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How CFOs can better support board directors—and vice versa

Governing boards face increasing pressure and greater scrutiny from investors. Here is how CFOs can reinforce their stewardship.

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Has there ever been a time when boards of directors were more in need of the sharp, fact-based counsel of a value-savvy CFO? With market forces intensifying, technology creating broad-scale digital disruption, and systemic threats looming in the form of cyber and geopolitical shifts, even the best-positioned board directors can benefit from a strong relationship with the head of finance. That is even truer for directors selected more for their industry, product, or technical expertise, for example, than their financial acumen.

Fortunately, CFOs at most large companies are more than up to the task and go well beyond the traditional role of helping boards ensure regulatory compliance. Yet we still see CFOs—typically those who are new to the role—who are unpracticed at engaging their board directors effectively. While our experience in the United States is the primary basis for this finding, the differences between companies in any given country can be just as substantial as the differences between countries. It all comes down to the individual CFO, CEO, and board.

Regardless of where they sit, many CFOs should spend more time helping board directors understand a company's strategy and defining value creation in the context of both the financial outcomes of the past and forecasts of future performance. The lessons go both ways: CFOs can benefit from effective relationships with board directors—particularly with the chair of the audit committee, who can share external perspectives and act as a thought leader and sparring partner. CFOs should be more assertive in anticipating questions from the board and providing the needed information to connect data to strategic and operating decisions. And CFOs should more actively collaborate with the CEO and other executives to present a unified perspective to the board. As our research suggests, improved board effectiveness can also result in better financial performance (see sidebar, "Understanding the link between board effectiveness and financial performance").

Define value creation in context

The traditional role of the CFO is to go through the results with the board, explain what happened, and look at the variances versus the prior period. It takes a very historical view on what the company just did, which in and of itself does not add a lot of insight with respect to potential future value creation. This inward-looking view focuses on the company and its results without comparisons to the market and how peers and competitors are performing, and it does not help the board understand what is good or bad. A board might celebrate organically growing 8 percent in a given year, for example, and then watch in dismay as the share price drops because the company's peers all grew at 20 percent.

The biggest opportunity for a CFO's relationship with the board often hinges on being able to put together an objective view on what a business's performance has been, how it compares with the market and other businesses in a company's portfolio, and what the board should expect of future performance. The CFO's input is especially important for creating clarity on resource allocation to higher-growth businesses within the portfolio, the value potential of increasing the drive toward digital transformation, the value from M&A (and other big-ticket investments), and the impact of broad-based performance transformations.

That input need not reflect the most-sophisticated analyses. In some cases, qualitative observations can suffice. Often, CFOs have the best read on what investors care about and should therefore influence how companies frame, measure, and communicate their value-creation plans. CFOs spend more time than most other executives on investor road shows and facing questions from analysts, and they know which issues can complicate or derail an investor story. They have also seen firsthand which metrics resonate best with investors and how investors will react. For example, after meeting with multiple investors, the CFO at one financial-

Understanding the link between board effectiveness and financial performance

Findings from McKinsey's global board survey point to benefits from good dynamics between directors and C-suite executives.

It has always been one of the more tantalizing questions in corporate governance: What effect does the board of directors have on financial performance? In a survey of more than 1,100 directors,[1] we attempted to test the link between the quality of board operations and boards' effectiveness at core activities with self-reported financial performance relative to peers.[2]

We considered three core variables of board operations: dynamics within the board, dynamics between directors and C-suite executives, and board processes. The results suggest that boards with better overall operations, as well as those that execute core activities more effectively, report stronger financial performance at the companies they serve.

For instance, at boards with top-quartile operations, 59 percent of directors report financial outperformance relative to their industry peers—compared with 43 percent who say the same at bottom-quartile boards.[3] Further, the bottom-quartile directors are nearly twice as likely to report weaker relative financial performance. According to the results, the operational practices that contribute most to outperformance are when the board has a long-term succession plan for itself, sufficient induction training for new directors, and an appropriate mix of skills and backgrounds.

The results suggest an equally strong connection between directors' effectiveness at core board activities and financial performance relative to peers: nearly 60 percent of directors at boards in the top-quartile for effectiveness say their respective organizations have significantly outperformed peers. In contrast, just 32 percent of those at the bottom-quartile boards say the same. Among the activities linked most closely with outperformance are setting a comprehensive strategy framework for the organization, assessing management's understanding of value creation in the organization and the industry, and debating strategic alternatives within the board and with the CEO.[4]

These findings emerge at a time when, across the corporate landscape, board responsibilities are growing. Directors are expected to go beyond traditional oversight and get involved with critical issues such as strategy, digitization, talent and succession planning, and risk.[5] CFOs, CEOs, and other C-suite leaders have a big role to play in ensuring that directors can manage these growing expectations. They could, for instance, support induction training programs by supplying relevant insights and materials that new directors can use to acquire a foundational understanding of the organization and the industry. Additionally, they could engage in regular, formal dialogues with board directors. By preparing concise reports on key issues and establishing clear operational processes with the board, CFOs and other executives in the C-suite can help directors meet their oversight responsibilities and create greater value for their organizations.

The contributors to the development and analysis of the survey include **Martin Hirt**, a senior partner in McKinsey's Taipei office; **Frithjof Lund**, a partner in the Oslo office; and **Nina Spielmann**, a specialist in the Zurich office.

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[1] The online survey was in the field from April 18 to April 28, 2017, and garnered responses from 1,126 board directors representing the full range of regions, industries, company sizes, and board roles; 31 percent of respondents are either board chairs or lead independent directors, and we asked respondents to answer all questions with respect to the single board with which they are most familiar. We excluded responses from directors on not-for-profit boards, since the financial-performance results are more relevant to private-sector boards. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

[2] Financial performance is measured as self-reported organic revenue growth, profitability, and change in market share relative to industry peers in the past three years. To control for potential biases (for example, board chairs tending to report better financial performance than other respondents do), we defined two control variables: the respondent's job title and his or her role on the board—for example chair, vice chair, or lead independent director. Before running the financial-performance analysis, we confirmed that the best- and worst-performing companies have an equal distribution of job titles and board roles across all quartiles. The outperformers are those companies that, according to respondents, reported to perform on average across all three reported performance measures—profitability, organic revenue growth, and growth in market share—higher or much higher than their industry peers in the past three years.

[3] With respect to dynamics and processes, the "top-quartile boards" are those where respondents agree with eight or more of the 14 statements we asked about, and respondents at the "bottom-quartile boards" agree with only three or fewer.

[4] The survey asked about 42 different board activities related to strategy, performance management, investments and M&A, risk management, shareholder and stakeholder management, and organizational structure, culture, and talent management. With respect to board activities, the "top-quartile boards" are those where respondents are effective or very effective at 26 or more of the 42 activities we asked about, and respondents at the "bottom-quartile boards" are effective or very effective at 13 or fewer activities.

[5] "The CEO guide to boards," *McKinsey Quarterly*, September 2016, McKinsey.com.

services company realized that the market was demanding a different way of dealing with and reporting on the company's major investments in growth. As the CFO discussed this dynamic with the board, they all recognized they had communicated up-front investments in growth in a manner that appeared more like separate, one-off restructuring charges. This board-level engagement by the CFO helped push the company to separate its communication of growth investments from cost-focused restructuring charges. More important, the dialogue helped the board better appreciate that the nature of the company's growth objectives would require material investment in data architecture, analytics, and automation.

In other cases, strategic assessment of a company's performance relative to peers can be helpful, whether it involves simple metrics such as share-price performance or more-nuanced metrics such as organic growth or margin expansion. Those types of contextual insights—the result of close collaboration with the rest of the executive team—can tee up the questions that the board needs to ask regarding value creation and strategy. They can help board directors understand the areas they should watch to reveal the company's potential advantages or weak spots. The impact can be striking.

Consider, for example, how the CFO of a natural-resources company helped the board understand its returns relative to peers. The overall benchmarks were all similar-size companies but lacked specifics on the individual businesses with different exposures to energy and commodity cycles. Without that detail, board directors were concerned that the company's performance had been relatively poor. Coordinating with the CEO, the CFO reminded the board that an underperforming business in the down side of a cycle will also benefit when the market recovers. Instead of presenting a current snapshot of performance, he led board directors in a discussion about what performance in two years might look like—and provided a set of historical financial analyses to gauge how much of the company's future returns would likely come from a recovery. The dialogue changed the board's focus from a question of whether the company should restructure or shut down to one defined by performance: given a certain measure of performance, when should they start investing again to make the most of the market's recovery?

That example is not the CFO presenting a business case for operational restructuring or recommending specific strategic actions. It is a case of the CFO going beyond pure financial reporting to put the company's performance in the context of its strategic direction and peers with the right level of detail so that board directors could see for themselves what they needed to do.

Proactively engage with the board

The more CFOs engage with boards, the better they can anticipate boards' questions—and the better they can keep boards informed ahead of potential surprises. CFOs can also expect to receive valuable support and advice in return. These relationships are most effective when CFOs have active roles in making presentations in every board meeting and are present for most of the discussion. Such involvement allows a CFO to understand board dynamics (and therefore engage more productively with board directors), answer follow-up questions, and track the context from prior meetings. This practice, of course, also requires the CEO to be open to the CFO's more inclusive participation.

When the board of a multi-industrial business was weighing its acquisition priorities, for example, the discussion eventually came back to a question of how the company created the most value. Would the company do better to trade off assets through M&A deals or grow its business organically? Having joined that board meeting, the CFO was better able to follow up in subsequent board meetings by adding several analyses to his reports to the board. Those included an overview of the company's organic growth relevant to its markets, some pre- and post-acquisition data on some of its businesses, and highlights of the company's strengths and weaknesses with respect to organic growth.

That input led the board into a more nuanced discussion. Instead of an "either/or" focus on dealmaking or organic growth, it considered the businesses in which it would or would not want to pursue acquisitions, whether the company had established the right assets and capabilities to execute those acquisitions, and whether it should pursue certain operational priorities before jumping into an active set of acquisition choices.

The importance of proactive behavior in a CFO's board interactions spans industries. The mechanisms for capital reallocation at banks or other financial institutions do look different from those at an industrial company. But a CFO's role looks nearly identical when it comes to identifying where to shift resources to create more value. In one instance, the CFO of a financial-services company observed that the company had allocated so much capital to high-priority growth areas that it had underinvested in lower-growth businesses with higher, faster returns. That is the same growth-versus-returns dilemma that industrial companies face and leads to the same predictably lower returns. Proactively raising the issue with the board enabled the company to adjust its capital-allocation rules and make relatively small adjustments that would improve returns without sacrificing new growth opportunities.

Manage board interactions as a team

Taking a more proactive role is not something a CFO can do alone; the CEO formally governs the CFO's relationship with the board. As head of the management team, CEOs are in the best position to judge how—and how often—their senior managers interact with boards. In our experience, reshaping the interaction typically happens only when a new CEO either redefines the current CFO's role or brings on a new CFO explicitly tasked with developing a refreshed level of engagement with the board.

From there, managing interactions between the senior management team and the board generally is most effective when it is some form of a team effort. The CEO, often in consultation with the board chair, leads the effort. But the CEO's success comes not just from knowing the facts and sharing perspectives but also from understanding the questions on board directors' minds, the context in which they are asking those questions, their own personal histories as board directors and executives, and the interactions between board directors. Who among the directors in the room will ask questions? Who will hold back? Who will be the doubters? And who will be open to providing support and advice to the CFO?

As a trusted source of facts and data as well as a strategic advisor, often alongside a chief of strategy or operations, the CFO is usually a lieutenant to the CEO in making successful board interactions happen. The team's efforts can allow the CEO to focus more mental energy on managing the discussion, understanding the way the board engages, and ensuring that the board is heading to the right outcome.

At a very minimum, CFOs should think of their role as improving the way boards and senior management teams work together by identifying, surfacing, and answering questions about different decisions well in advance of the formal meetings during which votes will occur. That effort helps avoid putting board directors on the spot and asking them to vote with limited information. It also helps ensure that if there are points of contention, there are facts on the table when boards engage in a formal setting.

A CFO should be especially mindful of his or her relationship with the audit committee chair. Audit committee chairs are often the board's biggest advocates for value creation, cash protection, and the board's fiduciary responsibility. Here, too, the relationship varies from company to company. But the one constant is that the audit committee chair is typically very engaged and often asks questions regarding value creation, the company's use of cash, payments back to shareholders, and the investors' perspectives.

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The CFO's relationship with the audit committee chair can also be an important driver of talent development and succession planning. For instance, the CFO and audit committee chair may schedule private sessions to identify strong candidates for senior finance positions. We have seen several instances in which the audit committee chair has offered coaching and mentoring to members of the finance team—particularly those in line for the CFO role. These high-potentials may be invited to audit committee meetings to make presentations on special projects and initiatives, giving them some exposure to board directors. We have also seen CFOs invite audit committee chairs to meetings of the finance function to help inform important discussions—for instance, changes required as a result of new accounting standards.

The way that CFOs should communicate with audit committee chairs will depend on the governance within a given board. In some situations, it might be most effective to establish a continuous dialogue between the CFO and the audit committee chair so they can jointly prepare for board meetings: the audit committee chair would have ample opportunity to review the issues at hand and provide relevant information ahead of full board discussions. Indeed, the audit committee chair can serve as a powerful ally for the CFO—holding board directors to task on financial discussions, translating complex concepts for the group, and reinforcing points that the CFO had previously been unable to make on his own.

As demands on board directors grow, CFOs will be increasingly important as resources to support them. Our experience suggests that the CFOs who can define value creation in context and proactively anticipate boards' needs will excel. Those CFOs can also accelerate their own development by working more closely with board directors and taking in their insights and experiences. Defining their relationships with the board in the context of the rest of senior management is critical.

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