VIEWPOINT

The Evolving Role of the Corporate Board:

Advanced Governance and the Imperative of Performance

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Part One & Two of a Four Part Series

The Evolving Role of the Corporate Board

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About Viewpoint

Viewpoint Foundation is a private charitable foundation that aims to demonstrate innovation and leadership in philanthropy in Canada. One key area of funding and activity is directed towards the advancement of leadership as a unique and highly important body of knowledge, which includes research and education relating to ethical leadership and corporate governance. Viewpoint Foundation is a part of Viewpoint Group, a team of trusted custodians who oversee the affairs of an investment management company and family office.

In all our endeavours, we have a compelling vision and commitment to business and philanthropic leadership.

Part One:

Governance, Strategy, and the Imperative of Performance

The Evolving Role of the Corporate Board:

Governance, Strategy, and the Imperative of Performance

Key Summary Points

1.

Most companies eventually underperform and fail, and most directors, most of the time, are unknowingly overseeing the forces of insidious decline. This must be true given that underperformance and failure is pervasive and predictable. Most corporate boards (eventually) succumb to complacency, failing to clearly see the dangers ahead and to effectively guide and influence management. Instead, management is blamed after the fact, once the damage is done and clearly visible.

2.

The current form of board governance is essentially **compliance-based**, concerned with the structures and processes used to minimize the adverse impacts of management and director self-interest. "Compliance-based governance" is essential in creating legitimacy, but the links with performance are minimal. More compliance-based governance may be needed in certain areas, but additional structures, processes, and rules will not address performance issues. Further, good compliance-based governance is a limited measure of board effectiveness.

3.

Corporate governance needs to expand in the direction of performance. Corporate directors need to embrace their role and responsibilities as lead partners in sustaining organizational performance. All of this can be achieved while honouring the clearly established separation and differentiation of board and management responsibilities. This more comprehensive view of governance has the potential to significantly enhance the role of the board to the benefit of all stakeholders and society (See Exhibit 1).

4.

The social milieu of the board forms the basis of **social-based governance**, a critical informal system of norms and guidelines governing how directors show up and behave in exercising our fiduciary responsibilities. There is generally a lack of explicit understanding of how board culture supports organizational performance. The linkage to performance is through consistent high-quality decision-making and the positive impact of modelling certain key values and norms that are essential to long-term success.

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5.

Another critical and underdeveloped form of governance relates to strategy. There is an absence of clear processes and conditions to direct and guide strategy development and implementation. This can be thought of as **strategy-based governance**. Most directors have an innate knowledge of the fundamentals of strategy, but this knowledge is not being brought forward, integrated, and actualized as a form of governance.

A strategy that integrates all essential fundamentals not only significantly increases the probability of organizational success, but it also creates a powerful framework for performance monitoring.

6.

Performance-based governance completes the picture and is potentially the most powerful and transformative form of governance. A clear and comprehensive understanding of strategic fundamentals creates the opportunity to identify and monitor progress against outcomes that are determinative of financial and other essential goals. The board and management can then source the hard evidence to support corrective actions versus reacting to the damage when it is visible.

EXHIBIT 1

What are the structures, processes, and authorities that direct and control a business?
Why would board governance not extend to all these systems?

Focus	External Stakeholder Focus	Internal Focus with Direct Links to Performance		
Type	Compliance-Based	Social-Based	Strategy-Based	Performance-Based
Purpose	Fairness and legitimacy	Commitment, accountability, collaboration, and discerning intelligence	Direction, alignment, consistency, and integration	Accountability and control of drivers of performance
Mechanism	Compliance and disclosure	Clarity of norms and values, social acceptance, or rejection	Conditions of good strategy, approval, and control	Monitoring and reporting
Performance Link	Access to capital	Quality decision-making	Competitive advantage, effectiveness, and efficiency	Responsiveness and corrective action

Governance and Underperformance

The experience of most corporate boards is fraught with the challenges of underperformance, which frequently leads to managerial change, asset and financial restructurings, mergers, shareholder activism, a change of control, the sale of the company, or outright failure. When the results are in, the problems are usually painfully clear, but the damage may be irreparable. At the very least, time, resources, and hard-won progress may be lost.

What are the warning signs of underperformance and failure within the context of director responsibilities and influence? If we can see these warning signs, and the underlying deficiencies or limitations, do we have an opportunity to act and potentially avoid the otherwise negative consequences? Do we have the opportunity to exercise our authority and influence in a way that might increase the probability of sustained superior performance?

More broadly, how do these questions and issues fit within the prevailing understandings and practices of corporate governance and board responsibility? How narrow is the current concept of governance and can it be expanded for the betterment of the organization and its stakeholders?

The answers to these questions point to a new understanding of how corporate boards need to evolve for the benefit of all corporate stakeholders and society.

Business Survivability and Performance

The overarching deficiency within a business is a board of directors or leadership team that conceives itself as infallible. The reality is just the opposite. The forces and dynamics of vulnerability to possible loss or diminishment are ever present. If we can see clearly into these realities, we then have an opportunity to respond pre-emptively to avoid adverse outcomes. We then have a chance to exercise influence and take corrective actions.

If we deny or turn away from the risks of underperformance and run our business like most businesses are run, it is only reasonable to expect that we will end up like most businesses and, as directors, we will find ourselves mired with the problems of poor performance and potential failure. Indeed, I believe this is what most of us are experiencing most of the time.

In his research on entrepreneurship, Scott Shane concludes, "Most new businesses fail. Pretty much all studies agree on that. The only question is how long it takes for a majority of them to go out of business (and why)."[1] He adds, "Entrepreneurship is a lot like gambling. The average outcome is negative."[2]

Underperformance is a challenge for businesses of all sizes and in all stages of development, even large successful companies. In *How the Mighty Fall*, Jim Collins states, "No matter how much you've achieved, no matter how far you've gone, no matter how much power you've garnered, you are vulnerable to decline." He adds, "Anyone can fall and most eventually do."[3]

In 2008, Industry Canada produced a report profiling the growth of Canadian firms (small, medium-sized, and large). The results, based on findings from 1993–2003, were as follows:

- **50 per cent** [roughly] of firms are gone after three years;
- **67 per cent** of firms are gone after five years;
- **75 per cent** [at least] of firms are gone after nine years.[4]

The same general picture is evident in the U.S. business sector and across all Organisation for Economic Co-operation and Development (OECD) member countries where data are available.[5] In most cases, and I sometimes think in virtually all cases, when companies "disappear" it's the result of having "hit the wall of underperformance," even if they did well historically creating value for their shareholders (at least for a period of time). The wall usually involves a lack of resources, a shortage of required expertise, insufficient funding, an inability to access markets, intensified competition, or other market factors. Whatever the reasons, there is almost always a loss of value or the perception that the company will not be able to sustain its going-concern value-creating activities.

After examining over 2,000 companies over a 10-year period, Bain and Company concluded that only 14 per cent created shareholder value, where total shareholder returns exceeded the cost of capital.[6] Many firms achieved positive shareholder value "for short periods of time, but nearly all stumble sooner or later (and mostly sooner)."[7] More serious stumbles end up being outright falls, where the viability of the company

1 Shane, *The illusions of entrepreneurship*, 98.
2 Ibid, 98.
3 Collins, *How the mighty fall: And why some companies never give in,* 8.
4 Parsley and Halabisky, *Profile of growth firms*.
5 Brandt, "Business dynamics and policies"; U.S. Bureau of Labor Statistics, *Entrepreneurship and the U.S. Economy*.
6 Zook and Allen, *The facts about growth*, 2.
7 Ibid, 2.

is threatened, leading to shareholder discontent and initiatives to restructure, merge, or sell the company, or at the very least to change the CEO.

I have drawn additional conclusions based on my experience of investing in over 150 companies over 20 years at ARC Financial Corporation, the largest private equity firm in Canada focused on the energy sector. Approximately one-third of these companies were unable to return our original capital. Another third successfully returned our capital and generated a positive rate of return, but at an inadequate level relative to the threshold we require to stay in business. From our perspective, given our return requirements, two-thirds of our portfolio underperformed. For the one-third of companies in our portfolios that did meet our required returns, a small number created most of the gain and carried aggregate portfolio returns across the required threshold. Based on these results, it seems reasonable to conclude that the experience of the directors and executives in most of these 150 companies was challenging and disappointing.

ARC Financial has benefited from more than the normal share of great performing companies. Consequently, our portfolio returns have been attractive. But our experience confirms that few companies can sustain superior results over the long-term. The corollary view is that all boards are preoccupied with performance issues and only a few can lead and guide their companies to long-term success.

At the end of 2014, ARC Resources had a market capitalization close to $8 billion. When we went public about 18 years ago, there were some 50 companies within the oil and gas index. Today, only five of those companies exist and of these, only two — ourselves (we were not initially in the index because of size) and one other — have a record of strong performance. The others are visibly struggling and one just announced that it is being sold. When we study the specific companies that "disappeared" over this period, the "wall of underperformance" was almost always clearly evident.

If we simply look more anecdotally within the energy industry in Canada over the last five years, we see many companies that experienced serious underperformance, even among those viewed as industry leaders. A few of these companies were sold, but most have gone through some form of restructuring, usually including the replacement of management.

Even major global companies can't escape the perils of underperformance. While some disappear through sales, mergers, or an actual dissolution of the business, more often than not, when they fail, they are restructured.

High-profile examples of failed major global companies are described below.

- In 2008, 158-year-old Lehman Brothers filed for bankruptcy with US$639 billion of assets. It remains the largest bankruptcy in history.[8]
- AIG was the largest insurer in the world. In 2008, the firm was essentially bankrupt and required US$85 billion from the U.S. Federal Reserve to avert collapse.[9]
- Citigroup was one of the largest banks in the world in 2008; however, to avoid bankruptcy, the U.S. government provided a stimulus package of roughly US$306 billion.[10] By 2009, roughly 52,000 people had lost their jobs.[11]
- The iconic General Motors declared bankruptcy in 2009.[12]
- Washington Mutual became the largest bank failure in U.S. history when it collapsed in 2008. With assets of US$307 billion, it was sold to J.P. Morgan Chase.[13]
- Founded in 1762, Barings Bank of London was one of the oldest banks in the world. In 1995, it collapsed and was sold to the banking and insurance group ING for £1.[14]
- Arthur Andersen, one of the largest accounting firms in the world, collapsed in 2002, in connection with Enron's criminal conviction.[15]
- In 1998, Long-Term Capital Management, a U.S. hedge fund, failed with liabilities of over US$100 billion.[16]
- WorldCom, Enron, MF Global, Chrysler, and Pacific Gas & Electric each exceeded US$30 billion in assets at their collapse.[17]

In Canada, we have a few "claims to fame" among major failed global companies.

- At its peak in July of 2000, Nortel was Canada's largest company. It represented 35 per cent of the entire

8 Onaran and Scinta, "Lehman files biggest bankruptcy case as suitors balk."
9 Karnitschnig and others, "U.S. to take over AIG in $85 billion bailout."
10 Enrich and others, "U.S. agrees to rescue struggling Citigroup."
11 Lorenzetti, "Microsoft's layoffs are huge..."
12 Isidore, "Bankruptcy: End of an era."
13 Sidel, Enrich, and Fitzpatrick, "WaMu is seized, sold off to J.P. Morgan..."
14 BBC News, "How Leeson broke the bank."
15 The Economist, "Arthur Anderson: Reversed and remanded."
16 Amadeo, "What was the Long-Term Capital Management hedge fund and the LTCM crisis?"
17 Oleinic, "Top 12 largest bankruptcies in U.S. history."

We will think we know when we don't, and we will become like most others — eventually underperforming and failing.

value of the Toronto Stock Exchange Index and had a total market capitalization of C$380 billion. Today it is valueless.[18]

- BlackBerry also had its day, with a market capitalization of $77 billion at its height in 2009. Today it is worth about $6.5 billion, with the stock off roughly 92 per cent from its all-time high in 2008, when shares were trading around $150.[19]

Clearly, it is extremely challenging to sustain superior performance. Clayton Christensen, named the most influential business thinker in the world in 2011 and 2013 by Thinkers50,[20] summarizes his views, as well as Raynor's, on this subject: "At best one company in ten is able to sustain profitable growth … the odds of success are frighteningly low."[21]

I have been a lifelong student of business leadership. I have spent years in investment banking advising boards of companies that were often financially distressed, plus decades being absorbed in the realities of business performance in building and developing companies. I continue to caution my business partners and fellow directors: "We are only two years from possible failure." No matter how successful we appear to be, if we lose focus on what is essential, we will unwind incredibly fast. This is a reality for all businesses, although it may not be two years. It may be one year or it may be three, depending on the specific circumstances and fundamentals of the company. Jim Collins has a great expression, which I often quote, and I appreciate being able to quote him as the source versus attributing this perspective to myself: Even the most successful businesses face the ever-present "creep of impending doom."[22]

What do these realities mean for the leadership of an organization – for the board of directors and executive leaders? If the problem of underperformance is not firstly a leadership issue, then what is it about?

Research conducted by Bain and Company found that most CEOs in fact see underperformance as a leadership issue: "by a ratio of three to one, [CEOs] cited controllable decisions over external factors as the reasons for large swings in their companies' financial performances."[23] Specifically noted was a failure to focus on the core business, poor decision-making, and the inability to develop and implement effective strategies.

Why do I place such an emphasis on these empirically-based realities? Why go on and on looking at all the evidence? It is because of the gap – the "overarching deficiency" — between these realities and the apparent attitudes and understandings of most corporate directors and executive leaders. If we can't see the road ahead, we will probably drive off it. If we can't see the challenges in front of us, we will understandably fall into complacency. We will think we know when we don't, and we will become like most others — eventually underperforming and failing.

Leadership and the Fundamentals of Enduring Success

Another overarching deficiency among directors is a failure to actualize certain leadership basics, notably "materiality" – the understanding of what is most important and "what might make or break the company." This deficiency could be described as an absence of "comprehensiveness," a failure to understand that there are multiple essential fundamentals (See Exhibit 2 "What Is an Essential Fundamental in Organizational Leadership?") that must be in place to ensure long-term success and that any fundamental, if absent or left unattended, could become the root cause of a company's demise. Not only do we fail to see all the fundamentals, there is a tendency to view specific fundamentals as separate pieces or fragments versus seeing that each is integrated and interacts with all others in determining performance. In simpler language, this is a failure to grasp the "big picture."

This isn't to argue that all directors should be generalists. One may be a specialist, an expert in an industry or within a particular functional area, but still appreciate that there are a set of key fundamentals that are all interrelated and each is essential to success. Consider a few such fundamentals, all backed by evidence of their importance to an organization. Ask yourself if you would be prepared to argue that any one of the fundamentals noted here is not important to your organization:

- A clear vision and a defined value proposition in the market
- Performance outcomes that are in alignment with purpose and vision
- A comprehensive, holistic strategy with mutually reinforcing sub-strategies
- A long-term orientation that supports strategy and human resources planning
- Structures and processes to support consistent high-quality decision-making
- Strong employee engagement and commitment

18 CBC News, "Nortel briefly loses title as Canada's biggest company."
19 CBC News, "RIM's shinking value"; The Globe and Mail, "BlackBerry Ltd."
20 Thinkers50, "Clayton Christensen."
21 Christensen and Raynor, *The innovator's solution*, 9.
22 Collins, *How the mighty fall: And why some companies never give in*, 8.
23 Zook and Allen, *The facts about growth*, 7.

EXHIBIT 2

What Is an Essential Fundamental in Organizational Leadership?

The term fundamental is being used to represent a basic or central component of a structure or system of organizational dynamics. The use of the word fundamental is neutral and allows for a clear assessment of the different dynamics within an organization.

One can use the concept of fundamentals to:

- See the "needs" of the organization more objectively, separate from the needs of individuals or leaders;
- Describe the qualities of leadership that must be delivered within an organization to support enduring success;
- Assess the drivers that relate to the actualization of the fundamental.

Although there are many fundamentals, some fundamentals are essential. An essential fundamental is one that, if absent, would lead to underperformance or failure. The word essential is included to underscore the necessity that this fundamental must be actualized to ensure enduring success.

Two examples are presented below:

1. It is fundamental that an organization have a vision. There is a need for direction. A vision statement is basic, but in itself is insufficient to support enduring success. It is *essential* that the vision include a concept of creating enduring value for the market or for customers. Further, it is essential that the vision is "lived" for it to create and sustain performance.
2. An organization must have a map or strategy, a combination of means, to move toward its vision. Strategy is fundamental to success. However, it is essential that the strategy be internally consistent and aligned with the vision and the imperatives of the organization's mission, notably profitability and risk.

- Technical and organizational competencies that drive operational effectiveness
- A learning orientation and related capacities required to innovate and adapt
- A high level of trust that supports inter-reliance and collaboration
- Fairness, honesty, and positive ethical values as a foundation for all activities

In the study of leadership, there is an understandable tendency to isolate a fundamental – such as strategy, innovation, or employee engagement – and conclude that this fundamental represents the "be-all and end-all" of successful leadership. There are in fact many essential fundamentals and each can be seen as the "be-all and end-all" of successful leadership. However, each is integrated and interacts with all others to form a dynamic system that drives (or hinders) performance. We often lack the explicitness in seeing how a particular fundamental integrates into all other fundamentals essential for success.

Ethics is a profound example of the tendency to isolate a fundamental and to fail to see how it interacts and integrates with other essential fundamentals. Most corporations view ethics as a compliance problem, resolved through a policy that establishes a set of guidelines and rules to discourage unwanted behaviours (i.e., stealing or harassment). The reality is that ethics is foundational to trust and supports inter-reliance, engagement, and collaboration, which link directly to organizational success.

I have found that the fundamentals of ethics are pervasive in all organizational activities, from one-on-one meetings, where we simply listen to another's point-of-view, to matters of governance, where conflicts arise between management and stakeholders. Ethics cannot simply be "grafted" onto an organization; it must become part of the lifeblood that flows through all decision-making and how we treat one another, our customers, and all others with whom we have contact. Ultimately, it all links to performance and sustaining organizational success.

Some may resist this understanding — that the realities of organizational performance are highly complex — as it may seem overwhelming. Perhaps though, this points to why most companies eventually underperform and fail — there is an extraordinary complexity involving many interconnected factors that are essential for sustained organizational performance. This complexity is compounded by the dynamism of change in the external environment and within the organization. Successful board and executive leadership is a daunting challenge and few companies seem able to put it all together.

Compliance-Based Governance and Performance

In recent years, initiatives to improve governance have dominated board agendas. Generally, the focus has been on structures, guidelines, and processes that limit management authority in order to avoid the potential costs and adverse impact of a misalignment of interests with shareholders and other stakeholders.[24] Considerable pressure has surfaced for boards to enhance what might be described as formal compliance-based governance as though this is the sole, if not the highest, priority of boards. In the extreme, the view would be that good governance in this form is the "be-all and end-all" of board responsibilities and ultimately of organizational success.

Yet, as Dominic Barton and Mark Wiseman point out in a recent *Harvard Business Review* article, "Where Boards Fall Short," despite more than a decade of regulatory reforms and a host of guidelines and related surveillance by independent governance agencies, "boards aren't working."[25]

For many reasons, "good governance," as currently practiced, is essential to an organization's long-term success, and in no way do I wish to imply otherwise. However, there is a strong case to be made that compliance-based governance is insufficient for creating and driving organizational success, and that "better governance" in this form won't necessarily lead to improved performance.

This view is born out in the evidence. Harvard's Jeffrey Sonnenfeld argues in his seminal article "What Makes Great Boards Great" that most advancements in board governance have been structural and process-related, concerned primarily with rules and guidelines.[26] These initiatives have been focused on areas such as the delineation of authority of the board and chief executive officer, director independence, the composition of committees, public reporting and disclosure, shareholder voting issues, and board and executive compensation. Most directors would agree that all these matters need to be attended to with care and diligence. But here's the rub: There appears to be no clear relationship between these governance initiatives and organizational performance.

As Sonnenfeld puts it, "good and bad companies alike have … adopted most of these practices."[27] McKinsey partner Simon Wong makes this point emphatically, referring to the failure of major financial institutions in 2008–09, pointing out that "it's a sure bet that most of these boards would argue and demonstrate that they had best-practice structures and processes in place." He concludes that "best practice isn't good enough, even if your board is stacked with highly qualified members."[28]

We have conducted our own research at ARC Resources on the relationship between so-called "good governance" (compliance-based) and performance. Based on ten years of data using the comprehensive board rating system published annually in *The Globe and Mail*, we conclude that there is no clear relationship between the prevailing views of what represents "good governance" and financial performance.[29] This finding is consistent with that of Gupta and colleagues, who studied governance and performance during the 2008–09 crisis. A comprehensive cross-sample of 4,046 publicly traded, non-financial firms from various countries found that well-governed firms did not outperform poorly governed firms.[30] This core finding has been confirmed by others.[31] However, it is clear from our research that "good governance" is highly correlated with company size. Larger corporations generally receive higher ratings for good governance than do smaller companies.[32] One possible explanation is that larger companies are more willing to allocate the resources to establish good governance practices, although this is only part of the story.

24 Filatotchev and Boyd, "Taking stock of corporate governance research while looking to the future," 260.
25 Barton and Wiseman, "Where boards fall short."
26 Sonnenfeld, "What makes great boards great."
27 Ibid.
28 Wong, "Boards: When best practice isn't enough," 2.
29 The Globe and Mail, *Board games 2014*.
30 Gupta, Krishnamurti, and Tourani-Rad, "Is corporate governance relevant during the financial crisis?"
31 Dalton and Dalton, "Integration of micro and macro studies in governance research"; Gupta, Kennedy, and Weaver, "Corporate governance and firm value."
32 The Globe and Mail, *Board games 2014*.

> Good 'compliance-based governance' is an antecedent condition of organizational success ...
> [but] it may not be as significant as certain other forms of director influence.

Compliance-based governance reflects a commitment to fairness, and that we will act in a way that is consistent with stakeholder interests, and establishes legitimacy. For small companies to grow and prosper, and to become large companies, they need to create the legitimacy and trust that comes with transparency and disclosure. Only then can they attract broad-based institutional support within capital markets to sustain themselves as going-concern entities.

As companies grow, the issue of support extends beyond capital markets, and moves toward the need to create legitimacy within communities, the government, and society. Canada's energy sector has learned this the hard way, as it struggles for community and public support to develop the infrastructure necessary to access world markets. Another example is executive bonuses in the major financial services firms, which were previously left to the board's discretion. Today, there is intense scrutiny from government and regulators, and numerous initiatives exist to limit or cap bonuses.

Good governance, as per prevailing understandings and practices, is a vital and worthwhile goal for any business enterprise, but is not a determinant of performance unless it is seen to include other forms of director influence and authority. Good "compliance-based governance" is an antecedent condition of organizational success, and even then, it may not be as significant as certain other forms of director influence.

Social-Based Governance and Performance

Where do we as directors turn to understand how we can be more effective – how we can exercise and fulfill our responsibilities in a way that increases organizational success? Other than formal governance structures, guidelines, and processes, many leading researchers are now focusing on boards of directors as social systems.[33] According to Sonnenfeld, "what distinguishes exemplary boards is that they are robust, effective social systems."[34] He and others argue that a board's social environment must be based on trust and candor, and encourage differing views.[35] The capacity to challenge the views and assumptions of our fellow directors and executive leaders must be ever present.

A suboptimal social environment will breed behavioural dysfunction and ineffectiveness. If the social milieu of the board is not generating the optimal set of conditions to support a high level of functioning, the board may be under-contributing or making decisions adverse to the best interests of the organization. The right formal governance structures and processes might be in place, but the board may still lack cohesiveness and effectiveness. There may be a lack of psychological safety and an unwillingness to be vulnerable with each other in expressing what we really think. Alternatively, the problem may be a lack of commitment, resolve, or will. Other directors don't seem to really care, so why should I?

If, as directors, we suffer from a lack of self-efficacy or confidence, we may not wish to be heard or held accountable. After all, how can we be accountable if we believe we lack the necessary knowledge and competence to perform as a director? We may be further burdened by an innate lack of interest and curiosity. Exploring and developing new knowledge may seem too difficult, and hence there may be a preference to operate on the surface, asking perfunctory questions, and "going through the motions" of being a responsible director.

Behavioural dysfunction can be corrosive to the working environment among directors and, of course, between directors and the executive leaders. It usually shows up as overt or covert aggression in the form of intimidation or bullying, or as withdrawal and indifference. Although it is usually obvious to all involved, my experience is that most directors just "put up with it." However, the failure to act comes with the cost of lowered morale, engagement, and commitment. Board inefficiency is a further cost, as there is often much director discussion of the problem, particularly if it involves the chair or the CEO.[36]

Throughout my career in business, I have repeatedly asked myself what outcomes need to be delivered by an organization's culture to support and sustain performance. This exploration has led me to see an understandable, but nevertheless serious, lack of explicitness as to what conditions must exist to create these critical outcomes. These would be outcomes such as commitment, accountability, collaboration, and discerning intelligence supported by a learning orientation. The conditions and related informal guidelines to create and deliver these outcomes can be seen as a form of governance – a holding or containment of the expression of our behaviours and actions. It is a form of informal, usually intangible guidelines as to how we will treat each other, how we

33 Cascio, "Board governance: A social systems perspective"; Sonnenfeld, "What makes great boards great."
34 Sonnenfeld, "What makes great boards great," 5.
35 Sonnenfeld, "What makes great boards great"; van Ees, Gabrielsson, and Huse, "Toward a behavioural theory of boards and corporate governance."
36 Leblanc and Pick, "Separation of chair and CEO roles: Importance of industry knowledge, leadership skills, and attention to board process," 5.

will show up in our engagement with each other, and how we will make decisions together. The nature and expression of this form of governance is of profound importance to the functionality of the board of directors and the long-term success of the organization.

The social dynamics of the board must be healthy and must support the highest level of rigorous discussion for the company to get the best from its directors and to make the best decisions.[37] I am emphasizing this as being of critical importance. In fact, I believe this is more fundamental to organizational performance than formal compliance-based governance structures and processes. I say this with considerable confidence, as many of the private company boards my partners and I are involved with do not score high on formal, compliance-based governance, yet they are extraordinarily functional on the social side, and they are achieving great results.

We may have the best governance possible, satisfy all the best practices asked for by leading governance advocacy groups, and have a robust and effective social environment, but a fundamental question remains: As corporate directors, are we effective and how can we evidence our effectiveness? Is it through "check-the-box" governance ratings and by demonstrating a high level of collaboration among ourselves? What about the results of the business? How do we as directors view the performance of the organization as evidence of our own effectiveness? Are we exercising our authority and influence in a way that increases the probability of sustained superior performance? I believe that the real value loss or add in director effectiveness exists in a realm other than good compliance-based governance and strong robust social-based governance. These forms of governance are essential but they are both antecedent conditions for sustained organizational success.

This other realm includes a deepening and broadening of knowledge in business fundamentals, and a more creative, comprehensive adoption of advanced practices. It's in this direction that there is the potential for boards to have greater impact on organizational performance; those that fail to move in this direction may well be left in the backwaters of poor performance.

Strategy-Based Governance and Performance

As directors, we have a responsibility to approve board strategy, although in most cases this occurs through the formal approval of the capital budget. We also approve dividends or any shareholder distributions. We control and approve material transactions, and mergers or acquisitions over a certain dollar threshold. In addition, we approve the structure of compensation, specifically that of the CEO. We also have the responsibility to monitor performance and the authority to hire or fire the CEO.

These fundamentals generally relate to the material choices the business has with respect to the use of financial surpluses, reinvestment versus distribution versus credit reduction, and, to some extent, versus executive compensation. These are the "going-concern" activities of the company, which are products of strategy development, implementation, and execution. As fiduciaries acting for the owners of the business, our input regarding how financial surpluses are managed leads to the self-evident, if not irrefutable, view that strategy is central to our governance role. This points to what I believe is the intersection between governance and strategy, and ultimately between governance and performance. For directors, the exercise of our responsibilities within the area of strategy offers the greatest opportunity to make a value-added difference.

But there is a problem, and I believe it is a serious problem.

I will frame the problem by quoting the title of a classic *Harvard Business Review* article by Donald Hambrick and James Fredrickson, "Are You Sure You Have a Strategy?"[38] When I first read this article, I had to sit down and take a deep breath. I knew the importance of strategy, but the article forced me to consider the meaning of strategy. What is strategy and how do I know we have one? I struggled in my response, even as it related to the company I was leading at the time.

There is another related question, which is equally confronting. How do you know good strategy from bad strategy? If a bad strategy was staring you in the face, would you see it? Most of the many bad strategies I have seen, unfortunately, were identifiable with the benefit of hindsight. By that time, the damage was done and the directors were either considering or already pursuing corrective actions. Of course, none of us want to embrace bad strategy, but what about good and great strategy? Can you describe what a great strategy looks like?

As audacious as it may seem, I am suggesting that another common overarching deficiency is a limited and shallow knowledge of the fundamentals of strategy. At the very least, the knowledge and understandings of most directors relating to strategy-making and

37 Cascio, "Board governance: A social systems perspective."
38 Hambrick and Fredrickson, "Are you sure you have a strategy?"

implementation is not being fully and adequately utilized. This is the serious problem referred to above. Directors owe it to the stakeholders they represent to develop a deeper understanding of the interconnections between strategy and performance, and to find effective ways to offer these understandings in support of the company's strategy development and implementation process.

It is critical for boards of directors to see that strategy interconnects with all essential fundamentals of organizational functionality. Strategy is at the centre of these essential fundamentals, and each and all must be satisfied to support enduring success (See Exhibit 3). If you think about this visually, strategy integrates upwards into the essential desired outcomes of mission, which encompasses why we exist and what we have to accomplish. The essential desired outcomes of mission can best be thought of as imperatives – indeed strategic imperatives. Notably, this would include profitability and value creation, predictability and risk, financial and organizational sustainability, and creating a "quality of experience" where people can feel safe and flourish, which places ethics in the same realm as profit and value creation.

Above this is our external market-based vision, which should capture a unique value proposition for our clients or customers, and a unique advantage relative to market-based competitive realities. Vision must also rest on certain deep, unchanging convictions about not just what we want to become, but who we are – our identity.

Beneath strategy lies what could be described as a set of "implementation imperatives." One central imperative is consistent, high-quality decision-making with an emphasis on the structures and processes that can mitigate the cognitive biases to which we are all susceptible. Another key imperative is a high level of employee engagement, which an abundance of evidence now links to organizational performance (see the section on employee engagement toward the end of this article). A third essential condition that must be present for enduring success is learning – the sourcing, development, and application of new knowledge, which drives adaptability and innovation. Again, there is ample empirical evidence linking a learning-based culture with organizational performance (see the section on learning and innovation toward the end of this article). The fourth implementation imperative is organizational and operational effectiveness. Can we get it done and done well? If not, all is for naught.

Beneath these implementation capabilities and conditions are our core competencies, both technical and organizational. I have found that organizational competencies are often not explicitly identified and developed. These include competencies relating to structures and processes that increase the probability of predictability and reliability; competencies relating to opportunity identification and capture; interpersonal or social competencies including emotional intelligence; and competencies related to leadership itself.

Strength of culture can be viewed as the bedrock. This involves the required outputs of culture referenced earlier. Notably, a performance-based culture must engender a high level of commitment and drive. We cannot create an enduring successful business without an enormous amount of determination, resolve, and drive. A culture must also deliver a high level of accountability, where we are all prepared to be answerable for the progress and results that fall within our area of responsibility. Additionally, the culture must deliver the conditions that support a high level of collaboration, where we can rely on each other and passionately create as a team. Finally, culture must deliver a discerning intelligence that infuses everything we do, otherwise "drive" will become "force" and lose its effectiveness; accountability will collapse into self-blame; and the trust that underlies collaboration may become blind.

Is this an argument for directors to drive to the centre of all the complexities of strategy-making? No, it is not. It is an argument that directors must have knowledge of business fundamentals and all of the complexities of strategy to develop, with management's input and concurrence, a set of conditions or criteria that newly developed strategy or ongoing

EXHIBIT 3

Integrated Framework of Leadership Fundamentals

- VISION
- MISSION
- STRATEGY
- IMPLEMENTATION IMPERATIVES
- COMPETENCIES
- CULTURE

EXHIBIT 4

Strategy-Based Governance Checklist for Directors

Do we have a strategy and is there evidence that it is a good strategy?

1. **The strategy is comprehensive and includes all fundamentals essential for success, from vision through to organizational values.**

   External market-based vision, essential goals in mission, imperatives of implementation, technical knowledge and expertise, organizational knowledge and expertise, and strength of culture – including values and ethics.

2. **There is internal consistency with mutually reinforcing sub-strategies.**

   Stakeholder support, capital resources and financial leverage, human resources knowledge and expertise, and quality and unique attributes of assets.

3. **It offers flexibility and scope for responsiveness to change.**

   Capital investment choices, optionality, contingencies, piloting, buffers, and off-ramps. Is it robust and dynamic?

4. **It is integrated into our organization's vision, based on deep knowledge and foundational convictions.**

   Value proposition tied to customer choice, and enduring advantage based on competitive realities.

5. **It is integrated into the essential goals or the imperatives of mission.**

   Profitability and value creation, predictability and risk, long-term focus (sustainability), and quality of human experience.

6. **It is integrated into the imperatives of implementation.**

   Quality decision-making, engagement and commitment, learning and innovation, and operational effectiveness and excellence.

7. **It rests on strong technical and organizational competencies.**

   Structures, policies and processes, opportunity generation and capture (entrepreneurialism), inter-relational skills, and leadership.

8. **There is a foundation of "strength of culture."**

   Collaboration and trust, accountability and self-efficacy, discerning intelligence and passionate curiosity, and commitment and drive.

9. **We are living our strategy now. We have identified the gaps, deficiencies, or points of misalignment.**

   Gaps or deficiencies represent obstacles or challenges.

10. **We have plans and action steps to resolve these deficiencies.**

    Established processes to create accountability and report on progress.

strategy must satisfy. We need to be able to answer Hambrick and Fredrickson's question: "Are you sure you have a strategy?" as well as the related question, "How do we know that it is a good or even great strategy?" The process to do this can be conceived as a checklist and be implemented as an advanced practice of board governance. A simple but comprehensive example is presented in Exhibit 4.

The benefits of this process are multifold. It will inspire, if not force, more clarity as to whether we have a strategy and whether it is a good or great strategy. It can be layered onto the existing strategy development process, or can be used at any time to stress-test key parts of a strategy. It will encourage more director engagement in the strategy development process and allow directors to more fully offer their own experience and judgment. It honours the line of demarcation between director oversight and executive responsibilities to develop and implement strategy. It will formally provide evidence that the board is embracing its responsibility for oversight and approval of strategy. Lastly, it will create a powerful framework for performance monitoring.

> If we don't understand these fundamentals with real clarity and depth, can we even ask management the right questions?

Performance-Based Governance

If you stand in the centre of strategy-making and implementation and take a good look around, when you see the fundamentals that are essential and the interconnectedness of it all, where does this take you as a director? If we don't understand these fundamentals with real clarity and depth, can we even ask management the right questions? Can we explore the best or most advanced practices possible in each area? Without a fulsome understanding of all strategic fundamentals, how can we effectively monitor performance? Do we simply go to quarterly meetings and ask a lot of questions about results, and then sign off on public disclosure? This is what preoccupies most board meetings and I would argue that this is an incredibly limited and shallow form of monitoring. Performance monitoring is possibly the most powerful form of governance, yet it is underdeveloped within prevailing corporate board practices.

When we can see the comprehensiveness of the essential fundamentals inherent within strategy, we can then begin to explore best practices to monitor progress within each area. This sets up a dynamic of accountability that can be transformative. Further, all of this can be done while maintaining the time-honoured separation between board and managerial responsibilities. However, management has to buy in to the fact that there are multiple fundamentals that must be actualized to support success. The next step is to creatively explore the monitoring structures and processes that would provide evidence that these fundamentals are in fact, in place.

In considering what I am calling performance-based governance, there are a few key understandings to note. One is that performance means "accomplishment of a given task measured against preset known standards."[39] The accomplishment part can be thought of simply as the results. Are the results above or below preset desired standards or outcomes? Are we performing or underperforming?

Results are the most powerful evidence available that what we are doing is working (or not). It all boils down to discovering the evidence as to whether we are moving toward desired outcomes. Systems and processes need to be established to allow for transparent and credible disclosure of information relating to progress toward desired outcomes.

The problem for most boards though is that we are generally too narrow as to what we consider evidence of progress. We need to look for progress against outcomes that are determinative of financial results. By the time it all shows up in financial results, it is often too late. In a sense, we need to shift our focus upstream from reported results. A focus on the last quarter or last year's results is necessary, but it lacks the power and effectiveness of reviewing progress against determinative factors that are implicit within the multitude of essential strategic fundamentals. Indeed, it is fascinating that there is now ample empirical evidence of the linkage between many of these fundamentals and performance.

Performance Essentials: Hot Topics in Corporate Governance

What follows are a few selected examples of fundamentals that are essential to performance, all of which are "hot topics" for corporate boards and among those concerned with governance matters. An attempt is made to discuss each example from the perspective of interconnectedness as well as to suggest certain related best or advanced practices. Two of these examples – risk and sustainability – can be seen as strategic imperatives as part of the mission, and two other examples – learning and innovation, and employee engagement – are drawn from what I describe above as implementation imperatives. The fifth example relates to interpersonal or social competencies, specifically emotional intelligence.

RISK

Prevailing views of risk and risk management in business represent a clear example of the inter-relatedness of essential fundamentals. All directors would agree that profitability and value creation are essential for success. In fact, many will argue that the maximization of profit is the sole responsibility of the modern corporation. The reality though is that we are never simply maximizing profit. Profit and value creation always occur with associated levels of uncertainty. Indeed, it is foundational in financial markets that certainty or predictability is a key factor in how markets will value an income stream. Yet in most businesses, few leaders explicitly identify the predictability of value creation as an essential outcome and account for risk within strategy and

39 Business Dictionary, "What is performance?"

decision-making processes. The advanced practice at the board level is to create a risk committee to provide more focus at the top of the organization on material fundamentals that determine performance from the perspective of risk. This is a critical board-level function needed to create the necessary monitoring and accountability within the organization for the ownership and management of risk.

At ARC Resources, we have a high-functioning Risk Committee at the board level, which has proven incredibly valuable. The function of the committee is to identify all risks within the environment, markets, competitor strategies, evolving technologies, and policy and regulations, and qualitative internal risks relating to succession, learning orientation, knowledge development and innovation, engagement, and strength of culture, including ethics. Determinations must be made as to the impacts of each risk factor; what can be influenced and controlled; possible specific mitigation strategies; and, importantly, who will be responsible for managing the risk. A recent trend within business organizations is to embrace enterprise-wide risk, but I am not convinced that boards are setting the right tone for the importance of this process, that the assessments are inclusive of internal organizational conditions (notably around culture and ethics), or that accountabilities are being incorporated into executive responsibilities. Once the factors have been clearly identified and the accountabilities established, there is a better opportunity to monitor and possibly take corrective actions.

SUSTAINABILITY

Sustainability can be seen as the opposite of "short-termism." The perils of being overly focused on the short-term have been well-documented. Certainly, this is a popular topic within corporate governance. However, what is missing in the debate is the inherent value of having a long-term focus. How can we develop strategy unless we are focused on the long-term? How can we develop our organizations and plan for succession unless we have a commitment to the long-term? More broadly, how can we build an enduring successful business without long-term commitment? Sustainability is the answer. We must commit to financial sustainability (through all market cycles), organizational sustainability (through leadership cycles), relational sustainability (with all stakeholders), industry sustainability (with regulators and industry associations), the sustainability of the communities within which we and our employees live, and environmental sustainability.

There are many structures and practices to consider when creating an organization focused on sustainability. First and foremost, sustainability has to be an integral part of strategy. Second, employees need to be incentivized to think and act with a long-term orientation. How can we provide evidence of a commitment to sustainability if we are not incentivizing our key executives for the long-term? I have been informed by compensation experts that 80 to 90 per cent of executive compensation plans for public companies all pay out within three years. The balance is made up of pension benefits, which is arguably a form of "pay to stay," with no link to performance. It is fair to say that there really is no established widespread practice within public companies to incentivize long-term performance. I believe that this represents a deficiency in governance.

At ARC Resources, we have broken the mould on this and are continuing to move toward bringing in creative forms of long-term incentives. The general question at the board level is: How can we provide evidence of a commitment to the long-term and to sustainability in the fullest meaning of the term, and how can we create the related accountability practices to monitor progress toward our sustainability goals? The different categories of sustainability — financial, organizational, relational, industry, community, and environment — can be looked at separately and specific monitoring processes can be established that are relevant and predictive.

LEARNING AND INNOVATION

The linkage between learning and performance is intuitive, but it is also now well-evidenced that learning companies are superior performers. Researchers Goh and Ryan conclude that "learning companies demonstrate strong performance in financial markets over time, beating the traditional market indexes in both bull and bear markets [and] … On a majority of the financial measures, the long-term financial performance of learning companies is significantly superior to that of their closest competitors."[40] A learning orientation is also clearly linked with innovation and long-term performance. Directors need to ask management how they can demonstrate a commitment to developing a learning culture. What specific educational programs and internal initiatives can be identified?

At ARC Resources, we have regular sessions with management focused on the theme of learning. Innovation timelines are developed to provide evidence of specific innovations in organizational processes

40 Goh and Ryan, "The organizational performance of learning companies," 225.

and practices, as well as in technology. We also incorporate a review of learnings as part of our CEO performance review. Similarly, at ARC Financial, we have quarterly strategy sessions focused on organizational excellence where learning and innovation are often highlighted. The key point for directors is to challenge management to provide evidence of a commitment to a learning culture and to monitor progress toward this outcome.

EMPLOYEE ENGAGEMENT

Employee engagement is another essential fundamental where there is ample evidence demonstrating a link to performance. In 2009, Gallup estimated that "disengaged employees cost U.S. companies between $250 and $350 billion a year."[41] How does all of this link to an organization's bottom line? In 2009, Macey and colleagues found that among "a sample of 65 firms from different industries, the top 25 per cent on an engagement index had a greater return on assets (ROA), profitability, and more than double[d] the shareholder value compared to the bottom 25 per cent" of employees.[42] Furthermore, in 2011, *Profit Magazine* aired a podcast on employee engagement, which stated that it "represents the strongest link between how employees feel about an organization and the organization's results."[43] In more recent work, Enterprise Engagement Alliance prepared a report in 2012 highlighting the link between engagement and performance. The report notes that the correlation between employee engagement and every measure of organizational success is now so well-established and so universally accepted that the focus in organizations should now move to action.[44]

There are many ways to assess employee engagement and manage the problem of disengagement. One piece of research by Rath and Harter offers a significant clue to the problem and management of disengagement:

> The most disengaged group of workers we have ever studied are those who have a manager who is simply not paying attention. If your manager ignores you, there is a 40 per cent chance that you will be actively disengaged or filled with hostility toward your job. If your manager is at least paying attention — even if he is focusing on your weaknesses — the chance of being actively disengaged decrease to 22 per cent. But if your manager is primarily focused on your strengths, the chance of you being actively disengaged is just 1 per cent, or 1 in 100.[45]

Directors need to be asking themselves: Are we measuring employee engagement and do our managers understand that they are accountable for creating the conditions that support a high level of engagement? At ARC Resources, we have been measuring engagement levels annually by department for the past 12 years, with a roll-up report going to the board of directors, including an assessment of changes over time and action steps to be taken. The point, again, is the value of monitoring at the board level to reinforce accountability and create the opportunity for early intervention.

EMOTIONAL INTELLIGENCE

As a concept, emotional intelligence (EI) is now quite mainstream and the links with performance and top-level leadership have been proven through an abundance of research.[46] One of the most significant studies linking leadership and performance to EI was undertaken in Canada. The authors sampled 186 executives who were members of either the Young Presidents' Organization (YPO) or Innovators' Alliance (IA).[47] They found that executives who possessed higher levels of empathy, self-regard, reality testing, and problem-solving abilities (key components of emotional intelligence) "were more likely to yield high-profit-earning companies."[48]

In addition, self-awareness is a building block of emotional intelligence and there is now research pointing to the relationship between self-awareness on an organizational level and performance. Based on 7,000 self and peer assessments (aggregated by company), in which participants were asked to identify blind spots or disparities between self-reported skills and peer ratings, researchers have concluded that companies with a higher percentage of self-aware employees consistently outperformed those with lower percentages.[49] In practice, what this underscores is the value of 360-degree performance assessments and leadership development. Given the importance of self-awareness as a long-term determinant

41 Attridge, "Measuring and managing employee work engagement," 388; Rath and Conchie, *Strengths-based leadership*.

42 Macey and others, *Employee engagement*; Saks and Gruman, "What do we really know about employee engagement?", 169.

43 Profit Magazine, *The why and how of employee engagement*.

44 Enterprise Engagement Alliance, "Enterprise Engagement Alliance curriculum series: Best practices in assessing employee engagement."

45 Rath and Harter, *Well-being: The five essential elements*, 26.

46 See, for example, Druskat and Jordan, "Emotional intelligence and performance at work"; Joseph and others, "Why does self-reported emotional intelligence predict job performance?"; O'Boyle and others, "The relation between emotional intelligence and job performance"; and Rosete and Ciarrochi, "Emotional intelligence."

47 Stein and others, "Emotional intelligence of leaders: A profile of top executives."

48 Ibid.

49 Zes and Landis, "A better return on self awareness."

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If you're truly committed to building a business that can sustain great results, you must embrace the reality that there are multiple fundamentals that drive success..."

of success, directors need to be asking, if not insisting, that these assessments and the related coaching be done on a regular basis. There needs to be a process at the board level to explain how this is being managed within the organization, and the effectiveness of the program needs to be monitored.

OTHER ESSENTIAL FUNDAMENTALS

Noted below are certain other essential fundamentals that, if not actualized, could imperil an organization. Processes need to be developed and information generated to allow for effective monitoring by the directors. Again, the focus needs to be "upstream" of the actual results or eventual impacts. For example, on the first point relating to "quality of relationships with customers," organizations need a process that will identify when and where relationships may be deteriorating, versus waiting until customers leave and then trying to find solutions after the damage is done.

These other fundamentals include:

- Quality of relationships with customers
- Changes in competitive strategies
- Quality of internal decision-making
- Operational efficiency and excellence
- Opportunity generation and inventory
- Strength of culture, notably trust and ethics

Performance-based governance must be comprehensive and focused on the early indicators of success versus simply bottom-line results. How important is this? For myself, I would not join a board unless this orientation existed among directors and executive leaders. Why? Because I don't want to preside over what would likely be underperformance and failure. I also want to have a positive experience, and there is nothing like being involved in a company that can sustain great results.

Summary and Conclusions

Directors of corporate boards need to see the realities of performance. If the company you are representing is not currently struggling with issues of underperformance, the probability is that it is just a matter of time. Most companies eventually underperform and fail. This is a fact. I will repeat a key perspective relating to this reality: If you are going to run your business like most businesses are run, it is only reasonable to expect that you will end up like most businesses — underperforming and failing. If you're truly committed to building a business that can sustain great results, you must embrace the reality that there are multiple fundamentals that drive success — each is essential and all are interconnected. This comprehensiveness points to complexity, but reflects reality.

Governance itself must be viewed more comprehensively. Compliance-based governance is but the visible edge of board influence and control. It is far from the "be-all and end-all" of board governance, as the linkage with performance is minimal. Social-based governance represents informal norms and guidelines for directors that represent an important form of governance. This provides context and support for quality decision-making, which clearly links to performance. Strategy-based governance can be viewed as a system that organizes and controls the direction of the organization. It is, by nature, inherently complex, as there are many fundamentals that are essential to sustain success and the context is of dynamic change. Governance also needs to explicitly, and more formally, extend into performance monitoring to complete the picture. Performance-based governance is a system of practices and processes that sources the hard evidence, and creates the related accountability, that demonstrates the organization is, in fact, progressing toward desired outcomes. This evidence can telegraph whether we have made a wrong turn or have taken some serious missteps well before the damage is done, allowing for early corrective actions and increasing the probability of enduring organizational success.

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