates in other spheres such as law, academia, and the social sector can be rewarding as well, creating a rich balance of perspectives at the table. Ultimately, it’s about defining what is nonnegotiable, such as digital or finance expertise, and then seeing what is flexible so as to deliver on gender-diversity goals and to meet specific challenges.

Maintain an active pipeline

Effectively creating and cultivating an active pipeline of female candidates is arguably the single most important element of a successful board-inclusion effort. When conducting a search, this means relying on both personal networks and search firms to identify candidates. Relying only on the former, particularly where a board is composed primarily of men, risks perpetuating the candidate slates from the old-boys’ network of yore; relying solely on search firms can produce highly qualified candidates who are not particularly suited to the personal dynamics of the board. A little patience may also be necessary. As John Thompson, chairman of Microsoft, points out, some of the best candidates may take two or three years to cultivate. By taking the trouble to get to know potential candidates, even those who may not be available for some time, companies will

establish foundations for the long term. Companies that are open about their quest for diversity, meanwhile, will also benefit in the long run. Michael Roth, chairman and CEO of IPG, told us his reputation as a male champion for diversity had prompted a search firm to send him a qualified female board candidate proactively, even though he hadn’t initiated a search engagement with them.

Make the case

The leaders we interviewed had long since crossed the bridge of understanding the benefits of gender diversity, but their experiences provide a useful checklist for those still trying to convince the skeptics:

- ***Board diversity helps to draw in and motivate talented employees.*** As Genpact’s Tiger Tyagarajan explains, “To attract the best talent into the company, you need to appeal to 100 percent of the top talent, not 50 percent. To do that, you need strong female role models.”
- ***Boards that represent the customer base have better intuition.*** For retailers in particular, the reality is that women make up more than half of global purchasers. Board diversity is simply better business.
- ***A diverse board boosts decision-making quality.*** As Scott Anderson, chairman, president, and CEO of Patterson Companies, states, “The quality of discussions goes up dramatically when you have a more diverse group in the boardroom.” Rodney McMullen, chairman and CEO of Kroger, adds that “you get questions from perspectives that you hadn’t thought of before, and I think this helps you avoid more blind spots.”

Several of our interviewees emphasized that getting more women on boards isn’t the end of the story. For starters, board diversity is not just about gender. As McMullen explains, “I always think diversity

of background is important, but also diversity of experiences, thinking, and career paths.” Marc Lautenbach, president and CEO of Pitney Bowes, puts it this way: “While we don’t have a specific number in mind, we do have an appreciation for the value that diversity can bring. To my mind, it’s a little bit like assembling an orchestra. I know I need a bunch of different instruments; whether I have three of one and two of the other, or three of one and three of the other—that misses the point. It’s about how all of the instruments blend together.”



It’s important to recognize, of course, that broader gender inclusion at all levels of the company is critical. Companies can drive board inclusion by preparing their own female executives for

future board participation: placing them in roles with profit-and-loss responsibility, ensuring they have committed sponsors and mentors, and equipping them with the knowledge and skills needed to confront the governance and strategy issues that boards typically face. This can create a virtuous cycle that speeds progress on board diversity and counteracts cynicism with success stories such as those in our survey. ■

Celia Huber is a senior partner in McKinsey’s Silicon Valley office, and **Sara O’Rourke** is a consultant in the Washington, DC, office.

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Straight talk about gender diversity in the boardroom and beyond

In these interview excerpts, leaders describe their efforts at promoting gender equality on boards and explore the challenges that still linger.

Celia Huber, Holly Lawson, and Sara O'Rourke

Much of the discussion around gender diversity on boards focuses on how far we still have to go to achieve parity in the United States. While important, this conversation can sometimes overshadow the progress that individual companies are making to drive change across their organizations. We decided that highlighting some of their experiences could prove useful for companies eager to learn how to make change happen. In the fall of 2016, we conducted an analysis of companies in the S&P 500 that had the highest percentage of women on their boards. We then spoke to leaders at some of those companies, as well as to a few European leaders who are making similar progress in their organizations. (For more on our analysis and best practices, see “How to accelerate gender diversity on boards,” on McKinsey.com.) What follows are selected commentaries from leaders at the Estée Lauder Companies, Frontier Communications, and Kering, in which they discuss everything from the benefits they’ve reaped to the remaining obstacles that must be tackled.

Driving sustainable change



Fabrizio Freda, president and CEO, The Estée Lauder Companies



William P. Lauder, executive chairman, The Estée Lauder Companies

William P. Lauder: Our company was founded by my grandparents, Estée and Joseph Lauder, based on my grandmother’s vision, so the idea of women in leadership is deep in its DNA. Today, 85 percent of our employees are women, and it’s estimated that 90 percent of our consumers are women. So it’s important for us to make sure that we have very capable women executives not only at all levels of the organization but also at the board level. It took an explicit effort to make sure that we had women directors on the board, and then from there it became a natural process, as those members advocated for more women to join them. You come to

realize that it's a self-fulfilling thing when you start by setting an example. It's about putting a stake in the ground, as a leader, on something you believe in and then working hard to make sure that the organization takes it up and moves it forward.

Fabrizio Freda: It really is about intentionality of leadership—continuing to drive diversity across the company, even if you have already achieved many of your objectives. You can't take progress for granted. Leaders must make sure that everyone understands the benefits to the organization, the results these decisions bring, and the power of talented women and all that they have achieved for the company. This will ensure that a model is sustainable in the long term, independent from the company's value system and the strategic priority to represent consumers.

We expect leadership initiative and participation from every person in the company, what I call "leadership from every chair." For example, in a practical sense, this means we require managers to have a slate of candidates for any new position that's 50-50 men and women at the start. Broadly speaking, it's about making inclusion a job for everyone at the company. Sometimes I meet CEOs who believe they need to convince their direct reports to exercise inclusion. I believe they need to first convince the people who entered the company yesterday, because that's how you make sure it permeates the culture. Often young people will be most active if you give them the responsibility to drive change.

For example, we decided that our senior leaders, both men and women, were not familiar enough with the big transformation of the consumer-engagement model via social media and the new digital landscape. So our company has taken the most talented young women in the organization and matched them with a senior leader on my executive team. They become a reverse mentor to that executive, teaching my team and me the latest trends and innovation in the social-media landscape today—in short, keeping us modern.

As a result, my senior leadership group has better ideas on how to modernize certain aspects of the business. Further, our millennial women around the world are growing their skills at the speed of light, because they feel that senior managers look at them as leaders and not just junior employees. We have many women who participate in the program; today, it's an important element of our company culture.

Benefits go both ways between management and the board



Dan McCarthy, president and CEO, Frontier Communications

I've seen the benefits firsthand of having a more diverse board tackling tough issues. Here's an example: At one point, we were reviewing a strategic direction around opportunities for products to bring to market. The management was in favor of moving in a direction that would have been not completely off strategy, but more like a near-adjacent technology for us.

Even though the strategy had been vetted and moved forward, the board, as they discussed it, really challenged management. Had they thought through these different risks and opportunities? The women on the board challenged management the most by drawing on their understanding of how more than half of the country would feel about these new products. It really changed the entire direction of the discussion. Having previous experience with a board that was not very diverse in any way, I think that we would have wound up in a very different place. Ultimately, we scrapped that idea and didn't move forward with it.

The benefits really go both ways between the boardroom and the management side. I would say that in the

beginning, management evolved a little quicker on diversity and in doing so had a very positive influence on the board. About seven or eight years ago, we started a unique program where we pair a top senior executive with a board member. The board member gets a much more intimate understanding of the industry, the business, and its challenges; the senior leader gets a mentor who can advise them on their relationship with the board and how they could be a more effective leader. When I look at the board, I can see that they are totally engaged when we do succession planning; they understand the individuals and their needs and desires. When I talk to my team about what they're getting from the mentorship, it's everything from opportunities to join a board at a different company to a sounding board for ideas on their career. It's created a kind of symbiosis between both sides.

It takes more than a nudge



François-Henri Pinault,
CEO and chairman, Kering

Every company has a social responsibility beyond the economic sphere, as a part of society. When I transformed our company to the luxury group that it is today, I wanted to make a commitment to women that was consistent with the changing profile of our company, where roughly 60 percent of our workforce and 75 to 80 percent of our customers are women.

My first move was to establish the Kering Foundation to combat violence against women. Thanks to my wife, I became aware of the reality of the situation in our country and throughout the world. This was, as we call it, our commitment to the external world. Around the same time, we decided to work on the internal dimension—including equal representation, remuneration, and career-path development for women across the group.

I wanted to show our determination early on through quick action and chose to set an example with our board. I was not forced to do it at the time. Of course, now we have a law in France requiring us to have at least 40 percent women at the board level. We anticipated that and went even further; 64 percent of our board is now women. The law in France created a lot of debate on quotas, with even some women being against the idea. But pragmatically speaking, if you don't ignite the process through that constraint, nothing will ever happen. Recommendations are not enough. Even if the consequences for not complying are not all that terrible, it increases visibility on where companies stand and forces many to move in that direction.

The board is more of a symbol than a catalyst for change. The real work begins at the executive level and below, as you try to understand and diagnose very precisely the many reasons why change doesn't happen. For example, corporate policies (or a lack thereof) on maternity and paternity leave continue to create unfair situations for women, often resulting in a loss of talented women in the pipeline. Ideally, they should have a free choice to make that doesn't require a personal or professional sacrifice, but most of the time there is no choice—companies have to start allowing men more flexibility in their working schedules to contribute. In a country like the United States, one of the least advanced countries in the world on this issue, the consequence is that gender parity at the executive level is very difficult to reach. ■

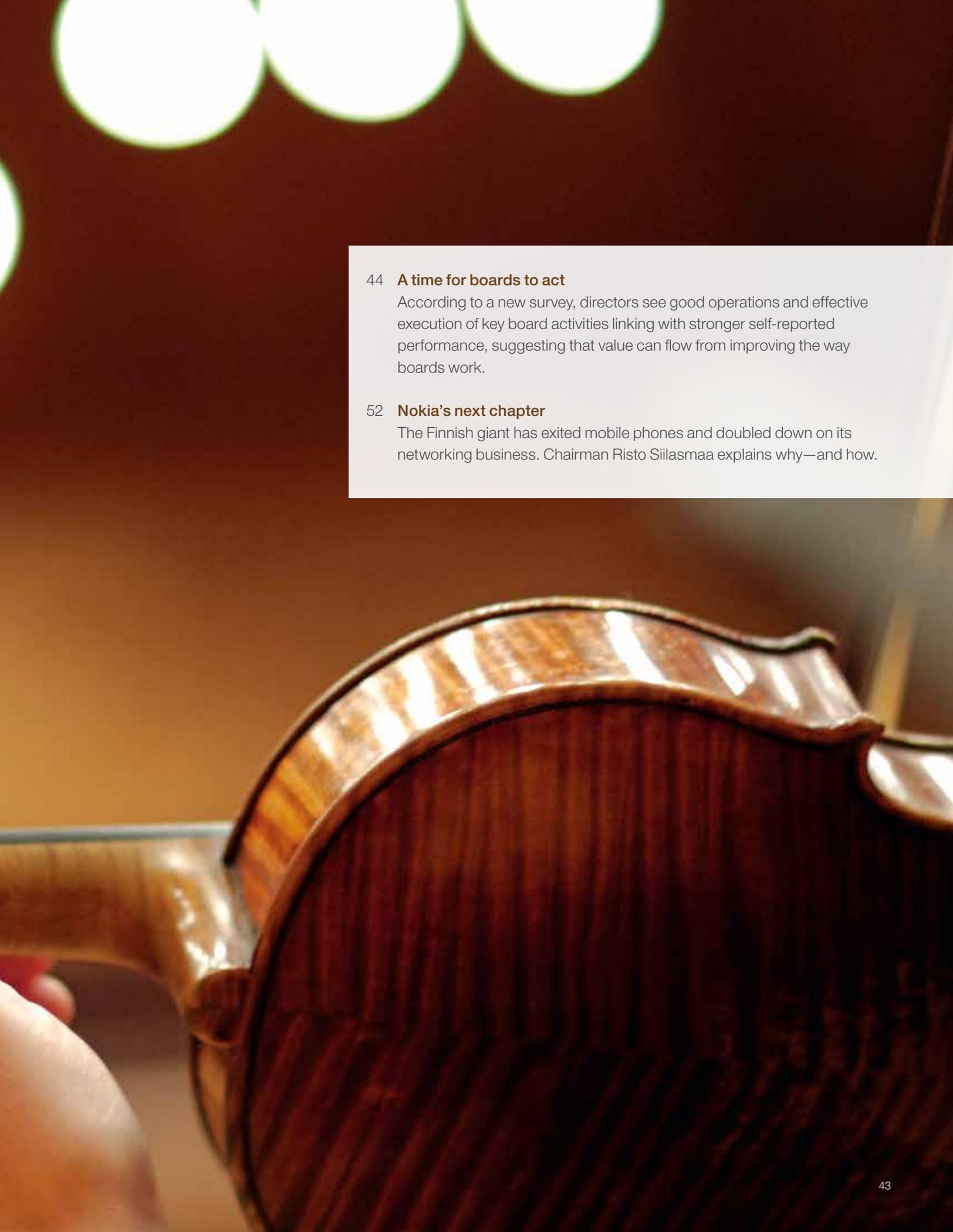
These commentaries are adapted from interviews conducted by **Celia Huber**, a senior partner in McKinsey's Silicon Valley office; **Holly Lawson**, a member of McKinsey Publishing who is based in the Chicago office; and **Sara O'Rourke**, a consultant in the Washington, DC, office.

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BOARD EFFECTIVENESS





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According to a new survey, directors see good operations and effective execution of key board activities linking with stronger self-reported performance, suggesting that value can flow from improving the way boards work.

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The Finnish giant has exited mobile phones and doubled down on its networking business. Chairman Risto Siilasmaa explains why—and how.



A time for boards to act

According to a new survey, directors see good operations and effective execution of key board activities linking with stronger self-reported performance, suggesting that value can flow from improving the way boards work.

Martin Hirt, Frithjof Lund, and Nina Spielmann

One of the more tantalizing—and elusive—questions in corporate governance has long been what effect the board of directors has on financial performance. In a McKinsey Global Survey of more than 1,100 directors, we attempted to test the link between the quality of board operations and boards' effectiveness at their core activities with self-reported financial performance relative to peers. Indeed, the results suggest that boards with better dynamics and processes, as well as those that execute core activities more effectively, report stronger financial performance at the companies they serve.

The findings come at a time when board responsibilities are growing beyond traditional oversight to involvement in critical issues, such as strategy, digitization, and risk.¹ In this survey, the fifth of its kind, we asked directors about three dimensions of board operations: dynamics within the board, dynamics between the board and executives, and board processes.² While the results indicate that few boards maintain good operations across all three dimensions and that processes are a

particular pain point, they also suggest that good dynamics and processes pay off.

Overall, the survey finds that the habits and practices boards engage in have changed little since our previous survey in 2015. Boards continue to focus most on strategy, an area in which many directors still want to invest more of their time. Yet fewer respondents now say their boards have a good understanding of their companies' overall strategy. And when asked about potential business disruptions, such as digitization and cybersecurity, surprisingly few directors say these topics have found their way onto the board agenda.

Boards have good dynamics but struggle with processes

Above all, directors' responses signal no improvement in how well their boards operate compared with two years ago. When asked about board operations along three dimensions—dynamics within the board, dynamics between the board and executives, and board processes—directors say they struggle most with establishing effective

Exhibit 1 Directors say their boards struggle most with establishing effective processes.

Respondents saying statement is true of their board,¹ %

		Percentage-point change from 2015
Dynamics within board		
There is a culture of trust and respect in boardroom	73	▲ +1
Board members' collective skills and backgrounds are appropriate for organization's needs ²	57	N/A
Board's membership is sufficiently diverse to ensure that relevant perspectives are represented in decision making ²	43	N/A
Board spends enough time on team building	33	▼ -6
After each meeting, chair invites directors to give feedback on meeting's effectiveness	26	▲ +3
Board-executive dynamics		
Board and management-team members constructively challenge each other in meetings	56	▼ -4
Board members seek out relevant information beyond what management provides, to deepen their knowledge of organization and/or industry	51	▼ -2
There is an explicit agreement between board and management team on their respective roles	43	▼ -7
Every board meeting's agenda includes a discussion among nonexecutive directors ²	19	N/A
Board processes		
Chair runs meetings efficiently and effectively	54	▼ -8
Board regularly engages in formal evaluations (ie, board-team and/or individual self-evaluations)	25	▲ +4
New directors receive sufficient induction training to be effective in their roles	23	▼ -4
Ongoing opportunities are available for board members' development and training	20	▼ -2
Board has long-term (ie, 3- to 5-year) succession plan for itself ³	18	▶ 0

¹ In 2017, n = 928; in 2015, n = 966. Excludes respondents from not-for-profit organizations.

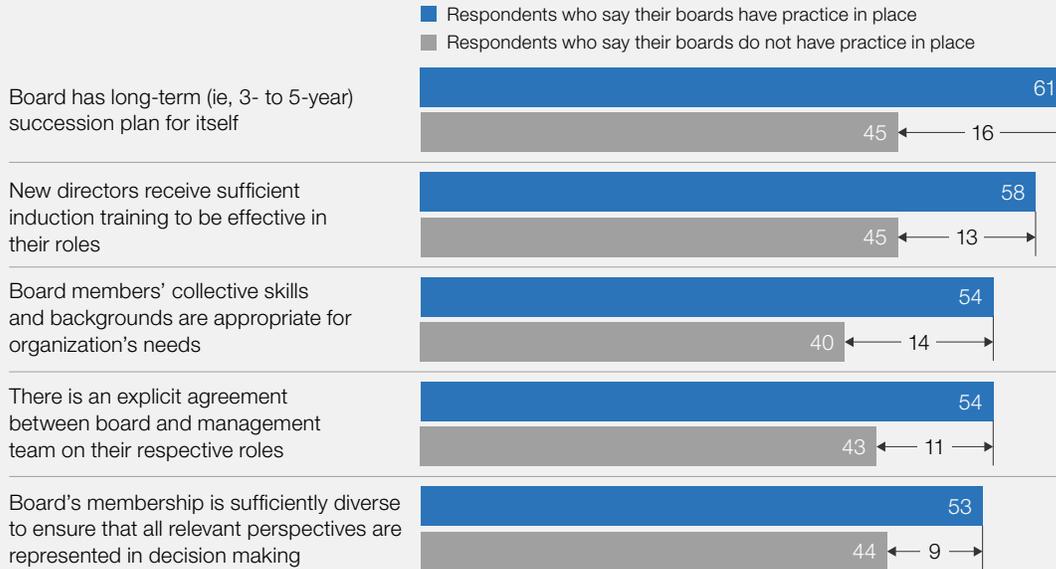
² Not offered as an answer choice in 2015.

³ In 2015, topic was "The board has a clear succession plan for itself over time."

Exhibit 2

Succession planning, induction training, and appropriate skills are the operations that contribute most to outperformance.

Rate of financial outperformance,¹ % of respondents²



¹ Respondents who say their organizations have higher or much higher performance on average than industry peers over the past 3 years across 3 measures: profitability, organic revenue growth, and growth in market share.

² n = 928. Excludes respondents from not-for-profit organizations. Out of 14 statements describing board operations; respondents were asked to select which, if any, were true of their board. Respondents who did not select any of the 5 statements above are not shown.

processes (Exhibit 1). Less than one-quarter say new directors receive sufficient induction training to be effective in their roles. In addition, only a small share (20 percent) say ongoing opportunities are available for board members' development.

Once directors are on the board, they are seldom involved in feedback and evaluation. About 25 percent of them say that their boards regularly engage in formal evaluations or that after each board meeting, the chairs invite directors to give feedback on the meeting's effectiveness. Across ownership types, only respondents on public-company boards are more likely than average to report sufficient training and formal evaluations. In some cases, respondents even report dwindling attention to certain

topics. Directors are significantly less likely this year to say that board chairs run meetings effectively and that there is an explicit agreement between the board and management team on their respective roles.

Better operations and greater effectiveness beget better relative performance

The importance of a board's effectiveness is widely discussed, but its impact on financial performance is hard to measure. We sought to understand this link better by looking at how boards operate (their dynamics and processes) as well as what they do (their effectiveness at core board activities) and comparing each measure with the financial performance of respondents' companies relative

to peers.³ According to the self-reported results, better boardroom dynamics and processes and greater effectiveness of activities seem to pay off.

At boards with top-quartile dynamics and processes, 59 percent of directors report financial outperformance relative to their industry peers, compared with 43 percent who say the same at bottom-quartile boards.⁴ Further, the bottom-quartile directors are almost twice as likely to report weaker relative financial performance. According to the results, the operational practices that contribute most to outperformance are a long-term succession plan for the board, sufficient induction training for new directors, and an appropriate mix of skills and backgrounds (Exhibit 2).

The results suggest an equally strong connection between directors' effectiveness at core board activities and financial performance relative to peers. Nearly 60 percent of directors at boards in the top quartile for effectiveness say their respective organizations have significantly outperformed peers.⁵ In contrast, just 32 percent of those at the bottom-

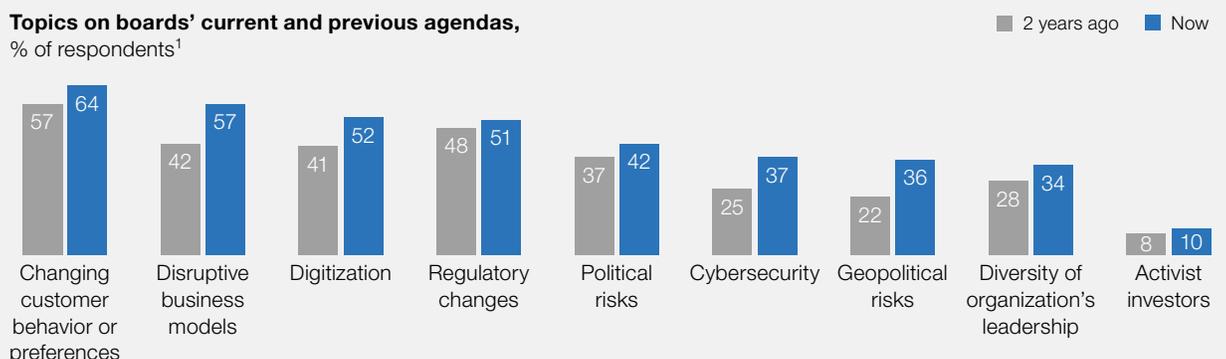
quartile boards say the same. The activities that most support outperformance are all strategy related: assessing the management team's understanding of the organization's and industry's drivers of value creation, setting a comprehensive framework for the organization's strategy, assessing the strategy's accounting of industry trends and uncertainties, and debating strategic alternatives within the board as well as with the CEO.⁶

Few boards address potential business disruptions

For more boards to realize the payoff from better operations and greater effectiveness, other results suggest room for where, and how, to improve. For the first time, we asked directors about the presence of nine potential business disruptions on their boards' current agendas and their agendas from two years ago. Of the nine disruptions, the most common agenda item—both now and two years ago—is changing customer behavior or preferences (Exhibit 3). Other disruptions appear much less often: approximately half of directors say digitization is currently on their agendas, and less

Exhibit 3 Of nine potential business disruptions, changing customer behavior is most often on boards' agendas.

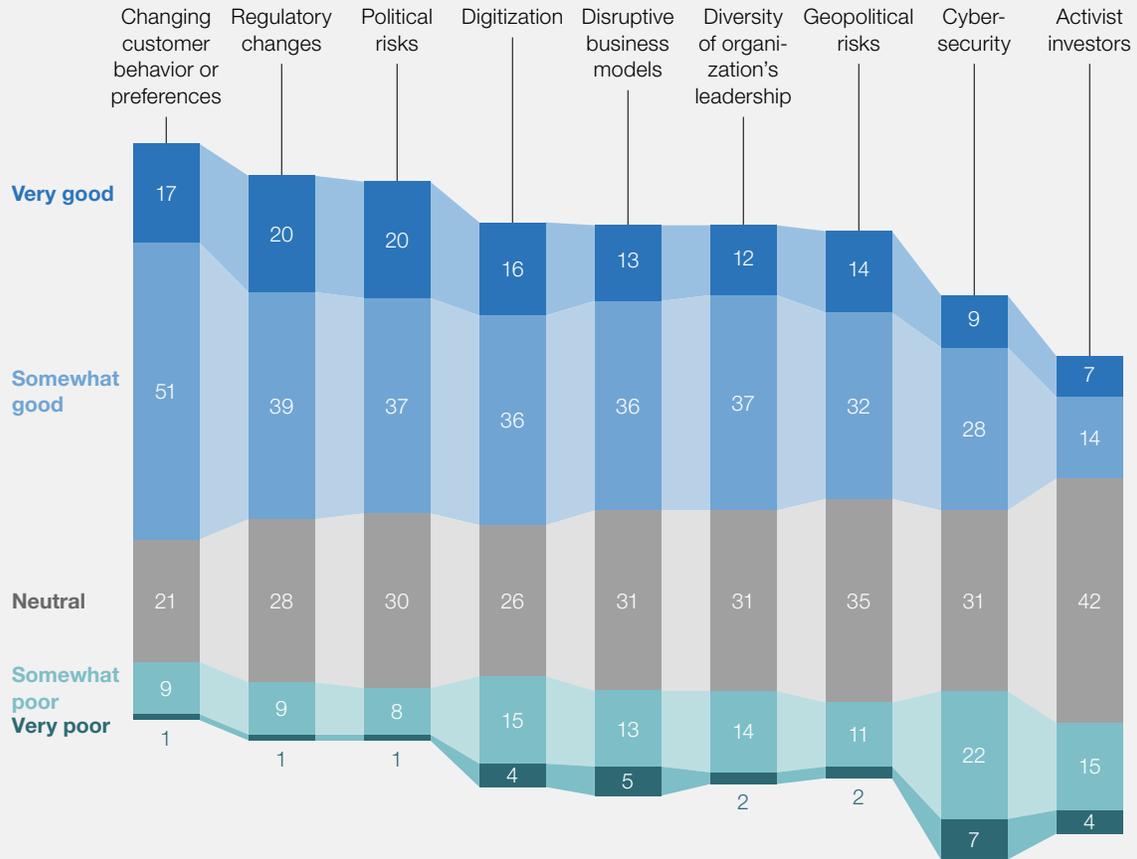
Topics on boards' current and previous agendas,
% of respondents¹



¹ Respondents who answered "other," "don't know," or "none of the above" are not shown; n = 928. Excludes respondents from not-for-profit organizations.

Exhibit 4 Boards' understanding of potential business disruptions is highly variable.

Boards' understanding of potential impact of each disruption on organizations' business,
% of respondents¹



¹ Respondents who answered "other," "don't know," or "none of the above" are not shown; n = 928. Excludes respondents from not-for-profit organizations.

than 40 percent say the same for cybersecurity and geopolitical risks. But boards appear to be catching up. Between their earlier and current agendas, directors report greater consideration of all nine issues; the biggest increases in board engagement are with disruptive business models, geopolitics, cybersecurity, and digitization.

According to respondents, boards' knowledge of these disruptions is highly variable (Exhibit 4).

Across disruptions, they are most likely to understand changing customer behavior, with two-thirds of directors rating their understanding as somewhat or very good. Perhaps not surprisingly, they most often report a poor understanding of cybersecurity, activist investors, and digitization. For each of the nine disruptions, directors are likeliest to say their boards understand the topic when they also say it appears on the agenda.

No real change in the order of boardroom business

The nature of directors' work—including where board members invest their time, how much overall time they dedicate to board work, and how well they understand their organizations' business—has changed only slightly compared with previous surveys (Exhibit 5).⁷ Since 2013, strategy and performance management have been the areas on which boards spend the most time during meetings. Still, respondents would like to spend even more time on strategy as well as on organizational matters, such as structure, culture, and talent management. Furthermore, board members are spending less of their time on board work than before. On average,

directors now say they spend 24 days per year on board matters, compared with 26 days reported in 2015.⁸ Respondents also report a decline in their ideal number of days spent on board work, although there remains the six-day gap between actual and ideal days spent that we previously saw. Ideally, directors now want to spend 30 days on their board work.

Looking ahead

Based on the survey results, boards can take several steps to improve their effectiveness and have greater impact on their organizations' value creation:

- *Make board processes more effective.* Out of the three dimensions of board operations the

Exhibit 5 Strategy and performance management remain the topics on which boards spend the most time.

Time boards spend on each topic during meetings,¹ %



¹ Figures may not sum to 100%, because of rounding. Respondents who answered "don't know" are not shown.

² Not offered as a topic in 2013.

³ In 2013 and 2015, topic was called "Organizational health and talent management."

survey covered, effective processes emerged as the most challenging. Many respondents report effective leadership of their boards, which is key to strong overall board performance and has meaningful impact on the organization's value creation. But in other aspects of how the board works, the results suggest room for improvement. One area is the quality of induction training, during which directors acquire a good understanding of the organization and the industry. Another is ongoing access to development opportunities so directors can continue learning and improving their contributions to the board. Finally, establishing regular feedback processes and a long-term board-succession plan can make a meaningful difference.

- ***Make more time for boardroom business.*** A notable gap persists between the number of days directors spend on their board work and the number of days they would like to spend on it. In our experience, the amount of time required to be an effective board member is usually more than directors initially expect. While some board members invest significantly more time than the average number of days reported in the survey, others would benefit from spending more time in meetings (for example, to discuss strategic alternatives) as well as learning more about the business and preparing themselves before meetings (for example, visiting company facilities or researching industry competitors). To become a true sparring partner for the management team, many board members would benefit from a better understanding of the company and the industry—in particular, the key value drivers of the business, the relevant risks, and the organization's talent situation.
- ***Rethink the annual agenda.*** It is not enough for directors simply to dedicate more time to their board work. Equally important is choosing

how to spend that additional time and aligning the annual agenda with their companies' strategic priorities. The results suggest that many boards could benefit from focusing more on long-term CEO-succession planning, reviews of core risks, and discussions about the talent pool—all of which are core activities at which many boards are not especially effective.⁹ Boards also should leave enough room on their agendas to cover potential disruptions to the business. No company is fully immune to the effects of cybersecurity, digitization, and geopolitical risks, so these topics should be on every board's agenda. Because companies' businesses evolve and potential disruptions can arise at any time, it is important that boards maintain flexible agendas rather than become prisoners of their annual schedules. ■

¹ "The CEO guide to boards," *McKinsey Quarterly*, September 2016, McKinsey.com.

² The online survey was in the field from April 18 to April 28, 2017, and garnered responses from 1,126 board directors representing the full range of regions, industries, company sizes, and board roles; 31 percent of respondents are either board chairs or lead independent directors, and we asked respondents to answer all questions with respect to the single board with which they are most familiar. We excluded responses from directors on not-for-profit boards in the first two sections of the report, which covered topics relevant to private-sector boards. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

³ Financial performance is measured as self-reported organic revenue growth, profitability, and change in market share relative to industry peers in the past three years. To control for potential biases (for example, board chairs tending to report better financial performance than other respondents do), we defined two control variables: the respondent's job title and his or her role on the board (for example, chair, vice chair, or lead independent director). Before running the financial-performance analysis, we confirmed that the best- and worst-performing companies have an equal distribution of job titles and board roles across all quartiles. We define an outperforming company as one that, according to respondents, has seen higher or much higher performance on average across three measures—organic revenue growth, profitability, and change in market share—in the past three years, relative to industry peers.

⁴ With respect to dynamics and processes, the top-quartile boards are those in which respondents agree with eight or more of the 14 statements we asked about, while

the bottom-quartile boards are those in which respondents agree with only three or fewer of the statements.

- ⁵ The survey asked about 42 different board activities related to strategy, performance management, investments and M&A, risk management, shareholder and stakeholder management, and organizational structure, culture, and talent management. With respect to board activities, the “top-quartile boards” are those where respondents are effective or very effective in 26 or more of the 42 activities we asked about, and respondents on the “bottom-quartile boards” are effective or very effective in 13 or fewer activities.
- ⁶ Chris Bradley, Martin Hirt, and Sven Smit, “Strategy to beat the odds,” *McKinsey Quarterly*, February 2018, McKinsey.com.
- ⁷ Responses from directors on not-for-profit boards are included in this analysis, so the results are more comparable with those from previous years.
- ⁸ Since the 2011 survey, directors have been asked to write in the number of days they spend on board work, both currently and ideally. In the most recent survey, we have used a different methodology to calculate the results. We have removed respondents from our analysis who met the following criteria: those who say four days or less or 101 days or more to the “actual days spent on board work” question, those who say 121 days or more to the “ideal days spent on board work” question, and those who did not answer both questions. When comparing previous results with those from the latest survey, we have applied the same methodology to the write-in responses from 2013 and 2015.
- ⁹ Dominic Barton, Dennis Carey, and Ram Charan, “An agenda for the talent-first CEO,” *McKinsey Quarterly*, March 2018, McKinsey.com.

The contributors to the development and analysis of the survey include **Martin Hirt**, a senior partner in McKinsey’s Taipei office; **Frithjof Lund**, a partner in the Oslo office; and **Nina Spielmann**, a specialist in the Zurich office.

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Nokia's next chapter

The Finnish giant has exited mobile phones and doubled down on its networking business. Chairman Risto Siilasmaa explains why—and how.

Rik Kirkland

The only way a corporation endures for a century or more, according to former IBM CEO Lou Gerstner in *McKinsey Quarterly*, is by changing 4, 5, or even 25 times over those 100 years.¹ Otherwise, he says, “they wouldn’t have survived.” By those measures, Finland’s Nokia is a paragon of corporate renewal. Over its 151-year existence, the company—which took its name from a lumber mill built on the banks of the Nokianvirta River, in southern Finland; later morphed into the power-transmission and phone-cable businesses; and then most famously moved into, and for more than a decade ruled, the entirely new market of mobile telephony—has made the ability to change a core competency. After surviving a near-death experience and abandoning phones, this corporate phoenix has reemerged as one of the world’s largest telecom network service providers. Recently, at its headquarters in Espoo, Finland, Risto Siilasmaa, Nokia’s cerebral chairman, escorted a visitor down a wall showcasing historical memorabilia from incarnations past—such as a pair of rubber boots, a power cable, the brick-like Cityman mobile phone from 1987, and Nokia’s beloved model 5110—and, turning a corner, paused to wave expansively at a corridor dominated

on one side by a blank, 100-foot whiteboard: “And there,” he said with a wry smile, “is our future.”

Siilasmaa himself is a big reason Nokia even has a future. As one of Finland’s most successful high-tech entrepreneurs (he was briefly a “dollar billionaire” on paper during the turn-of-the-millennium market boom), he joined the board in 2008 just as the emergence of Apple’s smartphone on the high end and a bunch of aggressive cheaper competitors on the low end were beginning to batter Nokia’s market leadership. Things went south with stunning speed, and by 2012, the company was hemorrhaging money. Named chairman in May of that year, Siilasmaa quickly found himself playing a complex corporate game of three-dimensional M&A chess, even as the company battled to survive. In quick order, he and his board bought back half of NSN (Nokia Siemens Networks), a networking joint venture that had been spun off at the height of Nokia’s mobile dominance, negotiated the sale of its phone business to Microsoft, and then wheeled to double down on networking by purchasing rival networking giant Alcatel-Lucent.

Amid the fog of uncertainty, Siilasmaa kept the enterprise focused by building trust among the board and top management team, by treating anxious employees with transparency and fairness, and by insisting on using facts and analysis to drive decision making. No nonoil company may have ever claimed more of a single country's GDP, tax base, and collective esprit than Nokia at its peak did in Finland. So amid the national emotional outpouring its decline engendered, it helped to have a quietly confident rationalist at the helm.

Recently, Siilasmaa sat down with McKinsey Publishing's Rik Kirkland to reflect on his own remarkable journey, as well as his company's. In these edited excerpts, he recalls his education as an entrepreneur, his love-hate relationship as a sometime supplier to Nokia, and the battlefield lessons he learned about how to forge consensus and build trust—and sketches out his vision of how the new Nokia intends to fill in the blank white wall of its future.

McKinsey: *Tell us about how you became interested in tech and being an entrepreneur.*

Risto Siilasmaa: I learned programming on a Commodore 64, actually a VIC-20 before that, when I was about 12 years old. My parents were not wealthy, so I had to earn the money to buy my own. I started working, doing all sorts of odd jobs, and began actively writing reviews and articles for Finnish computer magazines. When I was 15 to 16, I started helping some Finnish companies with their computer problems and later wrote a book on computer security.

I then attended the Helsinki University of Technology, where I didn't study computer science, because I was under the false impression that I already knew enough about that topic. So I studied economics, international law, business strategy, and leadership—a wide and nonscientific curriculum. As part of an exercise in one course, the university had us fill in the

papers required to start a company. But my partner and I used those documents to actually start a company. Shortly after, he left to do his thesis, and I was left in charge. Customers were happy, so I started hiring. And one thing led to another.

McKinsey: *This was F-Secure, a cybersecurity company, correct?*

Risto Siilasmaa: Yes. F-Secure launched in 1988. As we continued to grow, suddenly we had profits and were able to start hiring developers. So we shifted from services and consulting training to become a product company, which had been my dream since the early days of learning to program a Commodore 64. I had hoped to create the best text-based *Dungeons and Dragons* computer game of all time and sell that globally. For me, it was a fascinating thing to think that somebody on the other side of the world would use something I had created. However, the game didn't work out.

McKinsey: *So the Angry Birds path to success didn't end up being in your future.*

Risto Siilasmaa: No, but it was good fun. However, with the path we chose, F-Secure grew at an average of 80 percent annually for the first 12 years and was always profitable. We went public at the end of 1999, and the stock took off. As the founder and the largest shareholder of the company during the tech bubble, I soon saw my face on the TV news in Finland, sometimes several times a week. People started recognizing me when I was walking down the street, even though I was not giving interviews. The media were just showing my face, speculating on TV about the company's success, rising share price, and how much I was worth.

McKinsey: *How did that kind of celebrity affect you?*

Risto Siilasmaa: The learning for me was that what the media says about you has absolutely no bearing

on reality, especially when they're only saying positive things. You're not any better. The company's not any better. It's just that there's this huge hype. And you need to be aware of how that hype can affect you, for example, by potentially pushing you to spend much more than what makes sense and to think too much about the next month or quarter versus the next 25 years.

One thing we did, which is relatively unusual, is to say publicly, back in 2000, that we felt our share price was overrated and too high. Typically, the leadership of a publicly listed company doesn't do that. Two months after we did, our share price had tripled. It was absolutely absurd. But in the end, what made me so happy is that we had priced our IPO at the right level, so that after the bubble burst, my investors still made money. Even after the bubble had completely deflated, I could look any investor in the eyes and say, "If you invested

in the IPO, then you've still made money." That was important for me personally as well. When people ask me, "How did it feel to lose a billion dollars?" I can honestly say I never felt I lost anything, because it was only paper money. After the bubble, I still had the same amount of shares that I had before the bubble.

McKinsey: *In the meantime, Nokia's own star was burning brighter and brighter as well. How did that shape your course at F-Secure?*

Risto Siilasmaa: When I started my company, Finland was not a high-tech country. In fact, our reputation was quite low in that regard. We didn't really have international companies either. So when F-Secure started internationalizing and went to Silicon Valley in 1992, and Japan and other countries a few years later, I always tried to pretend that we were an American company. We still had printed

Risto Siilasmaa



Vital statistics

Born April 17, 1966, in Finland

Education

Holds an MS in engineering from Helsinki University of Technology

Career highlights

Nokia

(2012–present)

Chairman of the board of directors

(2008–12)

Member of the board of directors

F-Secure

(2006–present)

Chairman of the board of directors

(1988–2006)

Founder, president, and CEO

Fast facts

Chairman of the board of the Federation of Finnish Technology Industries and a board member of the Confederation of Finnish Industries

Earned the Nordic Chairman of the Year award (2009) and the Innovation Luminary Award (2015)

corporate brochures back then, and I always put the US office address first on the list so that people would mistakenly think that we were an American company. Finland showed up somewhere on down in the list.

But with Nokia's increasing success, I gained the confidence to start giving a real Finnish flavor to the F-Secure story. Because, for security, Finland is a great country of origin. We weren't on any side in the Cold War. We are impartial, objective, law abiding, and hardworking. There's almost no corruption in Finland. In many ways, we are the ideal home for a security company. But it was the rise of Nokia that encouraged me to open that door. Its success gave Finns a new pride in being Finnish.

Eventually, we became a supplier to Nokia, providing security software for its proprietary Symbian operating system. We started shipping an antivirus product for Symbian in 2001. But to be honest, when that happened, I discovered it was very difficult to work with Nokia. I loved Nokia, but I hated the way Nokia treated its partners. Besides the arrogance that can come with great success, the company had an attitude that it didn't need to please its partners. It treated them as a purely subcontracting, supplier relationship, which is not the way to act when an innovative product like software is part of your supply chain.

McKinsey: *So how did you move from supplier to board member?*

Risto Siilasmaa: In 2006, I turned 40. After 18 years in the same role as CEO of F-Secure, I felt that I was not learning anything anymore. Instead, I decided to radically transform my life. So I stepped down, became the chairman, and started doing a lot of other things—such as becoming the chairman of Elisa, the biggest, most successful domestic teleoperator in Finland. In 2008, I was asked to join the Nokia board.

At the time, they were looking to me because of my technology and business experience, and because I had given them strong feedback about the shortcomings in how they treated their ecosystem of suppliers. But there was then no sense of any impending crisis. In fact, 2007 had been the best year for Nokia ever. But in hindsight, we know that the turn had begun some years before as far as competitiveness, the right technology architectures, and the way to organize the company.

McKinsey: *Any reflections on how executives can foresee the kind of market shock that Nokia subsequently endured?*

Risto Siilasmaa: Very successful companies need to be extremely focused on forward-looking indicators. I often jokingly say that in business we all drive cars where the whole windshield is a rearview mirror. And we have only a small opening somewhere in that mirror surface through which we can look forward. That's because, in general, we are so focused on the historical numbers that we have little ability to look forward. None of our neighbors, in their right mind, would want to drive such a car, but we run huge businesses with exactly that approach. It doesn't make any sense. When everything you see looking through this giant rearview mirror is great, how can you begin to understand that, actually, your fundamental competitiveness has dramatically decreased over the last years?

McKinsey: *So, blinded by the mirror, Nokia missed the abrupt turn in the market and was forced to begin taking a number of radical steps to try to turn the tide. This included bringing in Microsoft's Stephen Elop as its first non-Finnish CEO in September 2010, and later deciding to stop investing in its own proprietary software and instead sell Microsoft's Lumia phones as its exclusive high-end option. Describe the situation at the time you were formally named chairman in May 2012.*

Risto Siilasmaa: To me, Jim Collins’s book *How the Mighty Fall*² describes quite well what had happened to Nokia. When I became chairman, I think we were in the fourth stage of Collins’s five stages. The fourth stage is sort of the Hail Mary stage, where you need to do something dramatic or you go into the fifth stage, which is death or irrelevance—with irrelevance obviously being worse than death. That spring had been pretty awful for us. We issued two profit warnings over two quarters. Our operating loss was about €2 billion during the first half. During the second quarter alone, our core revenues in handsets declined by 26 percent from the previous year. We were planning the biggest layoffs in the company’s history. Our core investors were categorizing Nokia shares as noninvestable and not even following us anymore. It was mainly hedge funds and short-term investors holding the shares. The press was speculating about the timing of the Nokia bankruptcy. Our employees were reading all that, experiencing major job losses that had already happened, and feeling very fearful for the future.

It was a difficult moment, substantively and emotionally. Many of the things that we did then were done instinctively. After thinking about everything that has happened, certain lessons have crystallized. But while it may sound as if I knew what I was doing, I assure you it was not always so.

McKinsey: *What were some of those lessons?*

Risto Siilasmaa: I have formed a leadership philosophy that I call “entrepreneurial leadership.” The core of that requires behaving as a paranoid optimist.

McKinsey: *That sounds a bit like Andy Grove’s Only the Paranoid Survive.*³

Risto Siilasmaa: Yes, but he stressed the paranoia. You need both. If you’re not an optimist, you can’t energize people. But if you don’t also scare them, then they won’t be thinking about everything that can happen, and preparing for it. So in 2012, I was both scared and optimistic at the same time.

Somehow I decided that before we could plunge into all the issues we faced, we needed to stop for a moment and think about how we were going to approach them. While this was done instinctively, in hindsight it’s one of the biggest lessons that I have learned: always, when you start something new, stop the team first.

Essentially, what I said was, “Let’s forget about the issues we have at hand for a moment. Let’s talk about what’s really important. How do we work together? Is it important that we have fun together? Is it important that we work hard and give this our heart and soul? What are we prepared to do? How do we make decisions? If we have conflicts within the team, how do we resolve them? What are the rules by which we will live the part of our lives

“If you’re not an optimist, you can’t energize people. But if you don’t also scare them, then they won’t be thinking about everything that can happen, and preparing for it.”

that we spend together?” And out of this, we created a list of what I called golden rules, for the board, and approved them immediately following the annual general meeting, where my board was formed.

There are seven, but I will call out two. The first rule is always assume the best of intentions from others. A simple thing, but if you can follow that, it will change how you behave in a lot of situations. The final one is that any meeting where we don't laugh out loud is a dismal failure. That's important, especially when you are making decisions that are emotionally hard. You can feel so bad, and everything is doom and gloom.

But that's when you need to work extra hard to get people to laugh. It helps you find the balance between being the optimist and the paranoid again. Otherwise, you just fall into the trap of being paranoid.

McKinsey: *Say more about the practical impact of adopting these rules.*

Risto Siilasmaa: Let's go back to Jim Collins's five stages of how companies fail. The third stage is denial of truth, which means that you are in such a great position that any bad news is a threat. You tend to start punishing people who bring you news you just don't want to hear. And because things are going so great, you don't dive deep into the details.

But as a board, we had agreed in our second golden rule that our philosophy would be data driven and based on analysis. Taking a stance of paranoid optimism meant we had to talk about the problems and about bad scenarios. We even had to discuss a possibility of a bankruptcy.

To enable those discussions, we first had to create a climate of trust with the executive team. Then CEO Stephen Elop gave me a lot of access to his top team, and our joint message was, “If you want us to respect

you as an executive, you'll level with us. You'll come into the boardroom and tell us, ‘I have a big challenge. I don't know how to deal with it. I have three initial plans. I'm not happy with any of them. Can you help me improve these plans and figure out the right way forward?’ But if you come with one idea, one solution, and try to sell that to us, then you will not get our respect.”

Next, having started the process to create trust within the board and between the board and the management team, we needed to create trust with employees—a difficult challenge given the layoffs we had endured and the many more we had to launch. To partially address this, we had already earlier created a program called Bridge, which provided substantial assistance in multiple ways to departing employees. It was so effective that, according to a university research study, about 18 months after people were fired, on average, 85 percent of them said that they were either “happy” or “very happy” or “satisfied” or “very satisfied” with the way they had been treated. That, in turn, created trust with the remaining employees, because those who had been laid off were not bad-mouthing the company. So the remaining employees were less afraid and more energized, which was critical, since many were working on key product projects with hard deadlines that required extra effort over, say, the holidays. But they did it. It blows me away when I think about it.

McKinsey: *With this foundation, you soon found yourself embarked on two years of hyperactive deal making. How did the strategy behind that evolve?*

Risto Siilasmaa: Just to set the context, shortly after I became chairman, Microsoft, which was then our exclusive handset partner, announced it was bringing out the Surface tablet. That was a real shot across the bow, since they were moving for the first time into the device business. We had to start

thinking, “What if Microsoft comes into the market with a smartphone of their own and competes against us? How do we manage that?” And then, early in 2013, Microsoft reached out to us saying they had an interest in acquiring Nokia’s handset business. At that moment, I still believed that we could turn handsets around. The optimist side was still winning. But after a series of exploratory discussions, and as more negative data kept coming in, I realized that the paranoid side was right, and we had to divest. Because if we didn’t, this could end really badly.

At the same time, we had a share in a network-infrastructure joint venture, NSN, which had been spun off some years earlier. Both Nokia and Siemens had, in effect, given up on the network business as noncore. As a stagnating joint venture, NSN and its management had been incentivized either to become an IPO or a trade-sale asset. At one point, each parent company funded NSN with \$500 million—and basically said that was it: “Go bankrupt if you will, but you will not get a penny more.” The fact that it subsequently became a vibrant business just emphasizes the fantastic turnaround that Rajeev Suri [now Nokia’s president and CEO] and his team pulled off there from 2011 on. As the recovery became visible to us, we decided in mid-2013, while exploring the handset sale to Microsoft, to buy the 50 percent of NSN that we didn’t already own. We could see that this could be of tremendous value. Once we made that decision, later that year we then began exploring how to implement our new strategy. One alternative out of six that we looked at was to create a market leader in networking by acquiring Alcatel-Lucent.

As a side note, one thing I instinctively felt, and that again proved critical in all these negotiations, was the importance of building a foundation of trust with our counterparties. In the first meeting with Microsoft, for example, we had probably 30 people in the room, lawyers and bankers on both sides, a huge

army of people. Under such circumstances, anybody speaking is performing for an audience. There’s no way to create trust when people are acting a role. So after that first meeting, I agreed with [then Microsoft CEO] Steve Ballmer that, from now on, we would not allow a single banker or external lawyer into the room, only the four key principals on each side. In a series of meetings, both one on one and as what we called the “four by four,” we discussed what was important, what we had learned, and what we were trying to achieve. That worked well, in terms of creating familiarity and trust and allowing us to get to results.

We used exactly the same model when negotiating with Alcatel-Lucent: no outsiders in the room and a lot of one-on-one discussions. As a result, we were able to avoid structuring the deal as a merger of equals, which have historically not had the highest odds of success. Instead, we were able to make the argument that it should be structured as an acquisition, where we took two-thirds and they got one-third.

McKinsey: *What motivated the Alcatel-Lucent acquisition?*

Risto Siilasmaa: During the period from announcing the Microsoft deal in the fall of 2013 to closing it in May 2014, there was a period of roughly eight months, when I was both CEO and chairman. We had the questionable pleasure to rebuild the future for the company, questionable in the sense that while it’s a great thing to be able to draw from a clean slate, it’s also the outcome from a failure of the previous business model. Because even after moving entirely into networking, Nokia was a one-trick pony. We were mobile-broadband specialists, and we couldn’t deliver an end-to-end experience.

To realize that future, we set five goals. First, create a new vision for the company. It’s a vision we call

the programmable world. In the programmable world, tens of billions of mobile sensors feed data into interoperable cloud platforms, which perform intelligent analysis and translate the learnings into actions that are fed back to the real world via actuators, such as valves, engines, locks, autonomous machines, and devices of all sorts. As the real world becomes programmable and connectivity expands massively, we can create new possibilities for people and businesses by embedding these intelligent, software-driven networks seamlessly in our lives.

We then had to create a strategy to help fulfill that vision. Next, generate the right organizational model to implement that strategy. Then put people into the model—the management team and the CEO. Finally, decide about the balance sheet. We did all five. And Alcatel-Lucent, under Rajeev’s leadership as CEO, turned out to be an ideal answer to many of the unanswered questions about, “How can we execute this strategy?”

The upshot is, it is working. In the summer of 2012, Nokia’s market capitalization was \$5 billion and our enterprise value was \$1.5 billion. By the beginning of this year, our market capitalization was close to \$28 billion and our enterprise value was about \$20 billion. While our share price has since dropped significantly in a tough year for the industry, we have continued to outperform our closest competitors. Out of some 100,000 employees today,

less than 1 percent had had a Nokia badge three years ago. We essentially transformed the whole company by changing out all the “atoms.” We are doing so much more than what Alcatel-Lucent and what Nokia did in our tech business and also in our R&D work. But this all started from that strategy process, and it’s still basically founded on that vision of the programmable world. That’s where we’re going. ■

¹ See “Lou Gerstner on corporate reinvention and values,” *McKinsey Quarterly*, September 2014, McKinsey.com.

² Jim Collins, *How the Mighty Fall: And Why Some Companies Never Give In*, first edition, New York, NY: HarperCollins, 2009.

³ Andrew S. Grove, *Only the Paranoid Survive: How to Exploit the Crisis Points That Challenge Every Company*, New York, NY: Crown Business, first edition, 1999.

Risto Siilasmaa is the chairman of Nokia. This interview was conducted by **Rik Kirkland**, senior managing editor of McKinsey Publishing, who is based in McKinsey’s New York office.

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