Corporate Governance

A New Tool for Boards: The Strategic Audit

by Gordon Donaldson

From the Magazine (July–August 1995)

In the aftermath of the wave of restructuring that peaked in the 1980s, the corporate oversight process has received unprecedented public attention, and investor activism has resulted in numerous proposals for reform. Board members, seeing the number of stockholder lawsuits and the escalating cost of directors' and officers' liability insurance, are feeling pressure from their increased risk as well. Even more important is the pressure from holders of large blocks of stock (pension and mutual funds), from judicial and regulatory authorities, and from the financial press—all of whom are calling for boards to be more active.

This attention has had an impact on the nation's public corporations and has brought about a change in boardroom behavior that is significant, if often imperceptible to outsiders. Outside board members are now much more willing to stake out independent positions in boardroom discussions and, at times, even openly oppose the chief executive when they believe the vital interests of the corporation are at stake. Recently, directors' independence led to the ouster of the incumbent chairman or the CEO at Morrison Knudsen, W.R. Grace, and Kmart.

Efforts to reform the governance process have also intensified. Investors and investors' advocates, impatient with the sporadic nature and rate of change, have proposed legal, regulatory, and structural improvements in the relationships among shareholders, boards of directors, and CEOs. Some proposals call for radical changes in the rules governing the election of directors at public corporations. Some recommend adopting certain attributes of the private corporation. Indeed, Michael C. Jensen ("Eclipse of the Public Corporation," HBR September–October 1989) predicted that in such industries as banking and food processing the public corporation will decline, to be replaced by new forms of organization, such as the LBO partnership. Other proposals are designed to address specific issues, such as directors' compensation or the separation of the offices of board chair and CEO.

One problem I see with many of the reform initiatives is that they are concerned only with the broad principles of governance and offer little practical guidance. More important, these proposals do not directly address the fundamental issue at the heart of investors' concern—namely, the capacity of the board to intervene in the face of an unsuccessful or ailing business strategy. Proposals to strengthen that ability are among the most important to consider but are also the most difficult to gain consensus on and to implement.

Board Oversight and Company Strategy

Board involvement in formulating and implementing corporate strategy has always been a sensitive issue. Although it is standard procedure for managers to brief directors on the evolving strategy and structure at the annual meeting dedicated to that purpose, it has always been understood that the "ownership" of the current strategy remains firmly in the hands of the chief executive and his or her management team. And for good reason. In order to be effective, every organization requires not only a clear and unambiguous strategic mission but also the confidence that its top management has the authority and ability to carry it out. By nature, the typical board of directors is poorly designed and ill equipped to provide hands-on product and market leadership.

The majority of its members usually lack the industry-specific experience, the company-specific knowledge, and, most important, the time necessary to turn broad strategic vision into operational reality. Board members give their undivided attention at most once a month for six or eight hours at a time. They can hardly be expected to have the detailed command of the issues and the requisite independent judgment necessary to make compelling proposals to counter those of management.

In addition, the typical board meeting is an inappropriate forum for raising serious concerns about a company's strategic direction. All who have served as board members know that attending a board meeting is rather like entering the on-ramp of an expressway at rush hour: You spend half the time getting up to speed and the other half trying to insert yourself into the bumper-to-bumper boardroom traffic, only to find that it is time to exit and try again a month later. The customary agenda is set by the chair and invariably focuses on details of implementing the ongoing business strategy. Presentations reflect the urgent pursuit of the company's established mission, and managers are likely to be impatient with board members who do not share their total commitment to the chosen path. Therefore, the regular board meeting is an unsuitable, even hostile, environment for revealing serious reservations about the underlying strategic assumptions.

Of course, individual board members, such as the company's founder, a major investor, or a former CEO, have often exerted considerable influence over strategic direction, although usually behind the scenes. Absent such unique personal prerogatives, board members are expected to serve as supportive critics of the strategy in place. Those who choose to violate the norms of boardroom debate by aggressively and persistently challenging corporate leadership, thereby invading the DMZ between board and executive—run the risk of finding themselves isolated and, in time, replaced. Without an established forum for vigorous debate, serious concerns either simmer in one-on-one discussions outside the boardroom or boil over in messy and destructive confrontations in front of subordinate managers, who are invariably present at board meetings. Both outcomes are unacceptable. As a result, outside board members seeking a change in strategy or, perhaps, leadership are wary, and examples of spontaneous intervention are relatively few and far between.

If these interventions occur at all, they seem to do so under one of three circumstances, as I describe in my book *Corporate Restructuring: Managing the Change Process from Within* (Harvard Business School Press, 1994). The most common is the retirement of the incumbent chief executive, even though the retiring CEO frequently nominates his or her successor. A second circumstance is a sudden, precipitous decline in profitability or asset value, as in the case of Morrison Knudsen. A third occasion that might trigger intervention is an external challenge threatening a change in control—the classic barbarian at the gates. Such a scenario was common in the 1980s, the heyday of corporate raiders, and so weakened incumbent chief executives that there was often an opportunity for boards to seize the initiative.

But the threat of one or all of these events is insufficient to guarantee vigilant oversight. A strategy may go sour long before the normal retirement date of the CEO responsible for choosing it. Evidence that a strategy is failing is more commonly seen in gradual or erratic erosion of profitability than in dramatic collapse. The barbarian may be off on other quests and may never show up at the gates, or, if he does, may be persuaded to go away. The worst characteristic of the three triggers is that the transforming event comes from outside the governance process and forces both management and board into a reactive mode.

Even when decisive intervention is initiated from within the governance process, it is usually not initiated by a formal action of the full board. What happens instead is that one board member impulsively steps forward to assume leadership and to provoke other independent members into unified action. Probably the best known example is John Smale's 1992 move on behalf of the GM board to replace chairman and CEO Robert Stempel. Like the three triggers I describe, such an approach is an unreliable mechanism of board oversight and seems unnecessarily disruptive.

Boards can fulfill strategic oversight duties better if they implement a formal review process: a strategic audit.

Therefore, the question remains: Is it possible to create a formal mechanism within the existing governance process so that the board can exercise proactively its responsibility for strategic oversight? My answer is yes. The mechanism is a formal strategic-review process—a strategic audit—which imposes its own discipline on both the board and management, much as the financial audit process does. I believe such an audit can be designed to stand the test of time and survive the inevitable disputes over authority. The process would center the leadership of strategic oversight in the hands of independent directors and provide them with the authority to establish both the criteria for and the methods of review. It would further require the board and the CEO to hold a regular, joint review of company performance. And it would signal to the investing public that both the board and management accept the board's authority and responsibility for active, ongoing strategic oversight.

The Case of CPC International.

In the summer of 1986, financial analysts began to speculate that CPC International, a leading manufacturer of food products in the United States and abroad, was ripe for major restructuring. In the early fall, the tone and content of the speculation changed as investor discontent grew, and word on the street was that CPC was being considered for a takeover by Con-Agra, Revlon, or an inside management group. These rumors turned into reality in October, when an investment group headed by Ronald O. Perelman attempted an unsolicited takeover. Could this outside intervention have been avoided? Quite possibly, if the board had had a formal strategic-review process in place. It is just such an event that a strategic audit is designed to avoid. It is helpful to review the events in the CPC case leading up to the Perelman raid to see how a review process might have worked.

If CPC had had a strategic review process in place before the downturn, past performance would have signaled trouble.

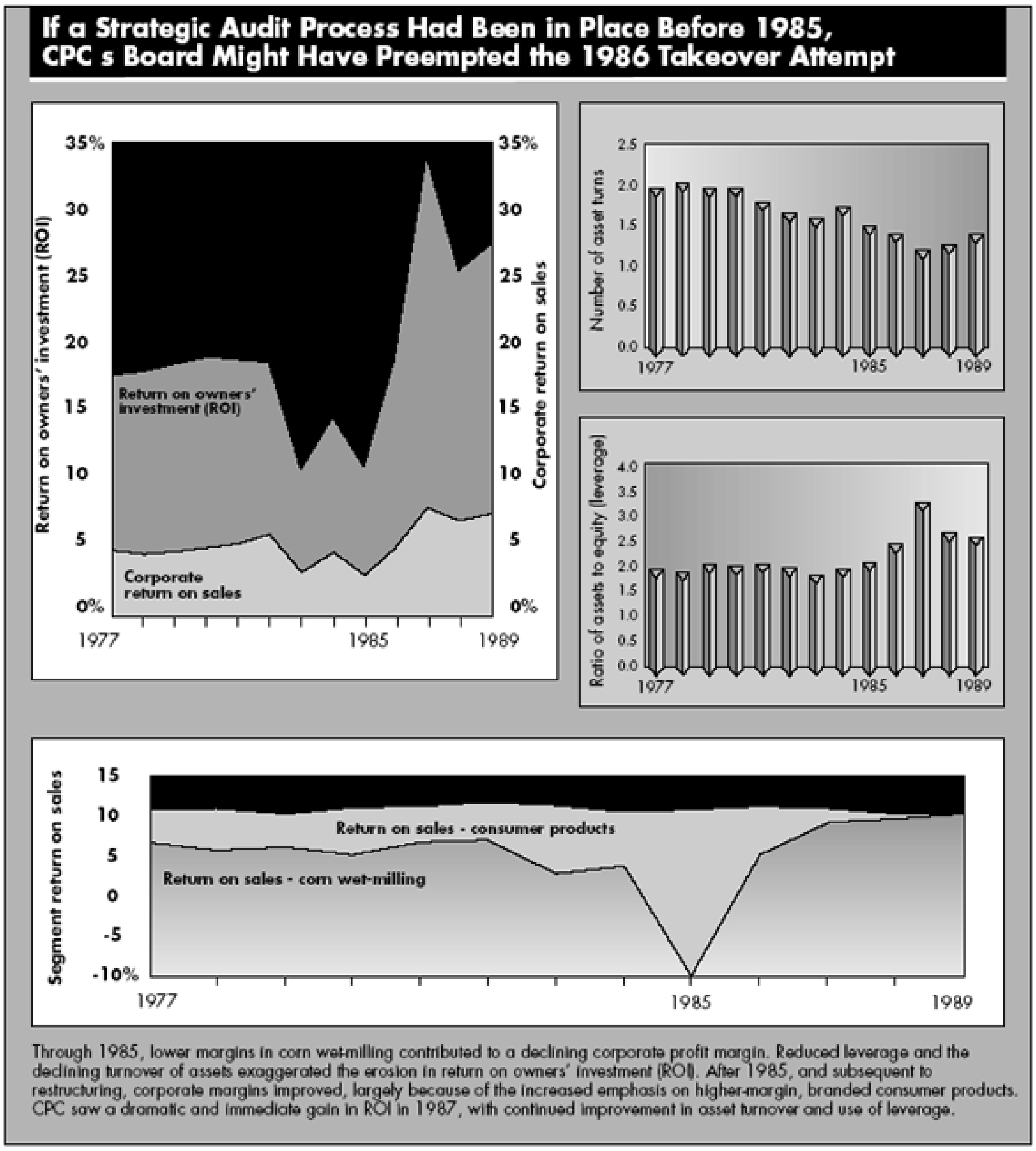
Corn Products was founded in 1906 with the development of a wet-milling process to refine corn by-products—corn starch, syrup, and oil—for both consumer and industrial use. In 1958, it merged with Best Foods, which was a grocery products company with well-known brands. At the time of the merger, however, the company was dominated by the wet-milling division, which was in a capital-intensive, high-volume, low-margin industry subject to periodic bouts of competitive overbuilding. The intent of combining the two businesses—later renamed CPC International—was to diversify the product line and enhance opportunities for growth and profitability in consumer products.

Beginning around 1980, the profitability of corn refining underwent serious, steady erosion because of overcapacity in the industry, and a widening gap developed between the performance of the corn byproducts and that of consumer foods. For example, in 1977, the return on assets (ROA) in consumer products was

24.4% and in corn refining, 12.6%; but by 1983, the ROA in consumer foods was 25.5% and in corn refining, only 6.6%.

Despite these data, management remained committed to its traditional revenue base in corn refining and to a long-term strategy based on the expectation of improving competitive performance in that industry. And management made no attempt to conceal from shareholders the effect its strategy was having on performance. Indeed, over an 18-year period beginning in 1974, CPC consistently used its annual report to present comparative data on the components of its corporate return on equity. Furthermore, the data were presented for the current year and the four preceding years in an identical format each time. It is rare for a public corporation to maintain such consistency and even more unusual for it to keep reporting the drivers of equity value over such a turbulent period in its history.

Although the actual disparity in performance between corn refining and consumer products was difficult to observe early on, it was impossible to conceal during the period from 1983 to 1985, when there was a short-term decline in the profitability of the consumer foods line. As the data reveal, CPC reported a dramatic decline in the corporate return on equity from 18.5% to 10.5%, turning a public spotlight on the milling operations' persistent drag on earnings. (See the exhibit "The Strategic Audit Report Card for CPC 1977–1989.") Capital market analysts and the financial press began to suggest that CPC should divest all or part of the milling business and release the full market value of the Best Foods product line to investors.



If a Strategic Audit Process Had Been in Place Before 1985, CPC s Board Might Have Preempted the 1986 Takeover Attempt. Through 1985, lower margins in corn wet-milling contributed to a declining corporate profit margin. Reduced leverage and the declining turnover of assets exaggerated the erosion in return on owners' investment (ROI). After 1985, and subsequent to restructuring, corporate margins improved, largely because of the increased emphasis on higher-margin, branded consumer products. CPC saw a dramatic and immediate gain in ROI in 1987, with continued improvement in asset turnover and use of leverage.

There is no record of what went on in the CPC boardroom at the time of this unfavorable public attention. We do not know whether any of the board members challenged the wisdom of the strategy in place, although the speed of management's response to subsequent events suggests that either the board or management—or both—had previously analyzed and debated alternatives to the strategy. Certainly the board could not plead that it lacked objective historical evidence on the inherent weaknesses of the business. The takeover attempt by Perelman occurred two years into the tenure of new CEO James Eiszner and forced his hand. He mounted a vigorous and successful defense, implementing many of the changes advocated by outside critics, including the divestiture of CPC's substantial corn wet-milling division in Europe.

The outcome of the restructuring was immediately apparent in CPC's financial performance in 1987 and was reflected in rising market values for CPC stock as well. However, the costs of restructuring under the guns of a battle for control were substantial. In addition to the legal costs, there were the costs of negotiations conducted in haste and from a position of weakness —namely, the sale of underpriced assets and the repurchase of over-priced stock. And there was a management team preoccupied with staying in office rather than doing the job it was hired to do.

So CPC's turnaround was dramatic and positive, but the costs of lost time and opportunities were high. This much we know. I suggest we can also be sure of another thing. If a formal board-level strategic-review process had been well established before the downturn between 1983 and 1985, periodic discussions about strategic direction between the board and management would have centered not on optimistic promises for the future but on the pessimistic realities of past performance. Set against the backdrop of public debate and investor discontent over the strategy, these discussions could well have resulted in a less costly and painful readjustment of the company's strategic path.

The Board's Unique Perspective

There will be some who resist the idea of another strategic-review process on top of management's existing annual reviews and reports. They will say, Isn't this overkill? Shouldn't review be a joint effort with management? Isn't management best qualified to select the appropriate criteria to evaluate the company's progress within its industry?

The answer to all these questions is no. Management and the board have unique and distinct perspectives on strategy. Managers are charged with turning strategic vision into operational reality. Of necessity, they must focus on one strategic path at a time and pursue it relentlessly to maximize its potential for corporate profitability. If managers equivocate, they default on their obligations to employees and shareholders alike, eroding much-needed morale and commitment. In this context, the best standard of performance by which to motivate the organization is a relative one—to ask how the company is performing relative to previous strategies, relative to the results of last quarter or last year, relative to the best competitors in the same product markets. But performance evaluation designed to motivate the people in an organization is not intended to challenge the chosen path.

The board's mandate in strategic oversight is distinctly different. Its responsibility is to represent the perspective of investors and question the strategic path itself. The board's evaluation of the validity of the existing strategy mustn't be based simply on the performance of the company relative to itself, its industry, or its past performance, but rather on comparisons between returns derived from the current strategy and those possible from other strategies. Management may think it's dealing with disloyal boards at times, but from directors' perspective, they are the "loyal opposition."

Although the two perspectives converge when board and managers are *developing* strategy, management's role in *executing* the strategy precludes it from also objectively evaluating the strategic path once it is in place. The strategic audit, therefore, must be directed by independent board members rather than by management insiders. And the board—not management—should select the key criteria to monitor strategic results.

Elements of the Strategic Audit

Establishing the Criteria.

The most important requirement for the data used in the strategic review process is that they be objective. In addition, the criteria should be familiar, well-understood, and accepted measures of financial performance. There are two reasons why. First, the ultimate responsibility of the board is to understand the impact of a given strategy on the value of the owners' investment. This obligation implies evaluating performance in financial terms. Second, although it's inevitable that much of the evidence on the success of an evolving strategy is subjective, managers' familiarity with the details of product-market and company-specific issues, and their access to an incredible amount and variety of data give them an advantage over outside board members. Objective data consistently presented and reinforced by the cumulative evidence of past performance can strengthen the power and credibility of the board's opinion. Standard financial indicators facilitate discussion in terms all parties can understand.

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Some will argue that using such indicators is just one more example of a myopic preoccupation with the corporate bottom line, leading to short-term decisions that erode long-term competitive strength and profitability in domestic and international product markets. I must disagree. Although I think that financial criteria should be the central focus of board oversight, I do not think such a focus prevents the board from considering other kinds of progress. It should certainly weigh all objective—or even subjective—evidence of strategic progress demonstrating long-term competitive superiority. But it is equally important for the board to intervene when it sees persistent, long-term erosion of the investment base, on which all corporate activity depends.

The criteria best suited to the strategic oversight process share two important characteristics. They focus on the sustainable rate of return on shareholder investment produced by the corporate income stream. They also permit objective comparisons among the company's separable income streams and with alternative investments in other companies inside or outside the industry. These data should help the board determine whether the company's chosen strategy—or a particular decision—will contribute to a long-term return of shareholder investment equal or superior to other investment alternatives of comparable risk. They should also allow a comparison of the promise of future returns with the reality of past performance.

In the final analysis, these criteria should reflect a fundamental economic reality: The long-term loyalty of the equity holders depends solely on sustaining a competitive return on investment. Without that, no product-market strategy is safe. Although professional managers might find this dictum hard to accept, it is nevertheless the reality of the public capital markets in which they operate. Just doing better than other immediate investment alternatives, better than last year, or even better than all major competitors in the same industry may not, in the end, be good enough to justify continued investor support.

With this in mind, boards will find that several criteria satisfy the basic requirements of a strategic review process. One is the reported return on book investment (ROI), particularly when it is disaggregated into its primary components, as shown in the exhibit. It has the advantage of being based on data familiar to shareholders and management. It shows profit per unit of sales (profit margin), sales per unit of capital employed (asset turnover), and capital employed per unit of equity invested (leverage). When multiplied together, these ratios transform profit margin into return on equity.

This particular set of measurements has two weaknesses, however. First, it may be subject to random changes in accounting practice, so that users may have to make appropriate retroactive adjustments to the raw data. In addition, it doesn't provide an external standard of comparison. The underlying components of the corporate income stream need to be broken out, and comparable data on companies inside and outside the industry gathered. The data of review should also encompass information on investor response, including price-to-earnings and market-to-book-value ratios. These data reveal evidence of investors' reaction to published information on company performance and are a measure of confidence. They are an essential supplement to any measurement based primarily on company-specific data.

Other commonly used criteria for the evaluation of strategic alternatives are:

Cash flow return on investment (CFROI).

This measure highlights net cash flows from operations rather than reported income and produces a rate of return that can be compared with alternative company or market rates of return (the cost of capital). It has the special merit of approximating actual flows of investable funds and is therefore well suited to rate-of-return comparisons with alternative investment opportunities.

Net economic value added from year to year (EVA).

This is an estimate of the absolute dollar value that is added to shareholder wealth whenever a company gains a return on investment in excess of its cost of capital. EVA incorporates the same basic variables of CFROI but expresses the evidence in a dramatic way. It highlights those periods in which, in comparison with alternative investment opportunities, the company's performance has led to the creation—or destruction—of economic value.

Total of shareholders' return on investment (TSR).

This measures the actual year-to-year taxable income received by shareholders in the form of dividends plus capital gains as a percentage of beginning-of-year market value. Unlike the other three measures mentioned, TSR has the advantage of reflecting value in hand rather than value in prospect. It is more a measure of stockholders' expectations than of demonstrated return on corporate capital employed, and it has the disadvantage of reflecting short-term and often exaggerated fluctuations of the stock market as a whole, for which management cannot be held responsible. For this reason, TSR is probably best used as a supplement to one of the other three measures mentioned.

Each of the measures I describe has its strengths and weaknesses, but one simple consideration should drive the choice of the particular measure—or set of measures—for a given company: The directors and the chief executive alike must have a thorough grasp of all the elements of the chosen measurement. Otherwise, debate over the validity of the index itself may undermine the impact of the objective evidence. If particular members of the board are more familiar with other indices, there might not be universal agreement about which to use for the audit. In such a case, individual members might be provided with the comparable data in the index of their choice. What all the measures I have presented share is an ability to capture significant and sustained trends, whether strong or weak, which then become the baseline from which to track strategic progress.

Database Design and Maintenance.

An effective strategic-oversight process requires that the board take control not only of the criteria of performance but also of the database in which the criteria are maintained. One of the problems that outside board members often have in evaluating strategic performance is that all the information they receive passes through the filter of a management perspective. In addition, data often come with limited historical reference and in a format that does not map to the previous one. Insiders may consider the presentation meaningful, or at least well intentioned; but outsiders may feel confused and end up misinformed. The credibility of the board's review process depends on the integrity and consistency of the statistics by which progress is measured. Typically, it will be the cumulative evidence that tracks emerging trends in the indices of performance over several quarters or years.

Effective oversight depends on how these data are assembled and maintained in the short and long term and who does the job on behalf of the board. Traditionally, boards of directors have neither the independent staff support nor the personal time and expertise to devote to data collection and analysis. One solution is to ask the company's chief financial officer for the help of someone on staff. This solution has some obvious practical problems, however. Conflict of interest could arise for an employee working with potentially sensitive data. Certainly issues of divided loyalties will come up if the employee uncovers data that could cause a problem for an in-house boss or for the company. And to the outside observer, a company employee acting as the "independent" liaison to the board is a contradiction in terms.

A better solution is for an outside consultant to design the database and gather the data the board chooses to monitor. The database maintenance function could become an ongoing contractual arrangement. The management challenge here would be to provide a consultant from the outside with enough information and context about the company that he or she could ask intelligent questions about the database design and data collection effort. At least initially, the board and its consultant would need a great deal of cooperation and assistance from management. The board would also need to be very familiar with details of the database design and reporting activities in order to ensure continuity if the consulting arrangement changes over time.

My preferred solution, one consistent with the model of the financial audit, is to involve the company's public auditors. Their assignment could be like that of an outside consultant in design and data collection, but the public auditors would bring much more to the ongoing effort because of their access to and familiarity with the company's financial information and systems. Their role would ensure, over the long term, consistency in maintenance, documentation, and reporting. Management would not have to be involved in establishing the relationship or in acting as a go-between.

The Strategic Audit Committee.

As we have already established, there is no existing mechanism in most governance processes for formal strategic oversight. A sustainable, effective process means assigning specific responsibility and leadership to particular members of the board, in much the same way that other committee assignments are made. The strategic audit committee's charter is not complicated, but it should cover the issues I have addressed. The committee should select the criteria for review of strategic performance, oversee the design of the database, and establish a review process. It should ensure the integrity and continuity of the ongoing data collection and reporting efforts, identify issues for discussion with the CEO, keep the full board abreast of the evidence, and schedule both regular and special meetings.

I suggest that the outside directors select three of their own members to form the committee. The selection of the chair is particularly important. If the board has an outside director who is the lead or liaison, he or she would be a natural choice to chair the strategic audit committee as well. In the event of a difference of opinion over strategy between the chief executive and outside board members, having the liaison director chair the committee will reduce the possibility that the leadership of the outside board members will be divided. As with the financial audit committee, committee membership should rotate on a staggered basis to preserve institutional memory. All outside directors should have a turn on the strategic audit committee before their time on the board is up.

The frequency of meetings will depend on the nature of the industry and the rapidity of change in the technological, competitive, and social environment. In addition to periodic presentations to the full board and absent a special need, such as the impending retirement of the chief executive, I suggest that the committee meet once every three years. Meetings should not be so frequent that strategic review is confused with an operating review or that the minor changes in key indicators are incorrectly interpreted as significant trends. Moreover, the board's normal oversight process must not imply that the CEO is on a short leash or that the leadership is constantly up for grabs.

Relationships with the CEO.

A central objective of a well-designed and -implemented strategic-oversight process is to reduce both the appearance and the reality of confrontation over disputed turf. The robust egos that normally inhabit the boardroom are highly sensitive to actions that appear to challenge their authority. Even though potential overlap between responsibility and oversight occurs throughout the entire management structure, it is a particularly delicate issue at this level. Every time the question of "the right strategic direction" comes up spontaneously and unexpectedly, there is a risk that it will be perceived as implicit criticism of the strategy in place and of the leadership. It takes sensitivity and diplomacy to raise such issues constructively, but sensitivity and diplomacy are attributes not all board members possess.

Normally, the committee would be a low-key operation that would add to management's credibility.

On the other hand, a regular, formal review process dedicated to the discussion of strategic performance with the CEO reduces the likelihood of an adversarial atmosphere. Equally important to a calm and thoughtful exchange of views are meetings in which the only people present are the outside board members and the chief executive. Differences of opinion can be kept private until they are amicably resolved or, if they can't be kept private, their public consequences can be thoroughly considered. The strategic audit committee is not meant to share in the leadership of the ongoing business strategy or be a backseat driver. Under normal circumstances, it should be a low-key, behind-the-scenes operation designed to lend additional credibility to management's leadership and authority.

Alertness to Duty.

Even with the imposed discipline of a well-designed, formal oversight process, a board can fall asleep at the controls. A period of sustained success can lull the board into the belief that success is forever and that the company can do very nicely on automatic pilot. It is essential that the board be alert both to signs of weakness in the established strategic mission and to events or initiatives that present a natural opportunity to confirm or modify the existing strategic direction.

The board must not only choose the measures and control the database

but also remain alert to varied signs of weakness.

The board must understand that every time it gives its approval to an investment proposal that enlarges the scope or extends the term of an existing business strategy, it is openly signaling to the entire management team that it supports that strategy. Because investment or funding proposals, large and small, come in a steady stream, the board cannot be constantly attaching reservations or qualifications to its approval. Such concerns should be reserved for the periodic review meetings between the outside board members and the CEO—meetings triggered by the strategic audit committee.

Nevertheless, some events may justify a special meeting of the strategic audit committee. In 1983, the board of CPC was no doubt well aware of the persistently poor performance of corn wet-milling and of its drag on equity values and corporate return on equity. But despite the facts of past performance, management was persistently optimistic about long-term improvement. For those board members who were disposed to cut back or terminate corn wet-milling, the downturn in the consumer foods business and the highly visible decline in corporate return on equity would have been a golden opportunity to bring the issue to a head. Another opportunity for strategic review came with the initiation in 1984 of a new $1.5 billion “Investment for Growth” program, which was primarily for corn wet-milling facilities. Unfortunately, these openings for board intervention were preempted by Ronald Perelman’s takeover attempt.

Alertness to duty and to opportunity is the capstone of a serious strategic-review process. CPC’s board passed up good opportunities. Such natural turning points are often occasions when management and the organization are best prepared—and even eager—to consider strategic redirection.

By focusing as heavily as I do on measurements and data relating to the creation of corporate and shareholder wealth, I appear to neglect the governance obligation to gather data on other organizational and social consequences of strategic choice. For example, although both growth and diversification may at times erode equity value, these objectives have traditionally been the means of attracting and retaining the best professional and management talent. Both were common corporate priorities in the 1970s but came under increasing criticism from the investment community in the 1980s. The significant restructuring that followed was directed at downsizing the corporate overhead acquired in years of high profit and accelerated growth, shedding peripheral activities with low profitability and marginal corporate synergy, and refocusing on core competence and long-term competitive advantage.

Every successful business activity involves the effective cooperation of several distinct constituencies—employees, unions, suppliers, customers, host communities, and shareholders—and they all have legitimate needs. Board oversight requires a broad perspective, and any strategic consequence that affects the ability of the organization to reach and sustain its full, long-term competitive potential will demand board attention. However, in the end, a given strategy must deliver a competitive return on shareholder investment.

Of course, no organizational process can guarantee that the people involved will do everything that with 20–20 hindsight seems obvious. On the other hand, a process ensuring that independent board members and the chief executive meet in private and focus on objective evidence about the strategy in place is the best guarantee that well-informed, orderly, and timely strategic change will spring from the established governance process.

Some chief executives will see a potential for mischief in the formation of a formal strategic-audit process plus a further burden on their already overburdened schedule. However, the pressures for more vigorous oversight by corporate boards are now well established, and the likely alternative responses—new legal or regulatory intervention or more frequent random outbursts of boardroom vigilance—cannot be preferable.

Pursued in a spirit of mutual respect, the process facilitates ongoing, constructive dialogue.

The process I suggest, if implemented in a spirit of mutual respect, opens opportunities for a sincere, ongoing, private dialogue about the strategic mission—a dialogue based on objective evidence, free of the imposed deadlines and undesirable distractions of sudden events and external intervention. It increases the possibility that a shared understanding will lead to evolutionary change in strategic direction, serving the best interests of all concerned. Chief executives and boards of directors need a formal and visible review process to demonstrate to shareholders their shared commitment to orderly and effective governance.

A version of this article appeared in the July–August 1995 issue of *Harvard Business Review.*

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