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Twelve questions every new director should ask

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Induction programs for new directors typically don't provide a sufficiently detailed understanding of the business. New directors should take ownership of their induction, designing and conducting their own due diligence, by asking twelve critical questions.

Introduction

The typical orientation for new directors combines a few internal meetings to learn about the company and one or two days at an external program to learn about the fundamentals of governance. Unfortunately, the internal meetings are often far too brief and the external programs far too standardized to provide real insights. As a result, directors are rarely prepared effectively for the role they are about to play.

In a 2011 *McKinsey Quarterly* survey of 1,600 board members worldwide, over half of the respondents said that their initial training needed improvement. One third felt that they had limited or no understanding of the dynamics of their company's industries and the risks their company faced. One quarter were not even sure how value was created in their company.

We clearly need a different model to educate new directors, and one source of inspiration might be private equity. The directors of private equity firms use due diligence to understand their companies in much greater depth than structured learning programs can provide. They spend more time, devoting 5-10 days instead of 1-2, and spend those days engaging with a wider range of managers, customers, analysts, and industry experts. As a result, they rate the quality of their induction and expertise much higher.

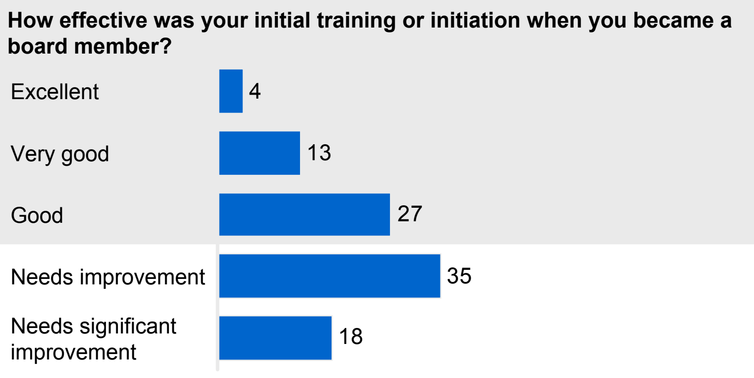
New directors should follow their lead and take ownership of their induction, designing and conducting their own due diligence. One way to start is by asking the twelve critical questions that follow. To be clear, these are not questions that a new director would ask at their first board meeting—they are questions the new director might keep in mind while scanning though company documents and during one-on-one conversations with top managers.

Note that this is not intended to be a comprehensive guide to a director's legal responsibilities; for more information on regulatory compliance and related issues please see the relevant country codes.

Exhibit 1

Most directors rate their initial training as needing improvement

Percent of 1,597 respondents



Source: *McKinsey Quarterly* survey April 2011

Board roles and relationships

1. What strengths are they expecting you to leverage?

Before diving into company analyses, it's useful for new directors to learn about the role that they are expected to play on the board, including the skills they have that other members may lack. Director selection committees often fill positions with specific functional or sector gaps in mind: a board may be well covered on risk, finance, and operations but lack legal expertise, or it may not understand the industry dynamics of one of its key subsidiaries. One way to start is to simply ask the chairman and CEO what they're looking for: What are the weaknesses of the board and how can I help to address them?

2. What will be your level of engagement and contribution to board dynamics?

The level of engagement of boards can vary dramatically. On corporate strategy, for example, boards can range from being kept informed about the strategy and its rationale to actively developing the strategy with the CEO and top team. It's important to get a read on these dynamics early on: does the CEO hold the board at arm's length or do they actively solicit the board's guidance? Do board members regularly challenge management's point of view or do they prefer consensus? Once new members understand the norms, they can of course decide the degree to which they want to follow them--in many cases new board members are brought in to provide a more independent view.

The general trend, in fact, is for board members to become much more engaged than they were in the past. In the recent *Quarterly* survey, directors said that more time spent on company matters—especially on Strategy, Talent, and Risk—would be the biggest factor in improving their board performance. The average director is spending 28 days per year and believes that 38 days would be ideal.

3. How will you proactively shape key relationships?

Another critical thing for a new director to learn about is their colleagues: the chairman, other board members, and key executives. The chairman, in particular, can help new directors to build support for strategic ambitions and discover hidden boundaries.

Within the remaining board members, there are often factions that wield a disproportionate amount of power—getting to know those dynamics will ensure that a new director becomes effective as soon as possible. And within the executive ranks, there may be 1-2 "confidants" who can provide unvarnished facts about the organization outside of the usual board-level presentations. In most cases there are 3-4 relationships that a new director should proactively shape, perhaps by starting with some informal dinner conversations.

Industry and company context

4. How is the competitive context evolving?

An obvious first step in understanding the external context facing the company is to understand recent gains and losses by core competitors and the behaviors that have driven those changes. But new directors shouldn't limit their questions to the traditional players in the industry; it's more important to test if managers understand who the next generation of competitors might be. One way to do that is by asking managers for their list of top ten competitors and then ask which companies would be the competitors of those companies--you may find that some companies are getting systematically closer to your industry.

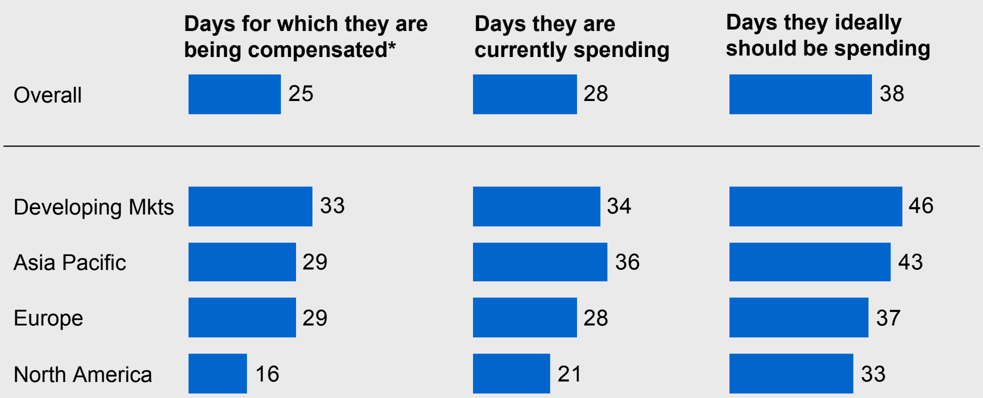
5. Where are the priority opportunities for the company?

When learning about company performance, new directors will naturally want to see which customer segments and product categories have experienced the most growth in recent years. They should also test whether executives are truly aware of the company's geographic momentum—not

Exhibit 2

Time spent on board work is consistently less than ideal

Number of days per year, as reported by 625 respondents



* Note that 51% are not compensated for their services; those that are compensated estimated days at their market rate
Source: *McKinsey Quarterly* survey June 2011

just in terms of revenue growth by country, but also in terms of recent shifts in talent and new initiatives, ideally at the city level. Comparing that momentum to GDP projections in key cities around the world, managers may find that the company is significantly underexposed to key cities based on their growth potential.

6. Which uncertainties could cause disruptions or opportunities for the company?

When trying to understand the key trends within the industry, directors shouldn't stop with a list of generic trends like "aging populations". The next step is even more critical: making sure that management understands the financial implications of the top 3-4 trends facing the industry. The most effective way to do that is to ask which trends represent the biggest uncertainties, because managers can then use those to build alternative scenarios, estimate the probability of each scenario, and estimate the industry impact under each. For example, an auto manufacturer trying to estimate the impact of rising Chinese manufacturers might estimate the market share impact under two uncertainties: whether Chinese companies develop significant scale advantages in clean tech and whether Chinese companies buy additional developed-market companies. That level of specificity allows management to translate trends into specific opportunities or threats.

Strategic direction

7. Does everyone have a consistent understanding of the corporate strategy?

The first clue to a sound corporate strategy is whether it is universally understood: new directors should see if top management and the board give the same explanation for what kinds of businesses they own and don't own—and why. Do they have the same understanding of the company's relative advantage? Do they describe the company's new growth platforms and investment requirements in similar terms? And have the core elements of those views been communicated to the entire organization?

8. Are resources dynamically aligned with opportunities?

A balanced portfolio will naturally include some initiatives to meet current earnings expectations, some to create medium-term growth, and others to serve as high-return options. The key is to check whether this portfolio is constantly refreshed by forward thinking investments: whether businesses are divested before investors suggest it, whether the CFO asks challenging questions about the trajectory of even high-profit core businesses, and whether the company sees potential assets for acquisitions well before other potential buyers to avoid multiple bidder situations. One of the most critical levers in creating value is active resource allocation, so ask for examples of regular, non-incremental shifts of resources such as R&D, sales and marketing dollars across different businesses and geographies, and test if capital spending is a leading indicator of how the company's growth emphasis is shifting across businesses and geographies.

9. Do business unit strategies meet the bar of effectiveness?

At the level of individual business unit strategies, directors should understand the assumptions, priorities and options put forward by management. A director can test for flaws by rating each strategy against ten tests of effective strategies. As described in the 2011 *McKinsey Quarterly* article titled "Have You Tested Your Strategy Lately?", these tests include whether the strategy taps a true source of advantage, is granular about where to compete, and avoids biases. It's a high bar: most company's strategies pass fewer than four of the ten tests. The two tests most likely to be failed were relying on privileged insights not available to competitors and taking into account uncertainties about the future, so an abbreviated set of tests should definitely include those two.

Organizational health

10. Is the board's dashboard value-driven and does it cover non-financial metrics?

Whereas senior management might monitor key performance indictors (KPIs) monthly with business unit managers, board members typically review results quarterly, discuss material variances, and ensure that corrective actions are taken. New directors should test if value is the common denominator of the performance management system. This implies that management understands which businesses and drivers create value, uses a balanced set of performance and health metrics that take value creation into account (EVA, ROIC, etc.), and then links strategy and value creation to operational KPIs.

A frequent gap is value-driven KPIs that are non-financial in nature, such as customer satisfaction, employee productivity, or attrition of top performers. An example of a more balanced view is McKinsey's Organizational Health Index, which collects employee opinions on 170 questions measuring internal alignment, quality of execution, and capacity for renewal.

11. Who are the 6-8 people that could make a real difference?

Getting to know the company's talent pool includes understanding not only potential CEO candidates but also the level of effectiveness within the top team, the development plan of pivotal roles, the optimal capabilities needed below the top team.

In particular, it's critical to understand the half dozen people within the organization that could make a real difference to performance—either positively or negatively—in the coming year or two. New directors can begin to understand talent issues across key layers of the organization by asking to rotate executives who present to board, interviewing the peers and direct reports of CEO succession candidates, and asking for the performance reviews of the top five candidates for critical senior management positions.

12. Is management optimizing the tradeoffs around risk?

The board is charged with setting the company's risk parameters, understanding major risk exposures, and ensuring that appropriate risk mitigation approaches are in place. A director establishing a view on the company's key risks might begin by testing whether management has a list of the potential crises that could occur—ranging from liquidity crises and patent disputes to product defects and natural disasters—as well as the steps the company has taken to prepare for those situations.

But directors shouldn't stop there: key areas to probe on here are whether management is ignoring big risks, paying too much to reduce minor risks, or missing high return / low risk projects. The emergence of sophisticated risk-transfer markets allows companies to own only those risks of which they are a natural owner, encouraging a shift from pure risk mitigation to risk-return optimization.

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The questions above are not comprehensive, but they should allow a new director to understand the company's critical issues and begin influencing board decisions quickly. Given the need for improved governance in most companies, new directors should set their aspiration at not only meeting the bar set by fellow board members, but exceeding it.

Summary of questions

Board roles and relationships	1. What strengths are they expecting you to leverage? — What types of skills or experience are missing on the board? — How can you help to address them?
	2. What will be your level of engagement and contribution to board dynamics? — Does the CEO hold the board at arm's length or actively solicit the board's guidance? — Do directors regularly challenge management's point of view? — How much time does the average director spend on board matters and do they feel it is sufficient?
	3. How will you proactively shape key relationships? — Which board members and executives represent the most important potential relationships? — How will you proactively shape those relationships?
Industry and company context	4. How is the competitive context evolving? — Where are your core competitors gaining share? — Who is revolutionizing the industry from the periphery?
	5. Where are the priority opportunities for the company? — Where is the geographic momentum? — Where is the product/service momentum? — Who are the emerging customer segments?
	6. Which uncertainties could cause disruptions or opportunities for the company? — What are the key trends within the industry? — Which trends represent the biggest uncertainties? — What are the probabilities and implications of alternative scenarios?
Strategic direction	7. Does everyone have a consistent understanding of the corporate strategy? — Do top management and the board give the same explanation for what kinds of businesses they own and why? — Do they have the same understanding of the company's relative advantage? — Do they describe the company's new growth platforms in similar terms?
	8. Are resources dynamically aligned with opportunities? — Does the CFO ask challenging questions about the trajectory of even high-profit businesses? — Does the company see potential assets for acquisitions well before other potential buyers? — Are there regular, non-incremental shifts of resources across businesses and geographies?
	9. Do business unit strategies meet the bar of effectiveness? — Does the strategy tap the true source of advantage? — Does the strategy embed superior insight and foresight? — Have alternatives been evaluated without bias or false inference?
Organizational health	10. Is the board's dashboard value-driven and does it cover non-financial metrics? — Does management understand which businesses and drivers create value? — Do they use metrics that focus on value creation and link value to operational KPIs? — Do they include non-financial KPIs (e.g. customer satisfaction)?
	11. Who are the 6-8 people that could make a real difference? — Who are the potential CEO candidates? — Who is in other pivotal roles? — What are their performance records and development plans?
	12. Is management optimizing the tradeoffs around risk? — What are the potential crises that could occur? — What steps has the company taken to prepare for those situations? — Is management ignoring big risks, paying too much to reduce minor risks, or missing high return /low risk projects?

Additional Reading

Board roles and relationships	1. What strengths are they expecting you to leverage?	■ Using the Crisis to Create Better Boards (*McKinsey Quarterly*, 2009)
	2. What will be your level of engagement and contribution to board dynamics?	■ Governance Since the Economic Crisis (*McKinsey Quarterly*, 2011)
	3. How will you proactively shape key relationships?	■ Boards: When Best Practice Isn't Enough (*McKinsey Quarterly*, 2011)
Industry and company context	4. How is the competitive context evolving?	■ Playing Wargames to Win (*McKinsey Quarterly*, 2011) ■ Getting into Your Competitor's Head (*McKinsey Quarterly*, 2009)
	5. Where are the priority opportunities for the company?	■ Global Cities of the Future (*McKinsey Quarterly*, 2011) ■ Is Your Emerging Market Strategy Local Enough? (*McKinsey Quarterly*, 2011) ■ Capturing the World's Emerging Middle Class (*McKinsey Quarterly*, 2010)
	6. Which uncertainties could cause disruptions or opportunities for the company?	■ The $30 Trillion Question: Is Your Strategy Ready? Global Economic Scenarios for 2011-2021 (White Paper, 2011) ■ Using Global Forces Thinking to Unlock Value (White Paper, 2010) ■ How Strategic Trends Affect Your Business (White Paper, 2010)
Strategic direction	7. Does everyone have a consistent understanding of the corporate strategy?	■ Leadership Lessons for Hard Times (*McKinsey Quarterly*, 2009) ■ Crafting a Message that Sticks (*McKinsey Quarterly*, 2007)
	8. Are resources dynamically aligned with opportunities?	■ Creating More Value with Corporate Strategy (*McKinsey Quarterly*, 2011)
	9. Do business unit strategies meet the bar of effectiveness?	■ Have You Tested Your Strategy Lately? (*McKinsey Quarterly*, 2011) ■ Putting Strategies to the Test (*McKinsey Quarterly*, 2011)
Organizational health	10. Is the board's dashboard value-driven and does it cover non-financial metrics?	■ Organizational Health: The Ultimate Competitive Advantage (*McKinsey Quarterly*, 2011) ■ Creating Value: An Interactive Tutorial (*McKinsey Quarterly*, 2010)
	11. Who are the 6-8 people that could make a real difference?	■ Do You Have the Right Leaders for Your Growth Strategies? (*McKinsey Quarterly*, 2011) ■ Three Steps to Building a Better Top Team (*McKinsey Quarterly*, 2011) ■ Planning for Your Next CEO (*McKinsey Quarterly*, 2010)
	12. Is management optimizing the tradeoffs around risk?	■ Risk: Seeing Around the Corners (*McKinsey Quarterly*, 2009)

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