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Governance Tools for Board Members: Adopting Strategy Maps and Balanced Score Cards

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Abstract

The accountabilities of the members of the board of directors (BoD) of companies have increased over the years. In nearly every country there is a spate of legislation that holds board members to far greater liability than in the past. Some courts in the US and elsewhere, for instance, are questioning the adequacy of “business judgment rule”. What this means is that increasingly it is not just deliberate misconduct of directors that is attracting legal actions, but also acts construed as negligence or arising from due deliberations of available facts. World over, negligence, including lack of knowledge or inattention to firm supervision, is increasingly being considered a violation of the directorial fiduciary responsibilities.

Corresponding to these developments, there are no adequate tools and frameworks available to the directors to influence, monitor and control managerial behaviour. This paper would examine how Balanced Score Cards (BSC) and Strategy Maps could be modified to be used for the purpose. Strategy Score Cards originally specified four perspectives. These perspectives are by themselves useful in addressing the various stakeholder concerns. Equally important is the way the various perspectives tie together to create “coherence”. Strategy maps are complex set of hypotheses that the company holds as true, even if temporarily, that needs to be continuously checked for its veracity. For directorial control, it is possible to extend the idea of score cards and strategy maps. This paper would show how this is possible.

First, it is possible to examine the various measures, adopt and extend some of them for directorial control. For instance, if the

BoD decides to be more active about the environment, then the scorecards would need to be modified to incorporate the environmental factors. These may be incorporated in the Internal Process perspective (one of the famous four perspectives originally proposed by Kaplan and Norton), “internal” here implying not just “internal to the firm” but also the “inter-organizational system”. Or such factors could be introduced separately under a new “perspective”; something that should be done in a conceptually sound manner. What is important is that while introducing, in this case, environment, the strategy map has to be correspondingly modified in the cause-effect scheme.

Tracking the strategy map by BoD over time provides for convenient monitoring. Take the case of an investment made in the past to, say, enhance consumer satisfaction (say, as claimed previously and appropriately represented as a cause-effect relationship in the strategy map). The BoD can now examine effectiveness of the investment based on the cause-effect claims that the strategy map makes. This paper would make a distinction between action variables and monitoring variables. Monitoring variables will be further divided based on two considerations; whether a) results met or not and b) whether causative factors met the expected levels or not. Based on this, ways to relook at how the monitoring variables could be more completely and accurately specified will be discussed with implications for directorial recommendations to the executive.

Keywords: Board of Directors, Directorial Accountability, Business Judgment Rule, Strategy Maps, Balanced Scorecards.

Changing View of Directorial Accountability

During the last couple of years, world over there has been more a several bankruptcies and huge investor losses that have been attributed to frauds and misadventures by corporate executives and incompetent boards. The governance failures of companies have resulted in calls to make the boards more accountable. There is also call for professionalization of the board (Pozen, 2010). Indeed there may be multiple ways to respond to these challenges. This paper takes the view that board directors have to:

1. engage the executive from a more informed position and
2. Undertake better self-management by the board.

In general, the response to governance failures has been one of outrage and exasperation at the “ethical lows” corporate world has sunken into! Our purpose of this paper is neither to dwell on them nor to report of such commentaries. We want to point out and help those of integrity to be more engaged and effective while doing the directorial function.

With higher expectations from the board, the courts too have been changing in their view of directorial responsibilities. Clarke (2007) writes of how in the US, or more particularly in Delaware where a large number of firms are registered, things have been changing. Talking of what has been happening until now he writes, “As long as there is no evidence of fraud, gross negligence or other misconduct, directors will not be held responsible for a business judgment... In

Delaware directors are presumed to have acted on an informed basis, in good faith and with no personal interest in the matter...” But, lately things are becoming different. “Recently however, Delaware courts have focused on instances of violations of directors’ duty of care so egregious that they rise to the level of bad faith, a serious matter as directors cannot be indemnified from liabilities arising out of breaches of good faith” (pp: 37).

In the US the rules themselves come in for a major overhaul through Sarbanes Oxley Act of 2002 (SOX) that were intended to prevent executives from committing fraudulent acts and misleading shareholders and public by manipulating information and by making false public announcements. To mitigate or check unethical behaviors and increase transparency, SOX subjected listed companies to tightened rules and regulations and to penalties for managerial misconduct. SOX has had some impact on corporate governance, even if there have been failure of several SOX-compliant companies in the recent past. This is creating further pressure on the BoD and directors in terms of greater accountabilities (Pozen, 2010) and reinterpretation of the business judgment rule more stringently.

Outside the US too this has been the case. For instance, Riordan (2004) reports of a High Court in Ireland restricting four non-executive directors of firm, Tralee Beef & Lamb Ltd., then in liquidation, “on the basis that they had acted honestly but not responsibly in relation to the conduct of the

affairs of the company.” The court found that the directors, one of them appointed by one of firm’s long – term funder, had failed to adequately keep themselves abreast of the company’s affairs though means such as attending the company meeting, raising issues with the firm when BoD meetings were not scheduled, making contacts with co-directors in discharging the duties and obligations as non-executive directors and supervising and controlling the executives in managing the affairs of the firm prudently.

We see that acts of commission are not necessary conditions for the courts to pronounce adversarial judgments on firm directors, whether executive or non-executive. Acts of omission (in this case, acting passively or not acting) too, according to the court, are violations.

World over, the fact that acts of omission and “honest but not-responsible” clause are increasingly putting pressure on even directors with good intentions is a foregone conclusion. Ironically, even insurance that directors could possibly take do not provide adequate cover only willful acts. Protections such as “Directors and Officers Insurance” that are designed to safeguard the interests of directors and managers of the firm against dereliction of duties do not cover honest-but-not-responsible situations (Thrope, 2010). In other words, there is no substitute for directors to actively partake in the board activities of the firm and keep themselves fully informed of what the executive side is doing. Otherwise, they are exposing

themselves and their reputations to risks that did not exist until recently.

Implications of Contemporary Directors

1. A role of a director is more than advisory.
2. World over the position of a director comes with certain risks that did not exist until recently.
3. Being a friend of the Chairperson of co-directors is an insufficient reason for being on a board.
4. It is not possible to be a member of too many boards. In fact it would be rather against one’s reputation to be in too many boards. There are human limitations on what one person can possibly do.
5. It is important to jell with other members of the board and create a professional yet collegial group working together for clarifying, understanding and achieving the vision of the company.

What these mean is that the board has to team up with the executive and create better results for the stakeholders. According to Pozen (2010) this would require a compact board, with directors having the right experience in the industry that allows them to counsel the executive side, and spending more time for board affairs. It will also require that the board self-manages itself in more thorough ways using appropriate tools.

Lack of Tools in Measurement of Board Performance

Epstein and Roy (2004b); Kiel and Nicholson (2005), Minichilli et al., (2007) through their studies have identified the potential benefits of board evaluations. Internationally,

initiatives by security regulators have placed requirements on boards to undertake annual performance evaluation (Long, 2006). Evidence from countries such as the USA suggests the majority of boards fail to undertake any form of regular performance evaluation (Conger et al., 1998; Epstein and Roy, 2004b). Further, where board performance evaluation is carried out, its form and rigor can vary considerably (Leblanc, 2007; Roy, 2008; Spencer, 2009). Consequently, it has been suggested that inadequate board performance evaluation practices present a significant barrier to improving governance and accountability (Collier, 2004; Epstein and Roy, 2004a & 2004b; Minichilli et al., 2007). Internationally, there is room for improvement in how board performance is evaluated. As a basis for considering potential improvements, we now reflect on the key theoretical perspectives on performance measurement and the argument for considering performance from a stakeholder perspective.

Theoretical Perspectives on Performance Measurement: Shareholder v. Stakeholder

Theoretical perspectives on performance measurement can be broadly categorized into shareholder perspectives and stakeholder perspectives (Fitzgerald, 2007, p. 223). The former view is predicated on the belief that financial measures provide the most relevant and direct focus for improving performance, since measuring and rewarding activities that improve financial performance is thought to best enhance shareholder wealth. This perspective is usually associated with the use of a single financial metric as the

focus of performance measurement (Fitzgerald, 2007, p. 229). Typical financial metrics employed within this perspective include shareholder value added (SVA) and economic value added (EVA) (Starovic et al., 2004).

Increasingly, however, an alternative stakeholder perspective has reshaped thinking about performance measurement. The stakeholder perspective "argues that companies compete on many dimensions whose evaluation cannot be confined to narrow financial indicators" (Fitzgerald, 2007, p. 224). Typically, performance measurement frameworks underpinned by stakeholder theory incorporate multiple measures, both financial and non-financial. While recognizing that financial outcomes are important for shareholders, the non-financial measures are designed to reflect the strategic importance of focusing on other stakeholders, such as suppliers, employees and customers. Well known examples of stakeholder-based performance measurement frameworks include the SMART pyramid (Lynch and Cross, 1991), the performance prism (Neely and Adams, 2001) and the balanced scorecards (Kaplan and Norton, 1992). The most well-known of these - the balanced scorecard - forms the focus of this paper. Its potential application to board performance measurement is discussed next.

Strategy Maps and BSC for the Boards

A potentially fruitful approach to board performance measurement, championed by Epstein and Roy (2004a), is Kaplan and Norton's (1992) balanced scorecards. This

framework provides a means of representing the multiple goals of boards and the multiple drivers of board effectiveness in achieving those goals.

Epstein and Roy (2004a) draw on Kaplan and Norton's balanced scorecard (BSC) model (Kaplan and Norton, 1992; 1996; 2001; 2008) to propose a framework for measuring and improving board performance. They note:

“By using a balanced scorecards developed specifically for evaluating and improving their performance, boards should be able to identify and understand the cause-and-effect relationships of their actions on shareholder value, thus focusing attention on the drivers of corporate success and the levers they can pull to improve their performance and the company's performance.” (Epstein and Roy, 2004a, p. 26)

The cause-and-effect aspect of any BSC design is important in ensuring its potential as a strategic management tool as well as a measurement framework (Kaplan and Norton, 2001), but the challenges of confirming BSC causality are well noted (Brignall, 2002; Nprreklit, 2000, 2007; Davis and Albright, 2004; Bukh and Malmi, 2005; Malina et al., 2007). Bukh and Malmi (2005) point to Kaplan and Norton's argument that performance measures should be derived from assumed cause-and-effect relationships, and note that these assumptions may inevitably be wrong. In other words, the BSC can only ever reflect a strategy that is a set of hypotheses about causality, rather than a set

of proven relationships. However, Bukh and Malmi (2005) also note that, ideally, organizations should attempt to validate their causality hypotheses when data becomes available (see also: Stemsrudhagen, 2004; Chenhall, 2009).

Building assumed causality relationships into a board BSC requires identifying (i) 'leading' indicators of performance in areas equivalent to Kaplan and Norton's learning and growth, internal processes and customer satisfaction dimensions, and (ii) 'lagging' indicators related to financial outcomes. Epstein and Roy (2004a) take this approach. They follow the Kaplan and Norton BSC framework very closely, simply substituting stakeholders' satisfaction for the customer dimension, since stakeholders can be considered the 'customers' for board outcomes. Epstein and Roy's inclusion of financial measures, (EVA, ROI, share price, earnings, cash flow, and profit in excess of plan), as lagging indicators rests on the assumption that good board structure and performance will contribute to strong financial performance. Although elements of this assumption remain contested (Dalton et al., 1998; Conger et al., 1998; Korac-Kakabadse et al., 2001; Bhagat and Black, 2002; Leblanc, 2007; Roy, 2008), other studies have found evidence to support the assumption that good board performance translates to good corporate performance (e.g. MacAvoy and Millstein, 1999). This assumption is also justifiable on the basis that boards which fail to lead their organizations towards targeted levels of financial performance are unlikely to be considered effective in the long-run.

In the following sections we will be discussing how to:

1. engage the executive from a more informed position
2. Undertake better self-management by the board.

Engaging the Executive from a more Informed Position

The BoD should look for ways to improve corporate governance by implementing new tools that help companies translate the strategic orientations into tangible goals. It has been shown that strategic management systems like the Balanced Scorecards can help the managers in articulating what the firm stands for and in developing objectives, goals, systems and metrics to help align strategy, actions and performance. The same system could be creatively extended to help the board engage the executive.

Let us look at the role of the board. Citing previous research, Mallin (2010) identifies three objectives for the board. We add a fourth one based on Monks and Minow (2004):

1. Provide superior strategic guidance to ensure the company's growth and prosperity;
2. Ensure accountability of the company to its stakeholders, including shareholders, employees, customers, suppliers, regulators, and the community;
3. Ensure that a highly qualified executive team is managing the company
4. Provide advice and counsel to the CEO

Provide Superior Strategic Guidance to Ensure the Company's Growth and Prosperity

While the board does not formulate the strategy of the firm, it needs to approve it and monitor whether the executive side of the firm has been able to meet the stated objectives. This requires more than a cursory understanding of the company (Mallin, 2010). The board needs to understand the product-market niche the company is serving, the competitive threats and opportunities, industry trends, the firm's competencies and whether the resource allocation and the processes that go behind it are sound. Nagal and Rigatuso (2003) report of a McKinsey study that showed that 44% of directors were unclear about the drivers of value for the organizations where they held directorship. This could mean two things, either lack of understanding of industry and firm dynamics or inadequate time spent for the purpose. While the former is addressable only by better selection of directors as suggested Pozen (2010), the latter can be addressed, at least, partly by having better tools for assessing the firm and being more engaged in the firm's affairs. This is where strategy maps could come handy.

A strategy map shows what the objectives of the firm are, how they are to be achieved and the connection between the objectives of the various sub-units (departments) and how these act together to produce overall results. For the directors the strategy map becomes a template not only to assess past successes and failures, but also understand the "organizational logic" that is being employed

for the future. The directors will be able to examine strategy maps and score cards and understand the strategy-making process of the executive. The collective experience of the directors could be marshaled to creatively challenge the assumptions inherent in the strategic maps that the executive has used. This will, if properly employed, greatly help the firm.

Ensure Accountability of the Company to its Stakeholders, Including Shareholders, Employees, Customers, Suppliers, Regulators, and the Community

It is the responsibility of the directors to ensure that the interests of the shareholders are taken into account. This is indeed a tricky issue. For the most part, the executive side is generally found to be singularly focused on day-to-day management of the company and stakeholder management is considered a luxury. Short-term maximization of shareholder returns takes the priority. If the members of the board could act as champions of different stakeholders while not losing sight of the realistic side of businesses, it would greatly help in building long-term value for the firm. It will be possible for the board to help shape the scorecards in terms of representing stakeholder interest and representing these as specific goals, followed by tracking and monitoring of the indicators.

Ensure that a Highly Qualified Executive Team is Managing the Company

The board can make a huge difference in the placement of the right persons in the right places. Even in CEO selection the boards may

not be doing a proper job (Khurana, 2001). The board could have a say in overall talent management if only the directors are knowledgeable and willing to make efforts. Of course, once the Chief Executive is selected it is important for him or her to have the freedom to place members of the team as he or she thinks fit. After all, the Chief Executive has to function on a day-to-day basis. However, there is a role for the board to suggest changes in the recruitment processes for senior executives, retention strategies, placement of advisors, succession planning etc.; in short, talent management. Strategy maps and the scorecards can help the board to understand existing talent management policies and processes and the need for changes there.

Provide Advice and Counsel to the CEO

Finally there is need to provide advice and counsel to the CEO. Western leadership style in the professional corporate realm, especially in the US, has been very individualistic. This has created the larger-than-life image of the infallible Chief Executive Officer. This will have to change if the board has to function effectively. There is need to marshal the collective wisdom of the board to benefit the company. This requires a rethink of the leadership style until now professed in textbooks of management. A recent article in Guardian sums up the dominant prevailing leadership view in the west (which is also that of the corporate world elsewhere); provocative and self-explanatory, the article is titled "Superheroes and super villains – why the cult of the CEO blinds us to reality" which says that "The urge

to identify company leaders personally with every corporate high and low is absurdly simplistic.”

Better Self-Management by the Board

Here by self-management we mean the management of the board members of themselves in a collective sense. This is indeed not easy. Board members are successful individuals who have a perspective of their own and to have anything that “smells” of harmony is not easy. And yet the strongly autonomous impulses of the members have to be matched with the need for collective thinking and action. Most research into the factors that contribute to board effectiveness has focused on structural aspects of boards using mainly quantitative research methods. During the last decade, however, there has been a move towards examining behaviour inside the boardroom using qualitative approaches (e.g., Higgs, 2003; Edlin, 2007; Parker 2007). In particular, researchers are increasingly concerned about explaining the functioning of boards and build theory based on the experiences of those who sit around the boardroom table (Corley, 2005; Roberts et al., 2005; Pye and Pettigrew, 2005; Edlin, 2007). This paper sits within this genre of research by examining the important issue of how board performance might be measured from the perspective of board members themselves.

Multiple factors have been identified in the relevant literature as contributing to board effectiveness. Several aspects of board structure and process are important. For

example, diversity of gender, age and race; percentage of executive v. non-executive members; chair/CEO duality; board size; number of meetings; information availability; and board member equity ownership (e.g., Jensen, 1993; Milliken and Martins, 1996;). Further, research from the UK and Commonwealth countries – where the roles of the chair and CEO are usually separated – has revealed more about the individual impacts of the chair and CEO on board effectiveness (Cadbury, 1992; Pettigrew and McNulty, 1998; Leblanc, 2004; Dahl, 2005; Kakabadse and Kakabadse, 2007).

Increasingly, 'softer' aspects of board practice have been identified as perhaps more significant than structural elements (Van den Berghe and Levrau, 2004). In particular, the importance of the relationship between the chair and CEO has been noted (e.g. Leblanc, 2004; Kakabadse et al., 2006), along with the influences that the leadership skills of the chair, the effectiveness of individual directors, and effective working relationships between management and the board have on overall board effectiveness (Leblanc, 2004). The importance of board 'culture' is also being recognized (Van den Berghe and Levrau, 2004; Leblanc, 2007; Parker, 2007), though it is acknowledged to be one of the more subjective and challenging factors when it comes to measuring performance. Modified Strategy Map (See Figure 1) and BSC (See Table 1) based on Epstein and Roy's (2004a) for board evaluation is presented below.

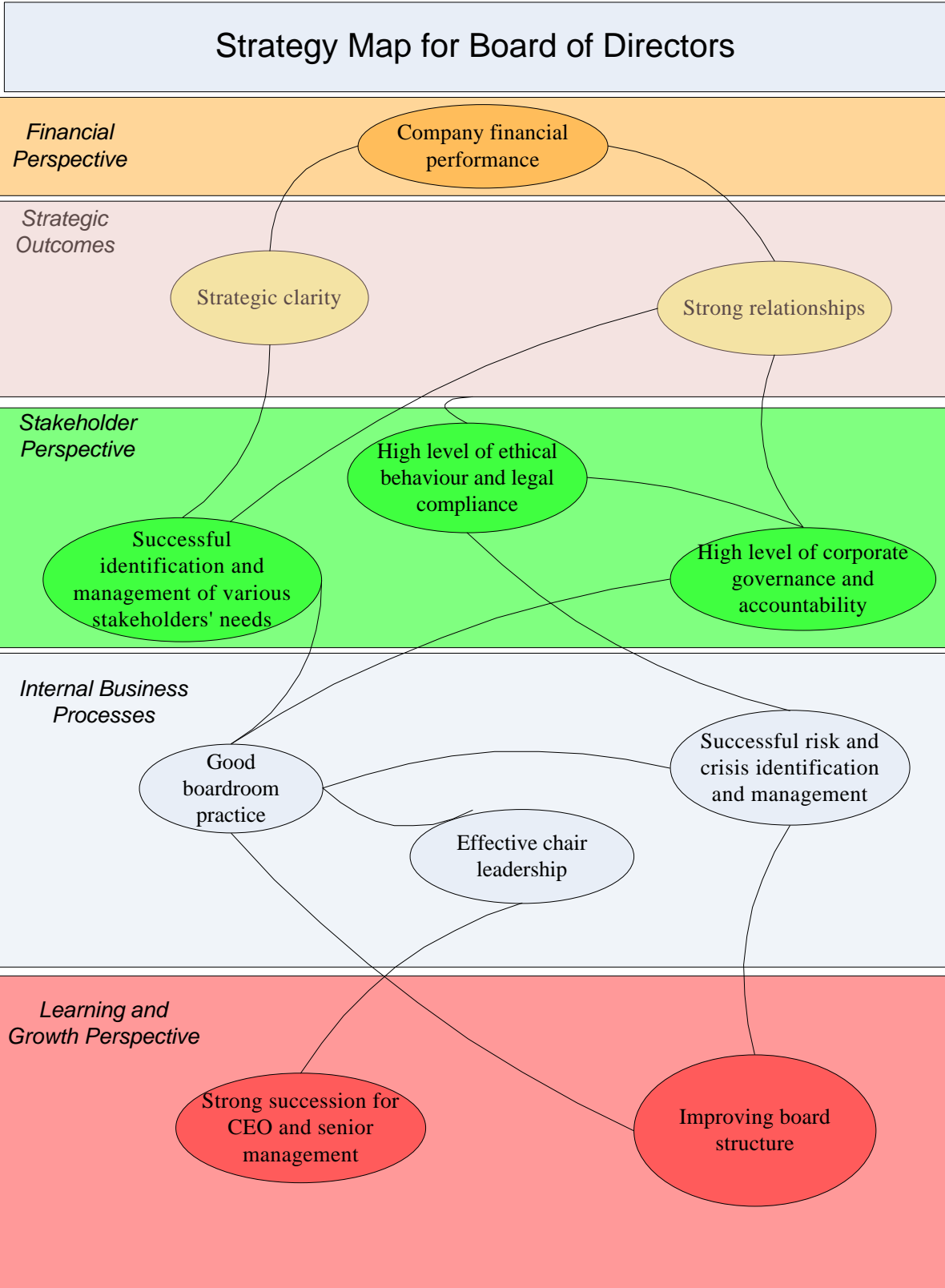


Figure 1: Modified Strategy Map.
 (Adapted from Epstein and Roy (2004a, pp. 28-29))

Board's Objectives	Key Performance Measures
Strategic outcomes	
Company financial performance	<ul style="list-style-type: none"> • EVA • ROI • Share price
Strong relationships	<ul style="list-style-type: none"> • Rating of board-management relationships • Rating of internal board relationships • Rating of stakeholder relationships
Strategic clarity	<ul style="list-style-type: none"> • Rating of board's understanding of strategic aims and direction • Rating of directors' involvement in strategy • % of accepted projects that meet/exceed expectations
Stakeholders	
High level of ethical behaviour and legal compliance	<ul style="list-style-type: none"> • # of ethical/legal violations • Level of compliance with governance guidelines
High level of corporate governance and accountability	<ul style="list-style-type: none"> • # of voluntary disclosures • Evaluation of quality of external disclosures by stakeholders or by experts
Successful identification and management of various stakeholders' needs	<ul style="list-style-type: none"> • # of meetings with stakeholders • # of complaints (employees, community, customer) • Existence of communication channels with board
Internal Processes	
Successful risk and crisis identification and management	<ul style="list-style-type: none"> • # of risk audits performed & results • # of crises and evaluation of response
Effective chair leadership	<ul style="list-style-type: none"> • Rating of Board-CEO relationships • Rating of chair's ability to steer the board towards a strategic focus and away from day-to-day management
Good boardroom practice	<ul style="list-style-type: none"> • Ratings of quality of debate • Rating of the quality of questions asked of the CEO • Ratings of inter-board relationships (positive and constructive v. negative and/or constraining) Rating of directors' behaviour (positive and constructive v. negative or undermining)
Learning and Growth	
Strong succession for CEO and senior management	<ul style="list-style-type: none"> • Existence of a position description for CEO • Interim CEO identified
Improving board structure	<ul style="list-style-type: none"> • The diversity of the board (backgrounds, experience and skills) • The number and quality of skills-development opportunities available to board members • Board selection processes regularly reviewed

Table 1: Proposed Balanced Scorecards for measuring Boards Conduct.
(Adapted from Epstein and Roy, 2004a, pp. 28-29)

Conclusions

In this paper we argued that, on account of the recent governance breakdown in several companies, there is a significant trend towards directors of firms being asked to oversee firms more closely than ever before. Directors' fiduciary responsibilities are being extended to newer areas. With this the risks they are exposed to are also on the rise. To handle this, directors require new tools for supervision of executive performance and self-management of the boards.

Strategy Maps have gained enormous popularity in the last several years. Traditionally they have been used for

ensuring fit between the firm's strategy with the environment of the company, stakeholder orientation, aligning executive action in functional areas with the firm's strategy, balancing between short-term and long-term action creating a measurement system that provides for overall superior performance. We have shown in this paper that the same tools could be appropriately modified and used by the board. We have also pointed out some directions towards such modification. Broadly we have shown how these maps could be used by the board for monitoring and advising the executive side as well as use it for self-management by the board.

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