Failures in corporate leadership contributed heavily to the global financial crisis. This paper sets out how boards can be more effective and challenge management confidently.

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Key conclusions

• Boards need an integrated approach to effective leadership.

• Directors must incorporate behavioural and structural factors.

• More attention must be paid to psychological factors contributing to board performance: creating a challenge culture, succession planning and effective risk governance.

• There must be rigorous, regular and systematic board evaluation. The model proposed by this report could provide a useful input to the board evaluation process.

• The board’s relationship with external stakeholders, particularly shareholders, is crucial. By focusing on its own effectiveness and contributions to the long-term sustainability of the organisation, a board will serve those stakeholders.
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About CIMA

The Chartered Institute of Management Accountants, founded in 1919, is the world’s leading and largest professional body of Management Accountants, with 171,000 members and students operating in 165 countries, working at the heart of business. CIMA members and students work in industry, commerce and not for profit organisations. CIMA works closely with employers and sponsors leading edge research, constantly updating its qualification, professional experience requirements and continuing professional development to ensure it remains the employers’ choice when recruiting financially trained business leaders.

CIMA is committed to upholding the highest ethical and professional standards of members and students, and to maintaining public confidence in management accountancy. CIMA has made an active contribution to the global corporate governance debate over many years and has, for example, made substantive responses to the recent Walker Review of corporate governance in the UK banking industry. For further background, see www.cimaglobal.com/enterprisegovernance

According to independent research conducted by the University of Bath School of Management, CIMA’s syllabus and examination structure are the most relevant to the needs of business of all the accountancy bodies assessed. See the CIMA Difference report for further information at www.cimaglobal.com/thecimadifference. The need for good governance is an integral part of the CIMA syllabus.

About the author

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Introduction

The global financial crisis represents the biggest and most damaging failure of corporate leadership of modern times.

In March 2009 the president of the International Federation of Accountants (IFAC), Robert Bunting, argued: ‘Regardless of who is to blame, the crisis was unquestionably exacerbated by corporate governance failures.’ He specifically criticised the lack of proper risk management processes and governance systems, which ‘do not seem to provide adequately for challenging management’s risky strategies’.

Only a month earlier the Organisation for Economic Cooperation and Development (OECD) had highlighted in its own review of the financial crisis the importance of qualified board oversight and robust risk management.

Sir David Walker’s review of governance in the UK banking industry similarly emphasises the board of directors’ role in overseeing corporate strategy and risk. Published in November 2009, it concludes that, when a board discusses major strategic and risk issues, there must be a disciplined process of challenge from directors. The review demands that ‘board level engagement in the high level risk process should be materially increased’, with particular focus on the organisation’s risk appetite and tolerance. It also argues for corporate stress testing, where directors should ensure that they ‘understand the circumstances under which the entity would fail and be satisfied with the level of risk mitigation that is built in’.

This paper explores some of the corporate governance issues in an effort to help boards understand what they must do to be more effective. It considers the processes and practices that enable directors to challenge management more constructively. It goes on to examine how executives and Neds (non executive directors) can build an effective relationship that is challenging and questioning, yet positive and productive. The publication also stresses the importance of succession planning and long-term talent management as important aspects of the strategic role of boards – a factor that can make or break their organisations.

Underpinning CIMA’s thinking is the philosophy of enterprise governance, based on the goal of running a company so that long-term sustainable performance is paramount. The fundamental question it asks is: what practices can organisations adopt throughout the business cycle to deliver sustainable performance? We argue that a key practice is to ensure that the board exercises its responsibilities effectively to ensure that the right things are being done – and done well.

Our report includes examples from the banking industry, especially in the UK, but its insights can be applied in other sectors worldwide. Corporate leadership failed spectacularly in some leading UK companies. It is therefore inevitable that some of the most dramatic and relevant lessons can be learnt from British experiences. By painful necessity, the UK is now among those leading the way in corporate governance reform.

It is also evident that the public sector is in no way immune – for example, governance lapses at the Mid Staffordshire NHS Foundation Trust in March revealed that systematic failures can exist even where the profit motive is absent. The non executive role is coming increasing under pressure where budgets are being squeezed and, in the view of some, public services potentially compromised. NHS trust boards are being faced with public pressure expressed through the media and vocal public representatives where services are said to be suffering in order to meet stringent efficiency targets. Among the questions to ask are: what happens when a non executive board member is of the view that the plans for financial break-even may compromise patient safety? Also, are they getting the right level of information to give them assurance that any risks are being appropriately managed?
Enterprise governance framework

In 2002 IFAC’s professional accountants in business committee explored the emerging concept of enterprise governance. The project considered why corporate governance often fails in companies and how to make it succeed.

The enterprise governance framework

Enterprise governance comprises two dimensions of corporate governance: conformance and performance.

Conformance encompasses board structures and roles, and executive remuneration. Codes and/or standards can generally help in this area, with compliance subject to assurance and audit.

Performance oversight, meanwhile, centres on strategy and value creation. A board needs to make strategic decisions while understanding its appetite for risk and the key drivers of performance. This does not fit easily with a regime of standards and audit. It is therefore desirable to develop a range of best practice tools and techniques that can be applied intelligently in different types of organisations.

The enterprise governance project took place against the backdrop of the failures of Enron and WorldCom in the US and of Marconi in the UK. Most shareholder value in these firms was lost. The failures eroded confidence in the corporate world in the West and much effort went into understanding how such incidents could be averted in future.
Based on a series of case studies, IFAC/ CIMA published their findings in 2004 in the joint report ‘Enterprise governance: getting the balance right’. Its key message was that companies must balance conformance and performance.

One worry was that the principal official response to the crisis was a tightening of corporate governance codes and legislation – particularly the US Sarbanes-Oxley Act of 2002 – and that this would prove excessive. The ‘Enterprise governance’ report argued that, while compliance was important, companies should not overlook long-term strategic performance as a way to achieve sustainable success. In other words, good corporate governance might prevent failure, but it cannot ensure success.

Preventing failure

Corporate governance

The 2004 ‘Enterprise governance’ case studies highlighted four crucial factors.

• Culture and tone at the top. The words and actions of senior managers can reinforce the application of appropriate behaviour or do the opposite. Enron's board directors spoke frequently about ethics and codes of conduct, yet the employees realised that this was not reinforced. What they actually valued most was rapid growth and bottom line earnings.

• Chief executives, especially those with dominant personalities, can come to exercise unfettered power, pursuing ambitious strategies with little restraint.

• Directors can be weak, failing to provide sufficient oversight of the chief executive and management team.

• Internal controls need to be strong, with relevant management information fed constantly to the board.

Achieving success

Strategy

A board must set the organisation’s direction and fully accept the role placed on its shoulders to enable the business to succeed. The following key factors are:

• choice and clarity of strategy
• strategy execution
• responsiveness to abrupt changes, fast moving market conditions and information flows
• competence in mergers and acquisitions
• effective risk management.

We identified two key issues for more detailed research:

• strategic oversight and board performance
• risk management.

Recent events as the financial crisis unfolded have illustrated that many boards are not able to perform these tasks effectively. This underlines the need for a better understanding of the factors that contribute to effective boardroom leadership.
Boardroom leadership

Related factors combine to achieve board effectiveness.

This diagram represents two sets of priorities and responsibilities:

- people and behaviours
- frameworks, processes and structures.

Each segment is connected to all the others. For example, the right approach to reward or remuneration requires a high degree of risk awareness. Similarly, a culture of ‘effective challenge’ requires a shared ethical approach built on mutual respect, backed by high quality management information that provides the basis for such a challenge.

The many previous official reviews of governance have led to the codification of the roles and responsibilities of boards, and those of their risk and other sub committees. But recent events have demonstrated that structures and processes, while useful, are insufficient by themselves and that behaviour is crucial.

This report focuses on behaviour. It is important not to make too rigid a distinction between structure and culture in shaping behaviour. Structure and culture can, and indeed should, reinforce each other. As a FTSE 350 director told a recent CIMA round table discussion: ‘Good structures and processes can, and often do, drive behaviour.’ Codification can set cultural change in motion. Weak processes can lead to complacency and box ticking. Consequently, processes may need to change in order to bring about a culture of effective challenge.
People and behaviours

Board composition
Self evidently, the right people should be appointed to the board. And they should work together as an effective team (it is acceptable to have a member who is time poor but experience rich, for example). Nevertheless, taken as a whole, the board must be appropriate for the business.

The board’s composition should also take into account the independence of non executive directors (Neds). Many corporate governance codes have specified that a significant proportion of Neds should be independent. But recent corporate failures – particularly in financial services – suggest that more value needs to be placed on their experience and technical knowledge.

Another consideration is diversity. Attempts have been made to broaden the range of people serving on boards. In Norway, for example, the boards of all public companies are legally required to have a female membership of at least 40 per cent. But diversity covers more than gender, of course. A board may appear homogeneous, yet it could contain a diverse range of life experiences, knowledge, attitudes and personalities. Conversely, a board that is superficially diverse may in practice comprise people with very similar backgrounds and personality types.

Professional behaviour
Individual board members must behave in the correct way towards each other and the executive management team. The board needs to set the right tone from the top by behaving in a wholly professional manner. It should be a model of ethical behaviour in articulating and exemplifying the organisation’s values. The board and executive management team need to treat each other with respect and value the distinct contribution that each makes.

At the heart of a board’s professional behaviour is the need to understand and manage the human aspects of leading the business. The crisis at many of the world’s leading companies has led many commentators to consider the role of key personalities.

I don’t believe there is a single field of capitalist endeavour that is free from mercurial characters and fairly constant conflict and over exuberance… Envy, megalomania, competitiveness and even madness can feature in the mix.


The chief executive [at RBS] exercised control through a daily 9.30am meeting where he would quiz managers about their divisions and openly question their competence. One morning he reduced a senior executive to tears. ‘It wasn't a positive or healthy atmosphere,’ says a former executive. ‘You have to wonder about the decisions people make in that environment.’

In between the rounds of golf, the executives were divided into small groups and asked to identify problems within management. Every group cited a ‘culture of fear’ as the bank’s biggest problem… The morning meetings… were invariably described by former executives as ‘unpleasant’ or ‘hostile’.

To say he [Dick Fuld, Lehman Brothers’ CEO] was surrounded with a cult of personality would be an understatement. He was the textbook example of the command and control CEO... Fuld inspired great loyalty and, on occasion, great fear. Those closest to him slaved like courtiers to a medieval monarch... insulating him from trouble – from almost anything he might not want to hear.


Even when in a relatively upbeat mood he seemed to take pleasure in violent imagery... Fuld had used this aggression to consolidate his reputation as the most successful chief executive in the banking business and one of the most respected corporate leaders in America. However, the style also contained the seeds of disaster. This meant that nobody would or could challenge the boss if his judgment erred or if things started to go wrong.


The prevalence of emotional factors in corporate success and failure means that they should be recognised as being at the heart of boardroom leadership and effectiveness. There may be a temptation to overlook such ‘soft’ factors or see human idiosyncrasies as ‘just the way things are’, about which nothing can be done. This is understandable: confronting aggressive and disturbed behaviour is often uncomfortable.

But lessons should be learnt from the corporate crisis, in which such behaviour has played a decisive role. The self belief required to climb to the pinnacle of a multi billion dollar business such as an investment bank may come at the price of a failure to listen to others – a particular weakness of the forceful or charismatic leader. This topic merits further study if corporate leadership standards are to be raised.

Supportive challenge culture

A recurrent theme in addressing the evident shortcomings in corporate leadership is the need for board directors to create a culture of ‘effective challenge’. Better decisions are reached when they have been thoroughly debated and subjected to proper scrutiny. A board can fall into ‘group think’ – the situation whereby all members think the same way. Members can become closed to new ideas and unable to incorporate a range of diverse factors into their thought processes. A fixed way of viewing things may not be so damaging once decisions are being implemented and total commitment to action is needed, but it can be disastrous at the decision making stages.

Jeffrey Sonnenfeld, senior associate dean at Yale School of Management, points out that many boards of failed companies had ‘fabulous individuals on them’, but ‘collectively something went wrong when boards did not ask the tough questions and did not have the stomach and the interest in working with the CEO to reinvent the business and challenge the status quo’.

In some cases, CEOs had such control over the workings of their boards and the flow of management information that meetings were stage managed, making it hard for directors to ask awkward questions without the fear of looking stupid.
Many HBOS directors had banking experience. But it is hard to see even knowledgeable non-executives having sufficient time to assemble the critical detail necessary to challenge full time executives... Directors need to have experience and knowledge, yes, but above all they need the cast iron self confidence to confront bank bosses when they look like overstepping the mark.


Royal Bank of Scotland’s ill fated acquisition of ABN Amro in 2007 attracted particularly heavy criticism, but the decision making process was later defended by RBS’s chairman at the time of the takeover, Sir Tom McKillop.

The premise that we allowed [CEO] Sir Fred [Goodwin] to proceed implies that this was driven by Sir Fred, which is not the case... The board received a presentation from our strategy group and the executive team: an analysis of the ABN Amro businesses. We looked at that in considerable detail... There was no proposition to buy ABN Amro at the first meeting; it was an analysis session. At every stage the whole board considered this and were unanimous in the steps we took... We did in fact make a bad mistake in purchasing ABN Amro. At the time it did not look like that – it is easy in retrospect. I could give... many bits of evidence... that there was widespread support for it. Yes, there were some voices saying it was overpriced, but we received 94.5 per cent shareholder approval. We received regulatory approvals and there was a very good financial case.

Sir Tom McKillop, former chairman, RBS, uncorrected evidence from the Treasury select committee, 10 February 2009.

We cannot judge the quality of the debate within the RBS board at the time. Did anybody play devil’s advocate and ask the awkward questions? Did the Neds genuinely understand what was being proposed and know the searching questions that needed to be asked? Did they challenge the answers?

The Walker review of corporate governance in UK banks and other financial entities

- Principal deficiencies in boards related much more to patterns of behaviour than to organisations. The right sequence in board discussion on major issues should be: presentation by the executive, a disciplined process of challenge, a decision on the policy or strategy to be adopted and then full empowerment of the executive to implement.

- All this will call for a material change of culture in some cases so that disciplined, but rigorous, challenge on substantive issues comes to be seen as the norm and inability or insufficient strength of character to participate will throw into question the continued suitability of a particular board member... Appropriate balance will only be achieved where the executive expects to be challenged, but where the board debate surrounding such challenge is conducted in a way that leaves the executive team with a sense of having drawn benefit from it.

- Neds and the boards of which they are members need to find the right point on the spectrum, which ranges from relatively unquestioning support of the executive at one end to persistent and ultimately unconstructive challenge at the other.

- The importance of challenge will be greater, the greater the entrenchment of the chief executive, especially if he or she is believed to face or tolerate little challenge from within the executive team and unreceptive or inaccessible to critical input from any other source.
The chairman of the UK Financial Services Authority, Lord Turner, has stressed how important it is for banks to obtain an external challenge to assumptions based on conventional wisdom. Yet there needs to be a description of a ‘challenge culture’, within boards and beyond, and a map for how a company can create this.

Recent guidance from the Institute of Chartered Secretaries and Administrators (ICSA) suggests that best practice boardroom behaviour includes:

- the questioning of assumptions and established orthodoxy
- challenge that is constructive, confident, principled and proportionate
- rigorous debate.

CIMA’s boardroom leadership model (see above) suggests key ingredients to create a climate in which challenge is possible.

- High quality management information.
- Diversity in skills, perspectives and experience.
- Mutual respect among players. There needs to be an understanding and acceptance on all sides that constructive challenge is vital.
- Robust processes and frameworks to support strategic development. It is difficult to challenge strategy if the board agenda does not allocate enough time to discuss strategy. Boards may find other devices useful, such as designating someone to play devil’s advocate for a particular discussion.

Although there may be acceptance that a challenge culture is positive, it is not easy to define, create or maintain. The following questions need to be considered:

- what does a constructive challenge look like in practice?
- how can a company assess its effectiveness?
- are there best practice examples of a constructive challenge that prevented costly mistakes?
- how much time should be spent on challenging proposals?
- when does a challenge become counterproductive?
- how can a company demonstrate to stakeholders that it has an effective challenge culture?
Talent development and reward

- Much attention has been devoted in the corporate governance debate to executive remuneration. Less attention has been paid to the nurturing of long-term talent and succession planning. Yet this is a critical function of the board that can significantly affect the continuing success of an organisation.
- In our initial enterprise governance work in 2002-2003 we found evidence that succession planning was a relevant factor in success or failure. UK retailer Marks and Spencer experienced serious boardroom upheavals and strategic difficulties, partly as a result of its board’s failure to address succession issues. Tesco, on the other hand, took senior level succession planning seriously. The transition between its chief executives worked well and the company’s performance benefited as a result.
- Long-term talent and succession planning – both on the board and in senior management – needs dedicated attention.

Frameworks, processes and structures

It is important to recognise the frameworks, processes and structures that support effective boardroom leadership.

Roles and responsibilities

There must be clear definitions of the roles of key players, including those of the chairman and the Neds, along with structures such as boards and board committees. Key processes should include board evaluation. This is well covered in traditional corporate governance codes.

Agendas and tools

Boards must use time and the setting of board and sub committee agendas constructively and with discipline to consider strategic issues. Boards can use strategic frameworks and tools to facilitate discussions. One framework is the CIMA Strategic Scorecard™, which enables boards to focus on the key aspects of strategy, to ensure that they receive the necessary information and to ask the searching questions.

Information and reporting

The information that boards need and how they report in ways that drive good governance have been explored extensively in CIMA’s ‘Report Leadership’ and ‘Improving decision making in organisations’ programmes. The institute is undertaking further work in this area to be published in a future report.

This is also linked with calls for a new model of reporting to take into account long-term sustainability issues. According to the Prince of Wales’s Accounting for Sustainability Project: ‘The recent financial crisis has highlighted the need for capital market decision making to reflect longer-term considerations and has called into question the extent to which corporate reporting disclosures highlight systemic risks.’

Risk awareness

Boards must properly understand risk, integrating it into strategic thinking and demonstrating a rigorous and consistent approach throughout the business cycle.
The crucial point is the quality of the conversations that the board has about risk – it’s not about ticking boxes in a risk framework. Organisations need to manage risks reliably throughout the business cycle to deliver sustainable performance. Risk management practices became too lax during the boom years. This was apparent in the financial services industry, with misaligned performance incentives and inadequate risk models leading to excessive risk taking.

Organisations tend to oscillate between under scrutiny in good times and over scrutiny in bad times. Sustainable performance requires reliable and consistent scrutiny over the course of the business cycle.

Greed reflects a failure of leadership. Turning your head to ignore the risk because you are making big earnings today certainly shows a lack of leadership.

Russell Palmer, former dean of Wharton Business School, ‘Greed reflects a failure of leadership’, Knowledge@Wharton, 28 June 2008.

The tendency towards greed is reinforced by ‘disaster myopia’. This is the tendency to underestimate the probability of adverse outcomes that have not occurred in recent memory. A parallel example is the homeowner who has been burgled but whose vigilance drops as their memory fades. Disaster myopia was recognised as one of the factors responsible for the banking crisis by Andrew Haldane, executive director for financial stability at the Bank of England.

Conventional approaches to decision making exacerbate this weakness. Wim Van der Stede, CIMA professor of accounting and financial management at the London School of Economics and Political Science, describes the oscillation between over and under scrutiny as a possible by product of the ‘management by exception’ approach that most companies practise.

‘[Management by exception] directs attention primarily, if not exclusively, to problem areas, assuming that all is well where and when performance meets or beats expectations… There tends to be an asymmetry in the attention paid to good versus poor performance – that is, there is more vigour to combat contractions than there is healthy scepticism or sensible restraint during expansions or towards unusually strong performance.’

An illustration of the imbalanced performance scrutiny cycle is that it is less common for firms to investigate unusual profits than unusual losses. Yet, as Van der Stede points out, unusual profits often provide hints of impending disasters. Unusually high profits might indicate that managers have been too aggressive, taking too much risk or focusing excessively on short-term goals, particularly where there is lax scrutiny.

‘Superstar’ managers should perhaps be assumed to be excessive risk takers, except where proved otherwise (Woods, 2009). Boards should celebrate stellar performance only once they have cast a searching eye over how it has been achieved.
Other relevant CIMA publications


All are available from www.cimaglobal.com/resources

References
