BETTER BOARDROOMS

Repairing Corporate Governance for the 21st Century

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INTRODUCTION - THIS CHANGES EVERYTHING

The Information Age fundamentally changes the very structure and nature of the economic, social, and political systems. Although these disruptive changes have been building at least since the mid-1990s when the internet became commercially available, they have been dramatically accelerated by the coronavirus pandemic.

When we finally emerge from lockdown, the world will look completely different than it did at the dawn of 2020. We will have crossed the digital divide between the industrial age and the information age.

The information age is different from the industrial age, not least because information is fundamentally different from physical assets.

- *Information is **expandable**. It expands as it is used.*
- *Information is **not resource hungry**: Producing and distributing information requires very little in the way of energy and other physical or biological resources.*
- *Information is **substitutable**: It can and increasingly does replace capital and physical materials.*
- *Information is **transportable**: It moves at close to the speed of light.*
- *Information is **diffusive**: Information wants to be free; it leaks universally, pervasively, and continuously.*
- *Information is **shareable**: If I sell you my automobile, you have it and I do not. But if I sell you an idea or give you a fact, we both have it and others will likely soon have it too.*

Central to the digital information transformation is a shift in the economy toward intangibles. Businesses in developed economies increasingly invest more in intangible assets (10 to 13 percent of GDP) than tangible assets.[1] The intangibles economy is driven by ideas, mostly proprietary ideas – in other words, intellectual property. The market value of Apple, Amazon, Alphabet, Microsoft, and Facebook is about US$4.8 trillion, with their total tangible assets amounting to about five percent (US$225 billion) of that figure. Intangibles and IP are not the same thing – the former also comprises, for example, goodwill and brand recognition. But the magnitude of the shift is telling as an indicator of the relative decline in the value of physical assets and the rise of technological advancements and intangibles.

[1] Jonathan Haskel and Stian Westake, *Capitalism without Capital,* 2017, page 24

The information age does not change the mandate of governance, but how and by whom it is conducted. The word governance is derived from the Greek word “to steer” or “helmsman.” As Sir John Harvey Jones, a giant of British industry, said “If the board is not taking the company purposefully into the future, who is? It is because of boards’ failure to create tomorrow’s company out of today’s that so many famous names in British industry continue to disappear.”

It is not surprising then that the average life expectancy of companies on the S&P 500 list has fallen dramatically. According to a 2018 report by Innosight, a consultancy founded by Clayton Christensen, companies included in the index in 1965 remained there for an average of 33 years. By 1990, the average tenure had narrowed to 20 years. It dropped to 18 years in 2012, and Innosight forecast it will fall to just 12 years by 2027.

The exponential advancement of information technology and the accompanying changes in society are disrupting business, but the vast majority of directors are failing to recognize the far-reaching impact of these changes. Even those who appreciate the enormity of the shift seem frozen in their tracks, unwilling or unable to equip their companies with the tools needed to adapt to the challenges of a new era.

Confronted with disruptive technological and societal changes, there are only three possible roads industries can follow:

1. *The easiest, and usually the most heavily travelled, is to keep on doing what worked in the past. However, going down this road means steady decline. The industry may survive, but no matter how hard it works, it will keep on going downhill.*
2. *The second road is for the industry to be replaced by innovating outsiders and newcomers – Schumpeter’s “creative destruction.” There is a lot of money to be made by taking pieces of lucrative business away from the struggling incumbents.*
3. *There is a third and final road – to become innovators and their own “creative destroyers.” This is clearly the hardest option; examples of companies that have successfully transformed their business model are exceedingly rare.*

LESSONS FROM THE PAST

Boards of directors sit at the apex of the internal control system, which to be effective must separate management decision rights from control decision rights. When it comes to competitive or business strategy, most boards believe that it is management’s responsibility to come up with the strategy and the board’s responsibility to ratify – not rubber stamp – it.

However, there are two levels of strategy – business (or competitive) strategy and corporate strategy. Most governance experts agree that the board has ultimate responsibility for corporate strategy, which requires dealing with two questions:

(1) what business(es) should we be in?

(2) how should they be organized?

The board can choose to delegate those responsibilities, but for the control to work effectively they cannot delegate them to the people managing the businesses. Boards can add tremendous value to the organization by asking the questions: "should we be in this business" or as Peter Drucker put it "if we were not in this business today, would we get into it," and if the answer is no, "what are we going to do about it?" Answering these questions, however, requires work and outside perspectives on the future of the industry. Few CEOs are likely to say to the board, "I think it is time we exited this business." Lack of attention to these questions has created many opportunities for activist investors to step in and try to create value from the assets of companies that have passed their best before date.

Although the information age is vastly different from the industrial age, the past holds several relevant lessons for the future of corporate governance.

1. *The board is responsible for the overall stewardship of the corporation and, as such, its duties must include:*
    - *Adoption of a corporate strategy.*
    - *Succession planning, including appointing, training, and monitoring senior management.*
    - *A communication program.*
    - *The integrity of the corporation's internal control and management systems.*
2. *People see what they choose to see, rather than what is actually happening. To ensure that the corporation is not blind-sided, directors and managers must learn to see and be prepared to confront reality. Tools such as searching for anomalies, scenarios, and dialogue can be helpful in surfacing the unexpected.*
3. *Organizations learn only through individuals who learn and share. Individual learning does not guarantee organizational learning. But, without individual learning no organizational learning occurs. Organizational learning is the key to survival in the information age.*
4. *Judicious allocation of resources – financial, manufactured, intellectual, human, social and relationship and natural capital – is a critical component of governance. But the allocation of capital is not a one-time exercise. Rather, as the environment shifts resources must be reallocated and business models tweaked to ensure they are being put to best use.*

5. *Resources, including access to information and the time and skills to analyze it, are essential for directors to make good resource allocation decisions. These resources can be provided by a corporate centre or by outsiders.*
6. *Activist investors play an important role. When the directors are not doing their job – in other words, not taking the corporation purposefully into the future – then, activist investors often step in to salvage as much value as they can. Private equity investors have more at stake than the typical public company director and are thus more inclined to do whatever it takes to set the business on the right track. However, these investors have a relative short time frame (five to seven years generally), which is much less than the time required for most business transformations.*
7. *It is almost impossible to transform an existing business. The only examples I can find are situations where the founders (or their descendants) have seen the writing on the wall and overhauled the business model, or where owners have sold a wilting business and invested the proceeds in an entirely new enterprise. Most of these transformations have taken decades to complete.*
8. *Successful corporations in the information age look and act very differently from the industrial behemoths of the past.*

    - *They are by design learning organizations, prepared to innovate, experiment, and accept mistakes.*
    - *Customers, employees, suppliers, and communities are more connected and empowered.*
    - *Progress is monitored and decisions are made in real-time with a higher degree of transparency than in the past.*
    - *Management and governance by necessity are more networked and focused on the future.*

These important lessons will need to be modified for the information age as the purpose of the corporation shifts from creating shareholder value to a much wider set of stakeholder goals, but one thing is clear, only learning organizations are sustainable in an era of massive and rapid change.

DIALOGUE, DIVERSITY AND IMAGINATION - THE KEYS TO EFFECTIVE GOVERNANCE

Company directors must prepare to face a series of governance challenges if they are to have legitimacy in the 21st century. While directors' duties remain much the same as they were 50 or 100 years ago, some far-reaching changes are needed in the way they perform those duties.

Successful businesses in the information age will be marked by a small but engaged group of directors who never stop learning about the fast-changing world around them, and never stop applying those lessons in the boardroom, in the office, and on the shopfloor.

In August 2019, the U.S. Business Roundtable issued a new purpose for the corporation. 181 member CEO's announced that they were now committed to leading their companies for the benefit of all stakeholders – not just shareholders, but also customers, employees, suppliers, and communities. A fresh mindset will mean sharing responsibility for governing with these stakeholders and recognizing that corporations exist to serve the communities in which they operate, not solely to create wealth for shareholders.

To deliver on these promises, corporations need a new model of governance. A cozy group of like-minded – and often closed minded – individuals is not equipped to steer a modern company, without constant input from a broad-range of stakeholders. Ongoing dialogue with these parties is the foundation for governance in the information age.

Dialogue is a powerful tool to build trust and create a shared language and decision framework. It enables a diverse group of individuals to come together and chart a common route forward. Dialogue has an important advantage in that it includes an emotional dimension, something our conventional model of knowledge and learning tends to exclude. The dialogue model recognizes that strong feelings are bound to surface when fundamental values, interests and cultural identity are at issue. We often rely on both facts and values when reaching our most important judgements, and dialogue takes account of this mix. Applied to corporate governance, it means that a well-functioning board of directors takes the emotional as well as the factual into account when making decisions.

Most important is that dialogue must be a continuing process that enables participants to construct shared norms and expectations. Within this framework, a diverse group of players can innovate and act on a series of initiatives to deal with disruptive change. Without it, effective leadership and governance will be impossible in the information age.

- *Serve Stakeholders not just Shareholders*
- *Uncertainty and Scenarios*
- *Co-creating the Future in real-time (Catalytic Governance)*

Dialogue is an essential precursor to decisions in the governance process. It is the only way to broaden perspectives, build trust and find common ground when dealing with multiple stakeholders. It does not replace debate, negotiation, or decision making. It precedes them creating the mutual trust that is most likely to come to a productive outcome.

Directors are also responsible for managing strategic risk, in other words, the risk that the wrong scenario occurs.[2] Dialogue and scenario planning improve our capacity to manage uncertainty, by showing us how much we *don't* know when it comes to disruptive

[2] Michael Porter, *Competitive Advantage,* 1985, chapter 13.

change. This can be disconcerting: many of us prefer to ignore uncertainty or erase it by simplifying our view of the world and our assumptions about how it works. However, these simplifications can betray us when we are trying to make weighty decisions – especially about unfamiliar issues or in times of crisis. Scenario planning requires directors to frame their concerns precisely, and to focus on the issues that really matter, drawing a distinction between those which are relatively certain and likely to persist, and those which are uncertain but likely to have much greater impact.

Dialogue and scenario planning can help directors and senior executives consider plausible alternative futures, and then find the common ground necessary to act on those forces about which they are reasonably certain, and to monitor those that are still uncertain, with a view to acting when the way forward becomes clearer. I believe this nimble approach to governance will be essential in navigating in the information age.

The necessary ingredients for the development of good scenarios are dialogue, diversity, and imagination.

Dialogue is necessary for people to open their minds to the possibility that the world might look vastly different tomorrow. Although the internet has been commercially available for 25 years, how many company's thought about the impact an event like Covid-19 would have on their business?

Diversity of perspectives and experiences is necessary to see the world through a different lens – for example, a 25-year old's view on privacy and security vs a 65-year old's or China's view vs. Canada's.

Finally, imagination is necessary to construct the stories that make these scenarios real, so that directors and managers can begin to understand the implications for the businesses they are governing. This is a hugely different approach to risk management.

There are some ways of preparing for the future. Obviously, staying abreast of new technology and other developments is important. Searching for anomalies, the unexpected, can alert us to changes in the environment. Travel can open our eyes to different ways of doing things. Books, movies, and other artistic endeavours have a way of signaling changes in societal attitudes. History can also shed a light on the future, for as Leibniz said in 1703: "Nature has established patterns originating in the return of events, but only for the most part." But as Nate Silver, author of The Signal and the Noise, captured in the prediction paradox: "the more humility we have about our ability to make predictions – and the more we are willing to learn from our mistakes – the more we can turn information into knowledge and data into foresight." This encapsulates the challenge directors face in managing strategic risk.

MEASURING WHAT MATTERS

Intangible assets now make up more than 85% of the market value of the S&P 500. That is up from just 17% in 1975. In the past, financial statements captured the vast majority of things that investors valued. Traditional accounting now accounts for a very small minority, less than 10% of the 10 largest companies in the world today.

In the information age most value creation (and destruction) is in intangible assets. For managers to manage and boards to monitor effectively, accountants must come up with a new approach to measuring value creation for the information age.

For the past year, accountants have been working on developing a new approach, suitable for real-time, economic value creation (destruction) measurement. This measurement process requires several key inputs:

- *An understanding of the purpose of the firm, its aspirations, and its goals.*
- *The strategy – how the firm intends to achieve its aspirations – and the business model underlying this strategy.*
- *The assumptions and beliefs upon which the strategy and business model depend.*
- *The intended audience – in other words, value creation (destruction) in the eyes of which stakeholder. Clearly, an environmentalist is going to look at value creation differently than a pension fund investor.*
- *The alignment of real-time performance metrics with the value creation proposition, so that management can make effective and timely decisions.*

A new way of accounting has huge implications for the role of Boards. In a world of real-time measurement and management, Boards must focus on the inputs and the integrity of the digital control system, not on past results. They must focus on the business model underpinning future value creation and ensuring that it and its underlying assumptions remain relevant and represent the optimal use of the company's resources (six capitals). They must monitor results to ensure that the company's strategy and business model are producing the desired results. They must ensure that all stakeholders have adequate information to make reasonable assessments. And, they must be constantly on the lookout for disruptive change – technology, society or government – that might threaten the sustainability of their organization.

GOOD GOVERNANCE IS AS IMPORTANT AS EVER

Revamping our corporate governance system should be an urgent priority for anyone with an interest in seeing capitalism survive and thrive.

Business has taken a heavy knock on its reputation over the past 20 years, and with good reason. All too often, corporate chieftains have been handsomely rewarded for failure. Short-sighted boards have steered once-proud companies onto the rocks, with devastating effects on workers, customers, suppliers, and local communities. In the meantime, directors have chosen to look the other way as disruptive forces have buffeted the businesses for which they had supposedly been accountable. Without access to information about the brutal realities of the external environment, it is almost impossible for the board to consider plausible alternative scenarios to the one the company is currently living.

Governance in the information age must be an integrated process where the directors are continuously learning with the rest of the organization. They must determine what path the company should follow, oversee its performance to ensure that this strategy is on track to produce the desired results, be on the lookout for changes in the environment that require a strategic response, and provide advice to senior management, if they ask for it.

A sound governance system for the information age has five essential components:

- *A compact board of directors (five to nine members) with decision-making authority and accountable to stakeholders for the long-term sustainability of the company. A diversity of perspectives is critical as the more turbulent the environment, the more likely it is that the board will be able to foresee and cope with unpleasant surprises.*
- *A network of stakeholders, with effective processes and social technology to engage them. This body would be charged with promoting dialogue between directors, managers, employees, customers, suppliers, investors, regulators, policy makers, community representatives and other stakeholder groups as issues arise.*
- *A chief external officer, reporting to the chair of the board and responsible for collecting and organizing external information and managing the processes to engage all stakeholders.*
- *A principles-based system of transparent performance measurement indicators and internal controls aligned with the company's strategy that gives employees the autonomy they need to make quick decisions.*
- *Finally, a clearly articulated and measurable model of value creation to assess whether the company is on the right track.*

The board's core role – to ensure that actions taken are in the best long-term interest of the corporation – is indispensable to this process. Its fundamental responsibilities remain the same, but it needs to carry them out differently in the information age.

Instead of simply reviewing and ratifying management's strategic plans, the board must take an active part in dialogue with all stakeholders, while on the lookout for signals that something is not quite right.

When it becomes clear that a problem is looming, the board must decide how to address it. If necessary, it must be prepared to trigger a transformative process that engages a wide range of stakeholders in dialogue and empowers them to envision and enact a desired future. The board plays a catalytic role by driving the process forward and monitoring its implementation.[3]

If directors keep their fiduciary duty to shareholders firmly in mind, big changes in the boardroom should follow.

- *Directors will be recruited not for their business experience, but for their differing world viewpoints and ability to share perspectives that shed light on plausible alternative futures.*
- *They will spend more time discussing disruptive innovations in the world-beyond that could lead to new goods, services, markets, and business models.*
- *They would ask what it takes to capture opportunities with big upside over the long-term and conversely, which operations no longer fit and should be discarded.*
- *They would spend less time talking about how to meet next quarter's earnings expectations, and more time monitoring real-time performance metrics to ensure the strategy is producing the desired results.*[4]

This is how we will build better boardrooms.

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[3] Patricia Meredith, Steven Rosell and Ged Davis, *Catalytic Governance: Leading Transformative Change in the Information Age,"* 2016.

[4] Many of these ideas were first proposed in an article by Dominic Barton and Mark Wiseman, "Where Boards Fall Short," *Harvard Business Review,* January-February, 2015.

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Former senior banking executive and strategy advisor, Patricia Meredith is a global thought leader, award winning author and consultant in the emerging field of strategic governance. She is best known for her role as Chair of Canada's Task Force for the Payment System Review, bringing together government, community and industry leaders to transform the payments system in under two years.

Pat Meredith is a Director of many public, private and not-for-profit organizations. She was Executive Vice-President and Chief Strategy Officer of a major financial institution and Senior Strategy Advisor to financial services and technology companies for a global strategy consultancy.

From 2010 to 2012, Pat was the Chair of the Task Force for the Payments Review. The Task Force – which applied a catalytic governance process – delivered a community supported action plan that enabled government and industry to quickly act on all four of the recommendations. With her Catalytic Governance co-authors, Steven Rosell and Ged Davis, she is working to create a community of leaders developing better approaches to governing in the information age.

Pat has written three books on strategy and governance – Stumbling Giants: Transforming Canada's Banks for the Information Age (2017), which won the Donner Prize for best public policy book of the year, Catalytic Governance: Leading Change in the Information Age, and Better Boardrooms: Repairing Corporate Governance for the 21st Century (2020).

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