

The Role of the Board of Directors in Setting Strategy in the Smaller Firm.

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A board of directors is a legal requirement for an incorporated company. For the small, privately owned company, this usually means that the founder and perhaps a family member make up the board, or that the board consists of the shareholders and/or a few friends. The annual meeting generally involves a good lunch, maybe a review of the financial statements, then back to work having had an enjoyable time. The board, in effect, is used only as a nominal body to support the owner's proposals. Given that theoretically a board of directors is charged with looking after the organization's long term future, this potential asset seems very underutilized. The smaller, private company is charting a course in an environment that is increasing in turbulence and becoming less stable. The winds of change can fill your sails or blow you off course. The changing times underline the importance of a dedicated board or advisory group.

Running a small company has been described many times as a lonely job. The entrepreneur is, by definition and character, a "loner" and a "doer". There is rarely time for reflection and long range thinking in the daily events of the chief executive officer of a smaller company. However, size unfortunately does not mean that many tasks and challenges are eliminated; they just take on a different dimension. What might seem to be a routine decision in a larger company may take on a greater significance in the smaller business, and may consume much more time for the manager or chief operating officer. Many decisions in the smaller company take on the characteristic of a "bet your company" issue (Hampson, 1989). Owner/managers often seem reluctant to share the planning of strategies with others, and often these plans exist only in a thinking stage.

As a business grows, the need for information, dialogue, sharing knowledge, planning, and delegation increases. A properly constituted board or advisory board is one body the owner/manager can turn to for advice and assistance. A board can offer the owner/manager a much needed source of guidance in developing a long run strategy. The board should be both a catalyst and a working partner in developing the organization's strategy.

The Board or Advisory Board

Basically, there are two possible routes: either a formal (legally constituted) board of directors, or an advisory board, group, or council (without the legal rights, obligations, and liabilities). The latter structure has also been labeled a quasi-board. An advisory board fulfills many of the functions of a conventional board.

Harold Fox, in a Harvard Business Review article, sets out the differences in table form. Exhibit 1 shows his comparison between the two types of boards.

Exhibit 1: Conventional boards vs. quasi-boards

<u>Conventional</u>	<u>Quasi</u>
1. Accountable to numerous interests for corporate conduct.	Not accountable.
2. Have or need director's liability insurance.	No such need.
3. Required to make certain public disclosures.	No such requirements.
4. Spend an average of 122 hours annually on board duties (survey of 576 major companies).	Spend an average of 30 hours annually (survey of 10 owner-managed companies).
5. Select or dismiss the president.	No such power.
6. Represent the stockholders.	No such representation.
7. Elected by stockholders for stated term.	Appointed by owner-manager who determines tenure.
8. Nominated because of respected position in the business world, pliability, or being a symbol of hitherto unrepresented group, as well as prudence and diligence.	Selected for prudence and diligence.
9. Comply with legal requirements.	No special requirements.
10. Evaluate performance of CEO and key executives.	Yes, evaluate performance.
11. Review and approve major corporate objectives, policies, budgets, and strategies as initiated by CEO.	Yes, plus take some initiatives.
12. Monitor the company's financial structure.	Yes, monitor financial structure.
13. Monitor, review and appraise management.	Provide opinion but lack authority.
14. Monitor, review, and appraise management's decisions and plans, management development and employee relations.	Yes, monitor, review, and appraise.
15. Serve individually as advisors to the president and, with his or her approval, to others in the company.	Yes, advise.
16. Monitor the company's performance.	Yes, monitor company's performance.
17. Assume responsibility for management of the board.	No such responsibility.
18. Review document of board responsibilities periodically.	No such review.
19. Ensure company's compliance with all national, international, foreign, state, and local laws affecting the enterprise.	No such function.
20. Do not usually arbitrate quarrels.	Arbitrate quarrels that threaten company's existence.

Source: Harold W. Fox, "Quasi-boards: Useful Small Business Confidants", Harvard Business Review, January-February 1982.

As can be seen, the operational differences are minimal. The legal differences are significant, especially in terms of the directors' liability, which may discourage individuals from becoming directors. The liability question can be resolved partially by insurance or indemnity clauses to protect the directors. This may prove expensive for the company and has spurred the growth of advisory or quasi-boards. It seems unlikely that advisory groups could be held liable for company actions, although there are no test cases on this topic. An advisory group may be less threatening to management and may therefore be a better working partner for the smaller company.

The author will use the term "board" to include both advisory and conventional boards. The interest is in developing a body of persons to help guide the company, independent of the legal aspects.

The Duties of the Board

The following sets out the duties of the board:

1. Goals, Policy, and Strategy Determination

The board is responsible for the goals of the organization. Although these goals may be formulated by management, the board has the obligation to explore, question, and approve both the short and long term goals of the organization.

The board has responsibility for policy decisions. Policy governs the manner in which an organization carries out its goals.

The board must set the strategic direction of the organization. This includes ensuring that the organization has a long term strategic plan which recognizes the threats and opportunities in the environment.

2. Budgeting

The board is responsible for evaluating and approving the budget. Once the budget is approved, the board has an obligation to assure itself, in periodic reports, that all is going as outlined in the original budget. The board has a responsibility to ensure that the organization remains in a healthy financial position.

3. Human Resources

The board is responsible for reviewing the organization's human resource needs to ensure that these resources are adequate to carry out the organization's goals.

4. Delegating

The board must delegate operational duties to its chief operating officer, and from time to time to various committees appointed by the board.

5. Controlling

The board must ensure that the organization's information systems are adequate to monitor performance and to provide input into board and management decisions.

6. Auditors*

The board recommends the appointment of auditors.

7. Ethics

In considering its responsibility, the board must balance the interests of the stakeholders.

8. By-laws*

The board must review the by-laws from time to time and make changes when appropriate.

9. Annual Meeting and Annual Report*

It is the duty of the board to prepare an annual report and to plan the annual meeting.

10. Growth

Board members should initiate ideas and proposals that will promote the purpose of the organization.

*Legally constituted board only.

The board's function is clearly not to manage, but to be involved in the larger issues of the mission and purpose of the organization, the monitoring of results, budgets, and major decisions.

The Director's View

In a recent survey of 100 CEOs of Canada's largest companies on board issues, the following key views were found (Arnold/O'Callaghan, 1988):

1. An activist board is a key corporate asset.
2. Outside directors should have direct access to line managers.
3. The CEO should not be chairman of the board.
4. Talent is becoming scarce.
5. Outside directors should be dominant.

6. “Stakeholder” representatives get mixed reviews.
7. Directors’ compensation is on the rise.
8. Pay for performance is not the answer.
9. Director stock ownership – desirable, but not essential.
10. Non-contributors must go.

Although these views are those from very large companies, most of the points hold equally true for the smaller, private company.

The Board and Strategy

The board has a pivotal role when it comes to company strategy. Firstly, the board must ensure that the company has a strategy, and that it is the proper strategy for now and the future. Secondly, the board may have to initiate the development of a long run strategy and may have to become involved in the further development of this strategy.

Kenneth Andrews (1980), when writing about the board’s responsibility, states:

“A responsible and effective board should require of its management unique and durable corporate strategy, review it periodically for its validity, use it as a reference point for all other board decisions and share with management the risk associated with its adoption.”

Andrews was addressing the very large organization, but his views hold equally true for the smaller firm, with one exception; that is, there may not be the depth of management available in the smaller company to develop strategy, and this role by default may fall to the board itself. The board, typically with a mix of inside and outside directors, may have to develop the long run strategy, either with or without outside help. If it is a large board, a strategic planning committee may be struck to tackle the task. The key point is that ultimately the board should be responsible for the organization’s strategy. Performing this function is undoubtedly the most important role that the board should play in the future of the organization.

Strategy is the balancing of the present and the future, of resources, and of opportunities or threats. It is a sensitive process for the board, albeit an important one. For the larger firm, the board’s involvement is more as an appraiser, asking hard questions and evaluating strategy on an ongoing basis. In the smaller firm, it is difficult for the board not to be involved in the process. There are many strategic issues that only the board can deal with, the principle one centred around the organization’s purpose, broad philosophy, mission, and broad objectives. The board of a smaller firm must go beyond being a body for sounding out ideas to become a board involved in the future dynamics of the organization. The board must accept, change and enhance the chief operating officer’s vision, and the vision must flow into the long run strategy of the corporation.

There are several reasons for board involvement in strategy:

1. The board must assure itself that a process is in place to develop strategy.

2. The board must develop a viewpoint for choosing among opportunities.
3. The board members must develop an understanding of the dynamics of both the organization and the industry. Knowledge and understanding of the environment in which the business operates precedes intelligent decisions.
4. The board must evaluate the strategy of the corporation as it is developed.
5. The board will eventually have to pass judgement on the outcome and the results of the strategy. Without involvement and knowledge, this becomes a meaningless act.
6. The board must, to some extent, share the risk and exposure of the chief operating officer and management. This sharing will create involvement and discipline, which in turn will produce a more valuable board contribution.

The Board's Involvement

Traditionally, boards are sounding or review bodies; however, in the smaller, privately owned firm, the board must be a part of the strategy process, perhaps not the whole board, but at least some of its members. The following illustrates one organization's struggle:

The small organization was being threatened by a disappearing market and a financial loss, the worst of both worlds. The board set up a small strategic planning committee and charged them with developing a strategic plan within a certain time frame. The committee hired a consulting company to provide both content and process. On one hand, the consultant developed the data necessary for market and financial decisions, and on the other hand worked as a facilitator or process consultant with the strategic planning committee. Jointly, they developed a strategy for presentation to the board. The board discussed the strategy, accepted it, and it became the future path for the organization.

A director cannot be effective unless he or she gets "inside" the company's concerns. There is no better way to understand the full depth of a problem than by getting involved.

Board Members

If the smaller, privately held firm is to achieve board involvement, it must choose the members of the board carefully. Selecting board members is a lottery and is becoming more difficult. You may start with a sound set of criteria, but find that there is no one who fits. A list of characteristics that should exist on the board of the smaller firm follows:

1. A person who has been a successful entrepreneur in his/her own right. This person has been through the process of growing a company.
2. A person who is committed to the success of the company.
3. A person who can lead the board.

4. A person who can be innovative and creative.
5. A person who has a particular skill that is valuable to the company.
6. A person who has a sense of humour – there will be many instances when this will be needed.
7. A person who is action driven.
8. A person who has problem solving skills.
9. A person who can integrate, simplify, and create synergy.

Many of these skills or characteristics can be found in one person. The important point is that these skills should exist at the board level.

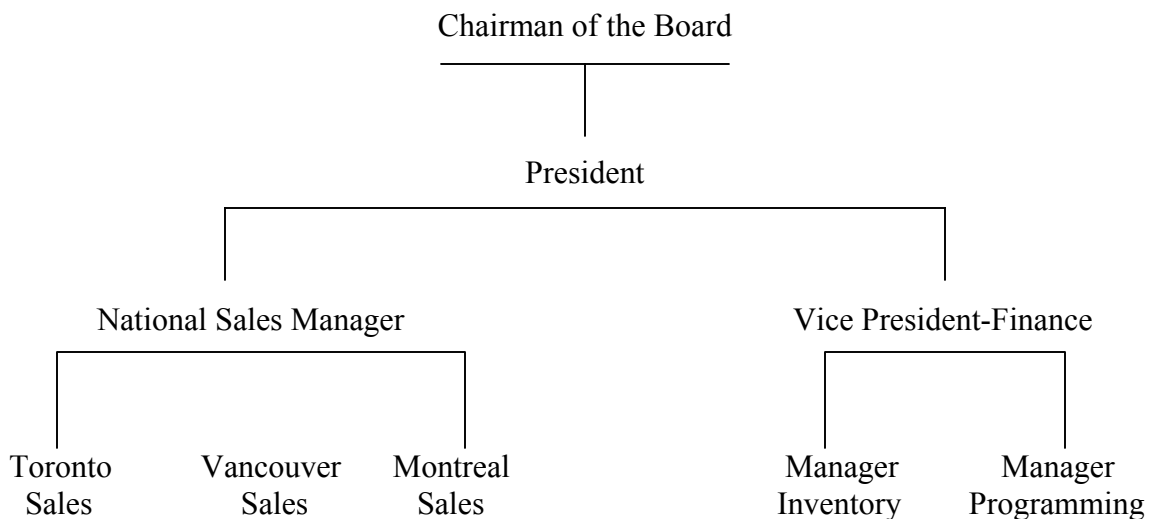
The following illustration demonstrates how a privately controlled company set up and used a board of advisors:

Ontario Engineering Company

Background

Ontario Engineering is a distributor of engineering products. The Company started in 1945 by representing a British manufacturer; more lines from both Britain and the U.S. were added. Today, the Company represents 10 manufacturers and generated \$10 million in revenue last year. Ontario Engineering has offices and warehouses in Toronto, Montreal, and Vancouver, and employs 40 people. The organizational structure is illustrated in Exhibit 2.

Exhibit 2: Organizational Structure of Ontario Engineering



A few years ago, the Company reorganized its board of directors and senior management, which up to now had consisted of the president’s friends. The meetings were more an excuse for a good lunch than anything else. The new president set up a legal board

consisting of the three shareholders of the company. The shareholders would meet on legal matters and in order to conform to the requirement of the Corporations Act. The president also set up a board of advisors consisting of the chairman, the president, the vice-president, the vice president – finance, the auditor (a senior partner in an accounting firm), a president of a very successful company, and a management consultant. The agenda for the inaugural meeting with the board of advisors was as follows:

9:00 am	Introduction
9:30 am	Company mission and the role of the advisory board
10:00 am	Strategy and market assessment
11:00 am	Discussion, questions, and ideas
12:30 pm	Lunch
2:10 pm	Monthly management report and finances
3:00 pm	Ideas
3:30 pm	Adjourn

The documents were sent to the board of advisors beforehand. One of the documents was a consultant's recent market report on the current products and the other a suggested strategy for Ontario Engineering, also prepared by a consultant. At the start of the session, the president addressed the meeting and outlined the role that he saw for the board of advisors:

1. To broaden the point of view of the Company.
2. To energize the organization.
3. To suggest and recommend.
4. To bring specialized knowledge to bear on issues.
5. To ask a lot of questions.
6. To provide answers for questions from management.
7. To look for things going wrong.

After this, the board reviewed and discussed the Company's mission to see if it was still relevant for today, evaluated the proposed strategy, and made changes and suggestions. The market assessment report was tabled, discussed, and related to the future of the organization. After lunch, the previous year's financial results were reviewed.

In order to evaluate the success of the new advisory board, five members were asked for their comments on the meeting one week later. Exhibit 3 outlines the feedback. Clearly, Ontario Engineering is starting to use the board effectively and to involve them in strategy. (Subsequently, Ontario Engineering added one more advisor, a human resource consultant, to provide the people dimension to the board.)

Exhibit 3
Ontario Engineering Board of Advisors Meeting Feedback

- President
- Too much detailed discussion.
 - Some irrelevancies.
 - Insufficient discussion on strategy.
 - Too unstructured.
 - Recommendation: Have a meeting to structure meeting.
- V.P. Finance
- First half (am) on track.
 - Meeting dragged into detail.
 - Meeting should have taken place earlier in the year.
 - Better than previous board meetings.
 - More planning.
- Outside Director
- Good meeting on marketing aspects.
 - Good comments.
 - Good guiding.
 - Previous meetings were mainly financial in nature and budget.
 - Quasi boards should not approve things.
 - Papers, etc. should be issued beforehand.
- Outside Director
- Good meeting.
 - Board can help in nuts and bolts.
 - Much better than previous meetings. Less dictatorial and less self-justification.
 - President seeks serious advice.
- Outside Director
- Good discussion of strategy.
 - Board received an understanding of external and internal environment.
 - Board became a true advisory body.
 - Avoided detailed financial discussion of the past.
 - Focus on the future.

Bibliography

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