VALUEISM

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Where boards fall short

Few people would disagree that the first duty of a company director is to ensure the organisation's long-term success. The law¹ states, a director must act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to the likely consequences of any decision in the long term.

In this most basic duty directors are often failing. That was the view of Dominic Barton, former global managing director of McKinsey & Company, and Mark Wiseman, president and CEO of the Canada Pension Plan Investment Board. In their article² "Where Boards Fall Short," it was stated, "most boards aren't delivering on their core mission: providing strong oversight and strategic support for management's efforts to create long-term value," adding "this isn't just our opinion. Directors also believe boards are

1 UK Companies Act 2006 Section 172

2 <https://hbr.org/2015/01/where-boards-fall-short>

falling short.” Based on their survey of 772 directors in 2015, they found only 34% agreed that boards on which they served fully comprehended their companies’ strategies. Only 22% said their boards were completely aware of how their firms created value, and just 16% claimed that their boards had a strong understanding of the dynamics of their firms’ industries. Has anything much changed since then?

The link with strategy

Over the last few years, I have spoken with senior executives, institutional investors, policymakers, analysts, business journalists, and directors about this, and the consensus view is that nothing has changed. In fact, the real situation is much worse than the McKinsey findings suggest.

When I have presented this research to senior executives, they always confirm they do not believe the board knows how the organisation creates value. In the vast majority of cases they struggle to answer the question themselves.

In my view three fundamental questions that any strategy should be able to answer are: What value are we creating? Who are we creating value for? And how do we create that value?

It is only through the creation of value that the long-term success of the business can be assured. So, the strategy also needs to answer the related future-focused questions: What value will we create in the future? Who will we create it for? And how will we create it? This will drive the change and innovation decisions in a process that needs to be continuous and iterative. But the future-focused question and plans cannot be addressed if there is no understanding of how the status quo is being achieved.

Directors need to be able to monitor performance in relation to the execution of the strategy and hold the executive to account. The board must ensure the firm is accountable to investors and other stakeholders through its reporting. That also requires measuring and reporting based on the factors considered material to the future value-creation potential of the organisation.

In whose interests?

The situation is made more complicated by the debate over whose interests the business needs to focus on. One school of thought, based on the Milton

Friedman logic, is that shareholder value should be the primary focus. It has been a long-held dominant view, until the announcements by the Business Roundtable and the World Economic Forum two years ago, that business must primarily concern itself with the interests of all stakeholders.

In his book,³ Arie de Geus, a former senior executive at Royal Dutch/Shell for 38 years, notes that if the purpose of business is

†to survive and thrive in the long run, then the priorities in managing such a company are very different than the values set forth in most of the modern academic business literature. Such a purpose also contradicts the views held by many managers and shareholders.

He makes clear that “It does not exist solely to provide customers with goods, or to return investment to shareholders.” Instead, it “exists primarily for its own survival and improvement: to fulfil its potential and to become as great as it can be.”

De Geus’s thinking stemmed from research on the lifespan of businesses that were at least as old and as successful as Shell. They learned what strategies would assist directors in fulfilling their duty, to act in the ways most likely to promote the success of the organisation for the benefit of its members as a whole, decisions being made with due regard for the likely consequences of any decision in the long term.

Making such decisions in a way that ensures sustainable value creation and the protection of it over the long term, is impossible if directors and executives lack a shared understanding of what value they are trying to create, who they are creating it for, and how they will create it.

On this point De Geus says,

Financial analysts, shareholders and many executives tell us that corporations exist primarily to provide financial returns. Some economists offer a rather broader sense of purpose. Companies, they say, exist to provide products and services, and therefore to make human life more comfortable and desirable. “Customer orientation” and other management fashions have translated this imperative into the idea that corporations exist to serve customers. Politicians, meanwhile, seem to believe that corporations exist to provide for the public good: to create jobs and to ensure a stable economic platform

3 *The Living Company: Growth, Learning and Longevity in Business* (Nicholas Brealey Publishing, 1997).

for all the “stakeholders” of society. But from the point of view of the organisation itself – the point of view which allows organisations to survive and thrive – all these purposes are secondary.

To what ends?

In the last sentence of the passage quoted above, I think he should have said, “all these purposes *should* be secondary.” But that does not mean they are unimportant. Creating value for all these groups is the means to the end, which is the long-term success of the organisation. Today we have a situation in which the means are seen as the ends, and maximising shareholder returns became the most important of these. This situation is made even worse in the case of publicly listed companies where share price is used as a proxy for shareholder value and has become the value that firms focus on creating, managing, and manipulating.

It is this focus on market value that makes the conversation about “what value do we create” so important. The right focus is not market value, but value for customers and all the stakeholders upon whom the business depends to achieve long-term success. Those stakeholders will include, but not be limited to, shareholders. They include employees and suppliers. They also include the society that grants the firm a licence to operate and create a profit under the terms of its social contract.

Introducing valueism and the value scheme

The focus on shareholder value maximisation, and market value as a proxy for that, has led to a system geared to value extraction by rent seekers, not value creation. The balance needs to be shifted back to a focus on value creation that will sustain the long-term success of a business. To distinguish this approach from the dominant logic, I call the value creation focused approach valueism.

Valueism includes the concept of the value scheme, a business’s unique scheme, or model, for creating value for all stakeholders in a way that is designed to ensure the long-term success of the organisation. Importantly, it is not limited to financial value.

A scheme is “a plan, design, or program of action to be followed; a project.” A value scheme is based on a design process that understands what

value means from the perspective of each stakeholder group, in both financial and non-financial terms. Once mapped, the aim is to ensure all stakeholders' interests are met in a fairly and balanced way over time. This is in the belief such an approach is the best way to achieve and sustain long-term success. By taking account of more than just financial value, it is possible to avoid the trade-offs that are wrongly assumed to be unavoidable by many.

The risks become clear

By thinking of value in these terms, and by creating a value scheme to deliver sustainable long-term value creation, the strategic risks also become clear. The importance of this should not be underestimated. Today, given that directors and executives have such a poor understanding of what value the firm creates, for whom and by what means, it hardly needs to be stated that their ability to understand and manage risks well must be close to zero. This almost certainly explains why they expect to have to deal with a major crisis every two years on average, or annually in the case of larger businesses. The evidence of this can be found in the PwC Global Crisis Survey 2019⁴.

Questions to ask

On the topic of value creation and preservation, the questions that should be being asked in the boardroom can be structured in the way they might be asked in the process of starting to map the firm's existing value scheme:

- Who are our customers (by segment)?
- Do we know what value we create for them, as seen from their perspective?
- Who do we depend on to create that value?
- What value do those we depend on expect in return, as seen from their perspective?
- Do we know what the appropriate key performance indicators (KPIs) are for all of the above?

4 [hwww.pwc.com/gx/en/forensics/global-crisis-survey/pdf/pwc-global-crisis-survey-2019.pdf](https://www.pwc.com/gx/en/forensics/global-crisis-survey/pdf/pwc-global-crisis-survey-2019.pdf).

- How do they compare to the KPIs we use today?
- Do we have the ability to ensure we understand how we perform in relation to the above?
- Can we be more transparent about our performance?
- Do we need to rethink our reporting approach in relation to the above?
- Can we map our value creation scheme to see how it operates as a system?
- Are there ways to improve this existing system?
- How long do we expect our current value scheme to remain relevant?
- Do we know what risks we are exposed to?

The board and executive might then collaborate to develop designs for a future value creation scheme, to ensure it drives strategic thinking, innovation, and any change/transformation plans, resource allocation decisions, and the development of new competencies and capabilities. Related questions might include:

- How long can we expect our current value scheme to achieve our goals?
- What might our performance look like in the short, medium, and long term without changes?
- What needs to change and when?
- Should we be making strategic choices now?
- Are incremental improvements going to sustain us, or is transformational change needed?
- Can we create a permanent value creation-focused innovation system?
- Does the firm have the capabilities and capacities it needs now, and will need, to execute future plans?
- How well are we communicating our future value-creation potential and plans internally and externally?

All the questions should consider financial and non-financial value. At regular intervals it makes sense to ask the “what if?” and “what needs to be true?” questions that expose related risks, and to design risk mitigation approaches.