What’s changing in board governance?

February 2016

Board governance continues to evolve to meet changes in regulatory compliance and the strategic needs of companies, requiring ever more collaboration between CEOs and CFOs.

In the new era of transparency, CEOs and CFOs can work together to improve a company’s performance in the face of shifts in the regulatory environment and in the company’s needs. In this interview, McKinsey’s Bill Huyett, an emeritus senior partner in McKinsey’s Boston office, speaks with Werner Rehm, an entity partner in the New York office, about how board governance has changed in recent years due to those shifts. An edited transcript of their conversation follows.

Werner Rehm: Thanks, Bill, for joining us today. We thought we would talk about managing boards, the trends emerging over the last couple of years, and your insights about how to lead a board to create the most impact for the company. We’re very excited to have you as one of our leading thinkers on that topic.

Bill Huyett: I’m excited to be here. Thanks for the invitation.

Werner Rehm: As you’ve mentioned in previous discussions, there have been some pretty significant shifts in governance over the last decade. Assuming we’re talking about primarily US boards, though there are echoes of the same shift in the UK and the continent and elsewhere, what’s going on?

Bill Huyett: I think you could say the pendulum is swinging back from a focus on regulatory compliance. I would call it generic regulatory compliance in the sense that this was a correct emphasis by boards on ensuring that they were in compliance with the expectations of the Securities and Exchange Commission—the Sarbanes–Oxley Act (SOX) being the most prominent of those, but not the only one.

And there were a good ten years where SOX compliance and associated enterprise risk-management matters were center stage for boards. Again, I would say appropriately so. But that is changing, and I think the pendulum is swinging back to where boards are emphasizing
the performance of the company, long-term value creation for shareholders, all the questions around the company’s strategy performance, as well as the various industries that that company might be in.

**Werner Rehm:** That’s interesting. What are the implications of that pendulum swinging for the sorts of people that are being recruited and added to boards? How are they expected to add value?

**Bill Huyett:** There was a period where regulatory expertise and cross-industry pattern recognition around compliance was pretty important. That’s much less valuable today than people with deep industry experience, and importantly experience from outside the industry, on themes—be it strategic or operational or technological—that are important to the company.

The second major implication is boards are expecting more from their CEOs. The comfortable relationship and crony relationship that characterized some boards—though I think that’s often blown out of proportion—has nearly vanished. The third implication is where the board spends its time. Not surprisingly, these notions of compliance are moving lower on the agenda. And topics around corporate strategy, corporate performance, and investor expectations are moving up on the agenda.

**Werner Rehm:** Don’t board members also have more at stake today with regard to their personal reputations?

**Bill Huyett:** Like every other sector of our society, there is almost complete transparency around board membership, and the personal reputations of board members are increasingly at stake in particularly contentious situations. Activist investors are an obvious example of that, where the activist makes quite public accusations of boards of directors and what they’ve done or not done.

There is also media attention on the behavior of a specific company, or the behavior of companies more broadly, be it with foreign corrupt practices or gender balance on boards. A host of nongovernmental entities like ISS also play quite important roles in how board members are perceived, are ranked, and in turn how companies are seen by investors.

Lastly, outside of activist investors, the expectations of the very largest holders of securities, like the index funds and others, for individual board members have gone way up. Many of these investors have gone from being quite silent on the topic to being quite vocal. Interestingly, because they must be in a security, these index funds increasingly have a point of view which is, “It is in the interest of my holders that we, as index-fund holders, are active in corporate governance, because it’s the only degree of freedom we have. We can’t sell the stock.”

**Werner Rehm:** What about the level of uncertainty that boards are confronting, some of which are quite novel and, at least in order of magnitude, different from what they’ve faced before?

**Bill Huyett:** If you just go down the list of everything that is moving under the feet of board members, from business-model disruption caused by new entrants and technology and shifts in big markets. Look what oil has done over the past couple years and look what China’s done over the last couple years. These gigantic markets have a profound impact on certain sectors
of the economy and the prospects for companies. There are topics that you never used to see before like cybersecurity, geopolitics, and associated risks that are typically not on the map for many companies. Then finally, the world is changing from a social standpoint and the expectations of the citizenship role that boards and their companies play is also changing.

Taken one at a time they aren’t daunting. But if you add them all up, they are. When you meet with board members you have a sense that they are grappling with uncertainty in ways that they would not have at least admitted they were 10 or 15 years ago.

Werner Rehm: With these kinds of changes happening all at once, how much of that is driven by what we read in the newspaper? Activist shareholders, a push for large transactions, breakouts, those kind of things, versus, quite frankly, just opportunities?

Bill Huyett: The activists are not primarily responsible for this. They’re the most obvious from a media standpoint. But I think the roots actually go back to the Great Recession. Coming out of the Great Recession we saw a far more fundamental examination on the part of virtually every large corporation asking, “Why are we in the businesses we’re in?”

We’ve just seen a shock, and my impression is that it woke up both senior leaders of companies and directors of companies to the more basic questions about the corporations’ scope. How does the corporation deliver value in the businesses it’s in? I think the combination of that shock and the transformative impact of some of these social and global economic forces combined are what have driven this.

That in turn caused investors of all kinds to be more interested and active in the performance of the company, relative to peers. So I think activists just happen to be active—if you’ll forgive the pun—today. I don’t think it would be accurate to attribute the cause of all this to them.

Werner Rehm: I hesitate to use the word “pressure,” but if that trend comes from all investors, what do CEOs have to do or what can they do to lead the board along the way, short of exchanging all the board members at once?

Bill Huyett: I think that is rarely required, to be honest. The quality of board members across most large US public companies is quite high. This is more about the CEO and/or the board chair taking a step back and saying, “How do we reallocate how the board spends its time and, in turn, how management spends time with the board?”

There are lots of ways to parse how CEOs interact with their boards. The three pragmatic buckets that I use are, number one, there’s a whole set of fiduciary obligations, or the duty of care obligations that a board has to its owners, which are important. I don’t think that has changed much. The second is the board’s oversight of value creation. This has typically not received as much focus, as I said earlier, given the emphasis on managing compliance and managing risk. And that’s changed. The third is, broadly, the idea that the effectiveness of the top team and the board can have a huge impact on the trajectory of the company, and the confidence with which the management teams of companies make decisions about the future and deal with investors about the choices they’ve made.
To put it another way, if the board is tentative and begrudging in its view of the corporation’s strategy, it’s very difficult for the management team to be assertive on matters of investments (be it capital expenditures, new products, or mergers and acquisitions) with its investors.

**Werner Rehm:** It’s interesting that you mention the importance of long-term value-creation thinking. On the other hand, we do know from surveys and conversations that management feels a lot of pressure from the board for short-term performance. As a CEO, how do you start to have those conversations about short-term versus the long-term value creation for the shareholders?

**Bill Huyett:** It’s a classic chicken-and-an-egg situation. If you talk to most boards, there are very few of them who doubt the importance of long-term value creation. Many of them would argue, in turn, that company management teams don’t always give them the tools to play that long-term value-creation role. Therefore they’re reduced to playing almost a caricature role in driving short-term performance with the usual phrases around earnings and growth and things like that. Both management teams and boards, with relatively simple changes, can completely change that dynamic.

**Werner Rehm:** What kinds of simple changes are we talking about?

**Bill Huyett:** Let me tick off what I think those are. Surprisingly, most CFOs and most board members will admit privately that the board does not have a comprehensive understanding of the value-creation dynamics of the company and the industry. It sounds surprising, but even blue-chip boards of directors will articulate that they have broad business judgment, they have the value-creation experience that comes from their own company, but they don’t have it for the company for which they are the board. The odd thing is, of course, very few board members will raise their hand and say, “I really don’t understand how this particular industry creates value and the trade-offs across growth and the margin improvement and asset intensity.”

The first step if you’re interested in long-term value creation is to make sure that the board has a common vocabulary of value creation for that company. Because in the absence of that, each director, with the best of intentions, will bring his or her perspectives from their industry. Given the diversity on boards in terms of company background, you end up with something that is potentially not accurate for the company in question. It’s a big opportunity for the CEO and the CFO to make sure that new board members in particular are brought on understanding the dynamics of intrinsic value creation in the corporation and its constituent parts.

**Werner Rehm:** Do both sides have to accept that they need to spend time on learning about what works and what doesn’t?

**Bill Huyett:** Yes. I think there is a general understanding that the time obligation of a high-performance board member today is greater than it might have been 10 or 15 years ago. It just comes with the territory. In general, board members don’t resist the idea that being a board member takes more time today than it might’ve a decade or two ago. I think what has changed, particularly in the group that you’re asking to bring outside views, is there’s an idea that those
views need to be more closely tied to company-specific themes, strategic themes, and operating themes that will allow the board to have a debate around specific choices that the company has to make about investments in new products and strategies. Whereas 10 or 15 years ago, that orthogonal view was bringing more of the general compliance risk and basic diversity.

There’s now an interest in what I’d call related diversity—related in the sense that it touches on choices that the company has on its strategy where directors could bring experience from industries that may be further down the path in something like digitization, for example.

**Werner Rehm:** We talked about the importance of understanding the value-creation dynamic. What are some of the other areas where CEOs can drive change?

**Bill Huyett:** The next one is, perhaps, an obvious one, but it’s not always core to the board’s discussion—and that’s the investor’s view. When I talk to board members who have been on the other end of a campaign from either an activist or an active investor, they’re usually a bit surprised at the difference between how these investors view the company and its performance, and what has been the tone of the board discussion. Now, to be clear, our bias is to pay attention to intrinsic investors, not people who are in and out of a stock every five minutes. Intrinsic investors typically have thoughtful and constructively critical views of companies. As a director, ensuring you hear that as directly as you can is part of doing a good job.

The other is it’s not a bad idea, given the tenor in today’s markets, to understand what an activist would say about our company. Even if you believe that an activist is 100 miles away from taking a run at the company, there is just something valuable about a manifestly critical view of the company, its portfolio, and its performance.

**Werner Rehm:** With that in mind, what is your view, Bill, about board members meeting other investors directly?

**Bill Huyett:** It is inevitable that boards will find mechanisms for more direct conversation with investors. Now, I say that with the important caveats that in general it is important for companies’ senior management to be part of those meetings, except in exceptional circumstances. Not to mention, of course, compliance with the regulations on how you communicate to investors. I think it is part of the longer, larger secular trends in society and the ability to insulate people from conversations like that is going away.

The third area of board value creation is a shift to corporate strategy. One of the common laments of both board members and company management teams is the enormous amount of energy and paper that go into detailed business-unit strategy reviews, often at an annual strategy off-site. There’s a sense that if everybody’s honest, this is not an area in most multibusiness companies where board members are going to add a huge amount of value. The management teams of those business units are so deep in those markets that it’s unlikely a board member is going to be able to add a lot of value, commensurate with the time required.

On the other hand, much of the attention of activists and much of the crisis of confidence that came out of the Great Recession in some sectors has dealt with corporate strategy and its
cousin, capital allocation. Boards are much more likely to be able to add value on the handful of fundamental corporate strategic questions about where this corporation should participate in the economy in terms of the businesses it owns, how the corporate center adds value to those businesses, and the overall balance of where the cash generated from these businesses goes, whether it’s to investors or within the company to grow or expand.

**Werner Rehm:** If I may interrupt you there, Bill, I think everybody agrees intellectually on those points, but how do you actually drive that discussion practically? Is it the board, or one member of the board asking for a discussion on this? Is it the CEO?

**Bill Huyett:** I think it’s CEO led. Unless we’re in the special circumstances of a company that’s under attack, then I think it really is the CEOs suggesting a pivot by the board. Because most CEOs will also say, “Listen, this preparation of 1,000 pages of business unit–oriented strategy stuff is a huge distraction for the management team.”

And while the board members like meeting the managers, it’s in a dog-and-pony-show format that’s probably not all that conducive to real debate. So I’ve seen CEOs and board chairs, if it’s a different person, just agree that they’re going to start to shift, sometimes radically, to spending more time on corporate strategy. The way that happens practically is typically the CEO and the lead director or the chair will agree on the four to six most critical corporate-strategy questions they face, and then agree on a sequence for how to tackle those questions. It goes from being an annual off-site to a more fluid process that’s organized around the specific corporate-strategy questions.

Now, sometimes that’s diversification. Sometimes it’s simplifying the portfolio. Sometimes it’s more operational performance on growth, or margin, or asset intensity. It’s obviously very company specific. But it’s not that hard a shift to make. At least my experience is both the management teams and the boards are happier when they spend their time on those topics.

**Werner Rehm:** How can a CFO help in that?

**Bill Huyett:** It typically takes the CFO in partnership with the head of strategy and the CEO, because the CFO’s perspective on the value-creation characteristics of each part of the portfolio are foundational. If it’s not done in conjunction with somebody who’s responsible for strategy, sometimes reporting to the CFO, it can seem overly financial. The best approach is the tandem one with the CFO providing the analytic rigor and the healthy skepticism on the assumptions that underlie corporate strategy, and the assumptions about today’s environments, to dealing with the possibility of more radical step change.

**Werner Rehm:** Going back to the board’s role in value creation, what about capital spending and M&A?

**Bill Huyett:** The relative importance of those two things, obviously, varies by industry and by company. But boards have always had a fiduciary role in approving those often large cash expenses. And what I’m suggesting is that they have a second, more important role to play on those, which is ensuring value-creation performance.
There has, in my judgment, been a bit of a mismatch between the attention boards pay to the P&L and the operating results, and the attention they pay to the multiyear value-creation effectiveness of these large events, be it an acquisition or a very large capital expenditure. Put it another way, the boards are responsible for making sure that the approval is appropriate, that the rigor that goes into the forecasts and programs to deliver value from these things is appropriate. And that role certainly can’t go away.

But I do see boards that are increasingly spending time on looking across the M&A track record, the capital-spending track record, and asking, “Are we delivering? Are we creating the playbooks for value creation from balance-sheet events—M&A, divestitures, capex—that we have always paid attention to on the P&L side?”

That’s another area where I see boards increasingly spending time. They recognize that M&A is a quite powerful value-creation tool. It’s also a quite powerful way to waste shareholders’ cash.

**Werner Rehm:** Indeed. I’ve seen both. Maybe we should come to the more personal side of this. What can the CEO do to build trust? How do you actually build the relationships? And what relationships should you build? Because there’s something to be said for friends on the board and something to be said for having an open discussion with folks who push back.

**Bill Huyett:** There’s a number of aspects of it. It is, at the end of the day, a quite personal exercise. When you’re in a boardroom that’s high performance, you know from the minute you walk in that there’s a degree of personal connection and personal commitment across the board and the management team that allows them to have some quite tough debates and push the envelope on the thinking.

Starting with the CEO, there’s no substitute for having a trust-based relationship with the lead director or the chair, and to make sure that trust is built on who you, as a CEO, are. If you’re a new CEO, to not try and mimic, necessarily, your predecessor and to have the early conversation with the lead director about how you’d like to work with the board.

Another thing that I find striking is the degree to which high-performance boards have CEOs who are not defensive about what their company has done and are not excessive advocates of a strategy. They are comfortable enough as CEOs to have a real debate among thoughtful members of the board about what they’re doing today and possible paths to the future. Nothing shuts down a board faster than a CEO who is defensive, or an excessive advocate of a particular path, and is not tolerant to debate.

Lastly, particularly early on in a CEO’s relationship with a board, it’s important to give the board confidence that in addition to mastering what’s going on inside the company, the CEO is able to switch hats and can view the world through the eyes of investors and can understand what makes media tick, as complicated as that may be. It’s pretty important in terms of the perception of the company and its value creation. And of course, the government. The government’s role varies a lot by the industry and the company. So that’s the personal impact.
Then if you step away from that, there’s questions about, how you make it easy for the board members to be effective in the roles we’ve described? How do you set agendas? How do you provide materials that strike the right balance between synthesis and brevity, but enough meat to allow the board to dig in, and above all set a very high standard for the quality of the material that gets sent from the company to the board?

**Werner Rehm:** One of the jokes that we hear sometimes is that we have to dumb it down for the discussion—whatever the discussion is. And it strikes me that what you have been laying out here is sort of exactly the opposite. Educating the board in detail, and on complicated issues, spending significant time so that everybody truly understands what the implication of an M&A move is, or a capex investment, or a geographic investment. It is really making everybody smarter than they are today about these decisions, right?

**Bill Huyett:** Yes. I think you’re right. The attitude, “I have to dumb it down for the board” is doomed and, at least in my experience, completely inappropriate. Boards are thoughtful, they’re interested in doing what’s right, and if you give them the right material and setup for a discussion they’ll deliver on it—at least until proven otherwise, and then you have a different question.

Back to my earlier premise of a more issue- and opportunity-driven view of the world, is the explicit agreement on what the priorities are for the board. The board can spend time on 100 different things, so it warrants a conversation between the CEO, the lead director, and the board more broadly about what the handful of things are that this board ought to spend time on to make sure that the board is not in a rut with respect to its agenda and where it spends its time. Because where the board spent time five years ago may not be the right place for the board to spend time today. Do you need more time or less time on strategy? Do you need more time or less time on organization, talent, and leadership? Do you need more time or less time on the government? There’s a whole set of questions that often don’t get asked.

**Werner Rehm:** Well, with that, thank you, Bill, for the conversation. It’s always a pleasure to hear from a real expert.

**Bill Huyett:** Thank you.

**Bill Huyett** is an emeritus senior partner in McKinsey’s Boston office, and **Werner Rehm** is a strategy and corporate-finance partner in the New York office.