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CEO Evaluation

Navigating a New Relationship With the Board

Never in recent memory has CEO performance been the subject of such intense scrutiny or broad concern. In the wake of some appalling corporate scandals and a general decline in company performance, shareholders, employees, analysts, journalists, and politicians are all looking for someone to blame—and the CEO is the easiest and most obvious target. In addition, increasingly independent and empowered Boards are moving faster than ever to remove CEOs who don't seem to be getting the job done. In this harsh and often unforgiving environment, a serious process for assessing CEO performance is no longer a "nice to do"—it has clearly become a "must have."

Regulations that require Boards to create a regular and systematic CEO performance appraisal process add one more element to a climate that's already tricky to navigate. These mandates leave CEOs with three choices. They can sit back and watch as the Board develops a process on its own. Alternatively, CEOs can get involved with the Board and come up with a superficial appraisal process that satisfies the legal requirements but little else. We strongly recommend the third option: having the CEO and the Board work together to design an appraisal process that is serious, deliberate, helpful to the CEO, and beneficial to the company.

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Indeed, CEOs can turn the heightened scrutiny of their performance into an opportunity to strengthen their own leadership. Most CEOs already participate in some form of formal Board review because they recognize the utility of evaluations in ensuring that their actions and decisions drive company performance and increase shareholder value.

Though the rewards of an effective CEO evaluation process are great, developing one with the Board that addresses both the CEO's needs and the needs of the business can be bewilderingly complex. Each company has its own unique blend of personalities, strategy, history, resources, and competitors, which rules out any standardized solution. The short answer is, as the saying goes, "the devil is in the details." The best place to start is with an examination of the principles that will enable a CEO to develop the best process for his or her company, given its particular strengths and needs. To help in this effort, this paper looks at the following:

- Clarifying the purpose of the CEO evaluation process through a close examination of its objectives
- Defining the key dimensions and measures of CEO performance
- Examining various feedback sources and methods
- Discussing the steps in implementing a process and the barriers to effective implementation

Along with examining the various stages of defining and implementing an evaluation process, the paper will also provide examples of what some CEOs and Boards have done to address their particular needs.

Before beginning, it's important to bear one particular thought in mind. In order for a CEO and Board to collaborate on developing an optimal evaluation process, a high level of communication and cooperation is required. Participants should recognize how fragile the process can be: without ongoing cooperation between the CEO and the Board, supportive decisions, and openness to feedback on the CEO's part, the best designed evaluation process will be undermined.

Clarifying the Purpose of the Process

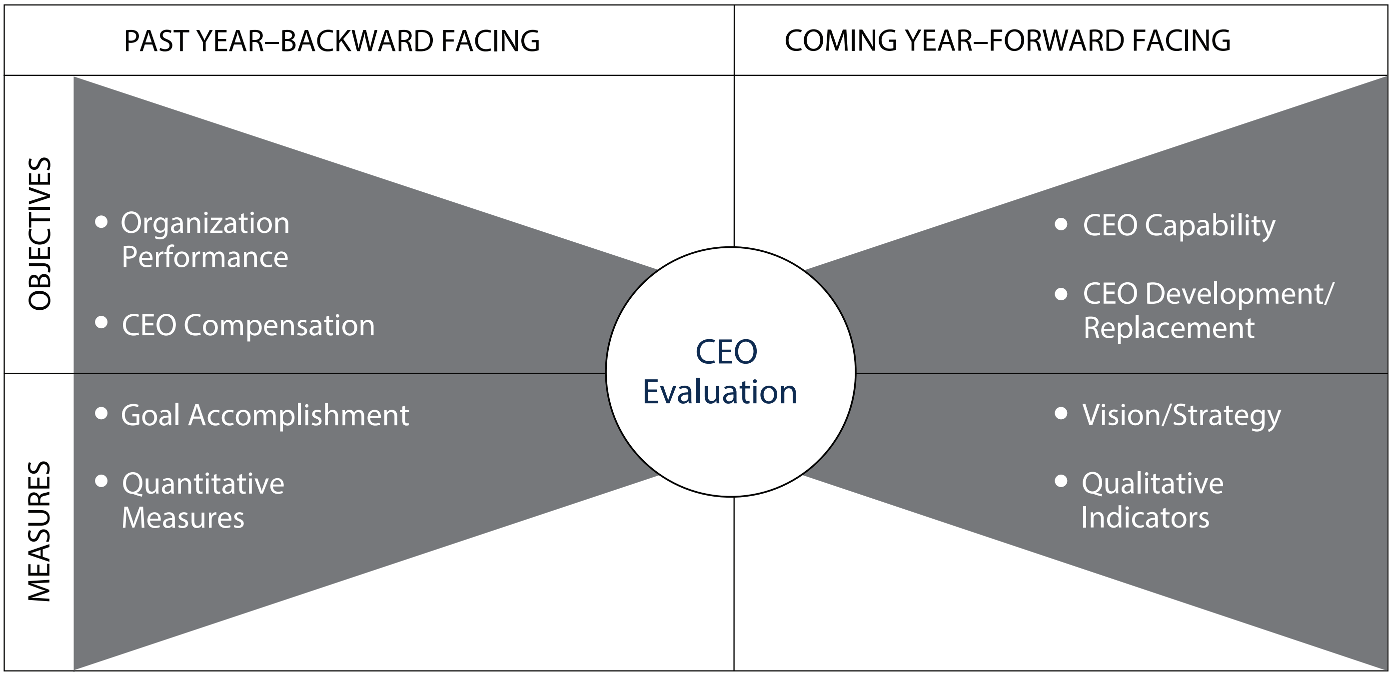
The first step in designing an effective CEO evaluation process is to establish a set of clear objectives. Just like performance appraisal processes at other levels of the organization, a CEO evaluation process can serve two related but distinct objectives: to collect information about past performance and to set goals for the future. More specifically, it can:

- Help the compensation committee of the Board collect and interpret the data required to judge the CEO's past performance. This is the basis for the decisions the Board is required to make regarding the CEO's compensation and continued employment.
- Help the CEO and the Board establish a clearer focus on the company's future direction by specifying a set of strategic objectives at the start of the evaluation process. This goal-setting aspect of the evaluation can also serve as part of the CEO's ongoing leadership development— with the Board providing feedback on the areas where the CEO needs to do a better job, learn new skills, or focus additional attention.

Thus, CEO evaluations can be "backward facing," focusing on accountability and rewards for past performance and/or "forward facing," focusing on future objectives and whether the CEO has the vision, strategy, and personal capabilities to achieve those objectives (see Figure 1). Though the Board's oversight role does not require the forward-facing component of evaluation, adding the future view turns the process into something much more robust than a mere accounting exercise. That perspective requires the Board to assess the degree of "fit" between the CEO's leadership qualities and the demands imposed by the organization's strategic objectives.

Although these evaluation objectives are clearly distinct, in practice they are frequently bundled

FIGURE 1: Objectives of the CEO Evaluation Process



into the same process. Time constraints may force the Board to evaluate the CEO's performance over the previous year while simultaneously making compensation decisions, setting next year's targets, and discussing specific areas for improvement—often in a single meeting. In addition, some Boards and CEOs may recognize the conceptual distinction between these objectives, without seeing it as important in practical terms.

However, when the two objectives are not clearly separated, neither gets served very well. Without clearly delineated processes, one objective may receive a disproportionate amount of attention relative to the other. When this happens, it is usually the review of past performance for the purposes of compensation that dominates the conversation. Because it is far more tangible and is focused on objective (or at least pre-determined) metrics, the compensation review tends to be more straightforward and produces fewer emotional or defensive reactions than discussions of the CEO's behavior and developmental needs.

When time is short, some CEOs and Boards may dispense with developmental discussions altogether, using the compensation review to set the CEO's future objectives. This approach is likely to over-emphasize "what" the CEO is expected to achieve (such as increased revenue from cross-business collaboration) over "how" the CEO is expected to behave (giving more attention to developing future leaders, for example). Given the status and power of the CEO role, the chief executive may rarely be exposed to candid, detailed perspectives about his or her behavior and personal impact without a Board committed to providing formal developmental feedback.

At a major manufacturing company, for example, separate meetings focusing on past and future performance ensure adequate attention to each evaluation objective. In mid-January, the CEO sends the Board his assessment of his past performance as well as his plan for the coming year, including his personal leadership objectives. As follow-up, the January Board meeting is largely devoted to discussion of the coming year's objectives, while the February meeting focuses on the CEO's performance over the past year.

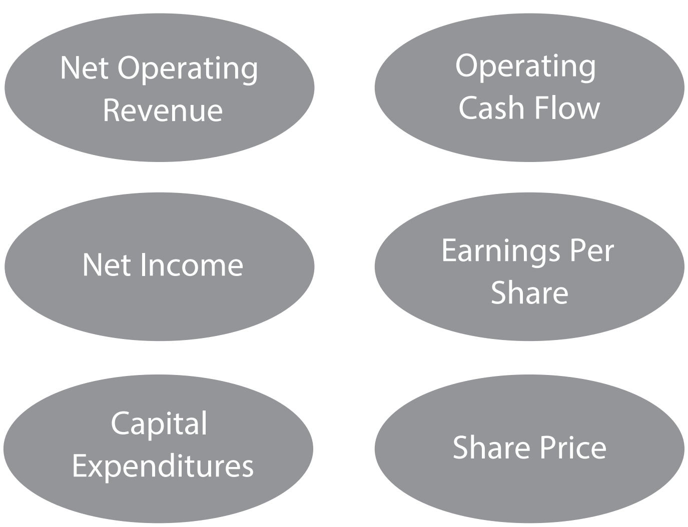
Whether or not these two objectives are served through separate meetings is less of an issue than the fact that both are ultimately served. For instance, at a leading consumer retailer with a reputation for solid governance practices, both evaluation objectives are well served in a single meeting because of the Board's and CEO's commitment to a detailed review of past performance as well as an open discussion of future performance expectations and developmental needs.

Defining Performance Dimensions and Measures

A defining element of any evaluation process – whether for compensation decisions, goal-setting, or developmental feedback – is the set of performance dimensions to be evaluated. These form the basis of the measures, objectives, and targets used in the process. Among all of the decisions that need to be made throughout the process, this is probably the most challenging, as it raises the complex issue of the relationship between the CEO's actions and effectiveness as a leader, and corporate performance.

A useful distinction is to consider how effectively the CEO behaves as a leader and the organizational impact of his or her actions. Further, the impact of the CEO's actions can be thought of in terms of the operational effectiveness of the organization as well as the organization's bottom-line performance. Thus, there are three generic classes of CEO performance: bottom-line impact, operational impact, and leadership effectiveness.

FIGURE 2: Bottom-Line Impact Dimensions Used in Evaluation of Telecommunications CEO



The compensation and personnel committee measures the company's actual performance against the CEO's projections in his/her actual plan.

BOTTOM-LINE IMPACT

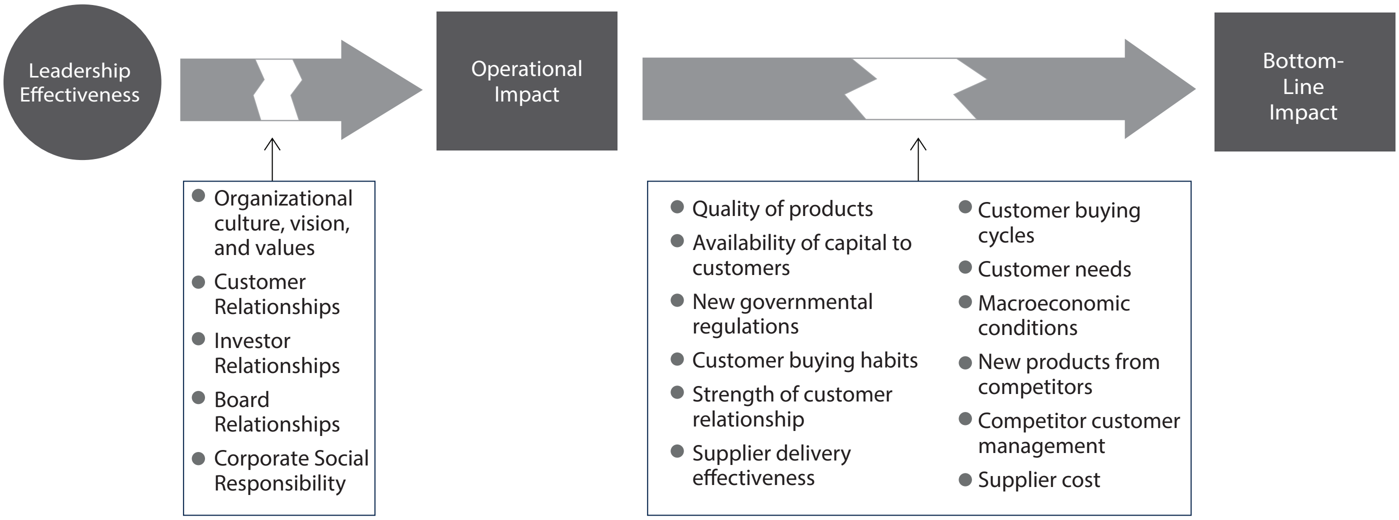
Although it is difficult to test in the short term except in extreme cases of brilliant decisions or egregious errors, an underlying assumption of almost all CEO evaluation and "pay for performance" plans is that the CEO has a direct and significant impact on corporate performance. Accordingly, the CEO is held accountable for the company's overall financial health relative to industry peers. Figure 2 shows the types of bottom-line metrics used to evaluate the effectiveness of one CEO. While CEOs know that it's critical to keep focused on corporate financial success, these bottom-line measures have severe deficiencies as sole indicators of CEO performance. As the person at the top supposedly "pulling all the levers," CEOs recognize that their ability to affect the organization's bottom line is not exactly direct and not always overwhelming.

Figure 3 provides an example of why this is the case in the area of customer relationship management (CRM). In this example, the CEO has engaged in direct actions to improve customer relations, directly intervening with key customers and sponsoring organizational programs to build CRM capabilities. The impact of these actions on the strength of the customer relationship (in this case measured by customer satisfaction) can be quite strong, diminished or enhanced by only a handful of extraneous factors. However, the impact of the CEO's actions on the bottom line (in this case defined as growth in earnings from existing customers) is moderated by a bewildering array of external factors. The further away the desired impact moves from the CEO's direct action, the more actual results are influenced by things outside his or her control.

OPERATIONAL IMPACT

Operational impact refers to the CEO's effect on the company's operational and organizational effectiveness. This addresses the question, "What

FIGURE 3: The CEO's Impact on Company Operations and the Bottom Line



changes or improvements has the CEO made in the organization's ability to function and perform?"

Operational impact measures include indicators of organizational functioning (e.g., retention rates, employee satisfaction scores), operational effectiveness (e.g., quality ratings of products, time to market), and strategic implementation (e.g., number of acquisitions, total headcount reduction).

LEADERSHIP EFFECTIVENESS

As a class of performance, leadership effectiveness refers to personal behaviors, which are completely within the CEO's control. Accordingly, this category is quite different than the previous two; the emphasis here is on the CEO's actions and personal impact, not on organizational outcomes.

Essentially, this speaks to the question of how well the CEO carries out his or her responsibilities, both in terms of whether he or she is executing on role responsibilities (identifying a successor, meeting with key customers, meeting with the investment community, developing a long-term strategy, etc.) as well as the quality of those actions (improving relationships with external stakeholders, energizing the organization, gaining the confidence of investors, developing innovative and compelling strategies, etc.).

SELECTING OBJECTIVES AND SPECIFYING MEASURES

The three categories just identified simply describe the waterfront of CEO performance in generic terms. The specific dimensions and objectives used in a particular evaluation process will vary for each company. Nonetheless, there are some general principles that leading companies follow in selecting CEO performance objectives:

- **Go beyond bottom-line performance.** As discussed, financial measures of corporate performance, while critical, capture only one aspect (and often a tenuous one, at that) of CEO performance. To perform a more holistic evaluation and to compensate for some of the limitations of bottom-line measures, it is important to include objectives that relate to leadership behavior as well as the CEO's impact on the organization's operational effectiveness.
- **Focus on a manageable number of objectives.** One risk in attempting to define a mix of objectives that captures multiple aspects of CEO performance is that the list of performance dimensions may grow so large as to be unworkable. It is important to get the number of dimensions right: too few and the process is likely to be dominated by short-term financial objectives; too many and the CEO and his or her management

team risk losing focus. Of course, there is no magic number; this has to be determined for each company individually. Best-practice companies typically have between five and ten.

- **Include separate objectives for Chairman and CEO performance (where appropriate).** In many American companies, the CEO also serves as Chairman of the Board. It is important to evaluate performance in both roles. The CEO's role as Chairman can be assessed as one component of a formal Board evaluation process. If a decision is made to incorporate in this process an evaluation of the CEO's performance as Chairman, the leader of the Board assessment (typically the chair of the nominating committee) will play a role in the design, collection of data, and the delivery of feedback on this aspect of the evaluation. Otherwise, the dimension of Chairman effectiveness can be added to the CEO's evaluation process led by the compensation committee.
- **Define measures for each objective.** It is critical that each objective has clearly stated measures that will be used to track performance against that objective. This is simple enough for all bottom-line and most operational impact objectives. These dimensions lend themselves to hard, quantitative measurement. There are robust methods for reliably and validly measuring the "soft stuff" as well. For instance, leadership behaviors can be measured through behavioral rating methods that ask Board members to indicate the frequency with which the CEO engages in desired behaviors and to what perceived effect.
- **Specify performance levels for each rating measure.** Clearly identified measures for each objective greatly facilitate the sharing of performance expectations with the CEO. For any given measure, multiple levels of performance can be "scaled." For example, 0–10 percent earnings growth is poor, 11–21 percent is acceptable, 22 percent and above is outstanding. Although this is rarely done, these levels can help the Board and CEO develop a shared under- standing of the performance standards.

Examining Feedback Sources and Methods

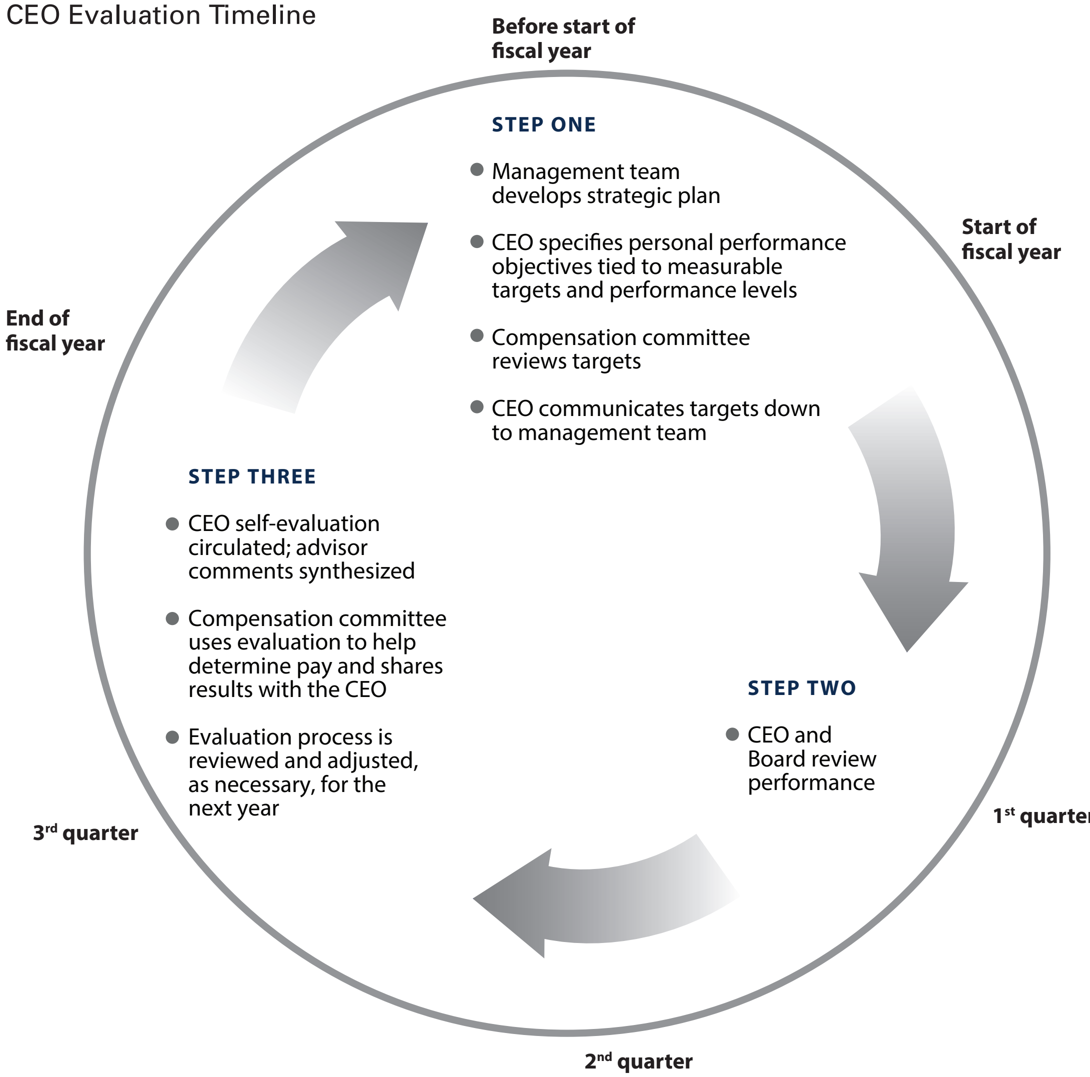
Though the independent directors who make up the Board compensation committee bear the principal responsibility for the CEO evaluation process, many others can participate constructively, greatly increasing the amount of information and quality of decision making. One increasingly popular practice in CEO evaluation is multisource feedback. In this process, the CEO is evaluated on a range of leadership effectiveness behaviors by multiple stakeholders—the Board, the executive team, customers, etc. If done well, a multisource assessment can provide the CEO with a clear picture of which actions and behaviors are facilitating and which are impeding his or her effectiveness.

There are two criteria to consider in inviting additional "voices" to provide feedback on the CEO's performance:

- Does the individual or group have a valuable point of view on the CEO's performance? For example, the CEO's management team is likely to have much more exposure to his or her leadership behavior than the outside members of the Board.
- Are there collateral benefits to involving the person or group in the CEO evaluation process? One potential upside of including customer input in the evaluation, for example, is a stronger relationship with the customer and the increased sense of ownership in the success of the company. Similarly, when the CEO's direct reports are involved, it can help to foster an environment of constructive feedback and diminish a "rubber stamp" mentality.

The decision to include additional people in the CEO evaluation should not be taken lightly. It increases the complexity of the process and introduces a set of political and interpersonal dynamics that have to be managed. In the end, for the feedback to have the appropriate impact, both the Board and the CEO have to be comfortable with the source.

FIGURE 4: CEO Evaluation Timeline



Implementing a CEO Evaluation Process

Effective CEO evaluation requires much more than clear expectations and clarity on performance dimensions and objectives. Successful implementation requires a detailed process map that identifies the various steps and ties the process to the company's existing calendar of business planning and compensation review. Broadly speaking, the process can be defined by three steps corresponding to the beginning, middle, and end of the fiscal year. These will be described in turn below.

STEPS IN THE PROCESS

Step One: Defining the CEO's Objectives. Before the start of the fiscal year, the CEO works with the compensation committee of the Board to establish key long- and short-term business objectives for the coming year that are consistent with the company's strategic plan. Using the strategy as a starting point, the CEO formulates an initial set of personal performance targets for the coming year specifying how progress against each target will be measured.

The CEO then shares the targets with the compensation committee. After reviewing the targets and amending them if needed, the final set is presented to the full Board for discussion and approval. Once finalized, the targets can be cascaded down through the organization in a goal-setting process that aligns the objectives of each leadership level.

Step Two: Mid-year Review. Six months into the year, the compensation committee of the Board and the CEO should take time to review the targets and progress against them. Although many Boards skip this mid-year review or do it informally, it can provide great value for two reasons. First, it helps Boards monitor progress against the objectives—to see how the CEO is meeting or exceeding targets and to identify areas that require closer attention. Second, it provides an opportunity to amend the targets in light of new circumstances, such as rapidly changing business conditions. This latter capability is crucial in industries with frequently fluctuating market dynamics.

Step Three: Year-end Assessment. The final step in the evaluation process occurs at the end of the fiscal year when the CEO's performance is measured against the previously established objectives. As with the creation of the targets, this process should begin with the CEO, who supplies a self-evaluation and has an opportunity to address areas where targets were not met. The self-assessment is shared with the compensation committee. Typically, the compensation committee then shares the assessment with the full Board and seeks other Board members' input on the CEO's performance. On these occasions, the compensation committee provides a guide for how other Board members should conduct their own assessment of the CEO's performance.

Evaluations by all Board members are collected and given to the compensation committee, which uses the results to determine the portion of the CEO's pay that is linked to performance. Before providing feedback to the CEO, the recommendations and the results of the evaluation process should first be discussed in the Board, without the CEO or other inside directors present. Once the results are discussed and fully understood, the final step is for the CEO to receive the feedback.

It is important to ensure candid and timely reporting of the feedback to the CEO. The ability to deliver impactful feedback is so critical that it demands careful selection of the feedback provider. This skill should be a selection criterion for any position that has CEO evaluation and feedback as a job requirement (e.g., chair of the compensation committee).

This entire process is repeated yearly. As part of its own annual performance evaluation, the compensation committee should include a review of the CEO evaluation process and seek ways to improve it. Figure 4 illustrates the steps identified above as a recurring cycle. This type of tool is useful for managing the pacing and timing of each step.

BARRIERS TO EFFECTIVE IMPLEMENTATION

Successfully carrying out an evaluation at this level of the organization is a difficult undertaking. To facilitate the development of an effective process, a worksheet is attached as an appendix to this paper. It will help stimulate thinking about the following: dimensions and objectives, linkages to the organization's vision and values, roles and responsibilities of the CEO, and content and measures.

Understanding and working to minimize potential hurdles at the outset increases the likelihood of a successful and sustainable process. As with all complex process, there are a number of common pitfalls to look out for. These include:

- **Uncertainty concerning roles and responsibilities.** As with any detailed, multistakeholder process, there is likely to be some initial confusion over roles and responsibilities. Much of this confusion can be alleviated through attention to the principles of effective process design—a clear charter, descriptions of roles and accountabilities, timelines and milestones, etc. The director leading the process (typically the chair of the compensation committee) should also contract with the various members of the Board to clarify his or her expectations for how they should participate in the different aspects of the process (e.g., as "judge" versus "coach," providing input to decisions versus making decisions).
- **Lack of time and energy.** One of the major constraints that all Boards face is how to find the time needed to monitor short-term financial performance, shape long-term strategy, and fulfill the many other duties of the Board—all within the

limited amount of time the Board spends together. Given this constraint, an elaborate CEO evaluation process requiring significant input from the Board is likely to meet with resistance. Yet, a well-designed CEO evaluation can bring structure and efficiency to many of the Board's oversight responsibilities, actually saving the Board time in the long run. A well-designed process, with clear roles and adequate administrative support to manage the "paper trail," can also reduce the amount of effort required of each individual Board member in the process.

- **Disagreement over criteria for assessment.** In the early stages of designing a CEO evaluation, a debate over the appropriate criteria for assessing performance is actually quite healthy, indicating that the relevant stakeholders are thinking carefully about the process. Before the process can be enacted, however, the CEO and the Board must agree that the dimensions of performance and the objectives used are the right ones. The ultimate standard for resolving disagreements is consideration of the strategy and business needs of the organization—ultimately, all criteria for CEO evaluation should have a direct line-of-sight back to the needs of the business.
- **Lack of direct information about non-quantitative performance.** Financial and key operational metrics are readily available in most organizations. However, measures of the "softer" aspects of performance, such as leadership effectiveness, often have to be designed specifically for the purpose of the evaluation. These measures can be quite useful and informative if based on a well-understood model of leadership effectiveness and developed with appropriate concern for psychometric validity by a professional trained in attitude and behavioral assessment.

Ultimately, the CEO's behavior and attitude towards the evaluation is the greatest single determinant of the effectiveness of the process. Performance reviews are most valuable when they are characterized by a complete and candid discussion of the CEO's strengths and areas for improvement. Of course, the CEO and Board share responsibility for setting the right tone. However, because the CEO is the focal point of the process as well as the "beneficiary" of the feedback, the bulk of the responsibility rests with him or her. Defensiveness, detachment, or antagonism can change an otherwise helpful evaluation into a yearly unpleasantry.

Board members often report that the difference between a good evaluation process in which everyone wants to participate and an evaluation process that becomes mere window dressing is the CEO's attitude towards the process and reactions to the feedback. At the same time, an ad hoc evaluation process sprung on the CEO can send the wrong signals about the nature of the Board/CEO relationship. The Board therefore needs to make a similar investment to ensure that the process is well thought out and part of the normal course of business.

Summary

Today's CEOs find themselves subjected to unprecedented levels of scrutiny and concern. Statistics on contracting CEO tenure indicate that this is not a passing phase. Regular evaluation, however, is a healthy part of corporate life. In fact, a forward-looking CEO evaluation process offers great promise—heightened performance accountability, stronger links between performance and rewards, support for CEO development, and better Board/CEO relations. Indeed, an effective CEO evaluation process is an important part of the top leader's success.

Appendix: CEO Evaluation Process Review

Purpose: This worksheet is designed to assess the quality and comprehensiveness of a CEO evaluation process. The questions are derived from best practices in three areas: the process of evaluation, relevant roles during the process, and the content of the evaluation itself.

Instructions: Enter Yes, No, or N/A (Not Applicable) in the rating column.

Procedural Elements

Criteria	Rating	Comments
1. Is there an explicit description of the CEO evaluation process with articulated goals, roles, and responsibilities?		
2. Is there an explicit process calendar with detailed deadlines and milestones?		
3. Is the process calendar aligned with the corporate calendar (i.e., do CEO evaluation events fit with pre-existing governance and management schedules)?		
4. Does the process include a mid-year check-in on CEO performance?		
5. Does the process include a focus on CEO development and opportunities for developmental feedback?		
6. Is the process consistent with the company's values and culture?		
7. Does the process include quality assurance mechanisms that allow it to be revised as needed?		

Roles and Responsibilities

Criteria	Rating	Comments
8. Does the process have a clearly identified leader?		
9. Is the process sufficiently controlled (led and managed) by outside directors to preserve the integrity of the evaluation?		

Criteria	Rating	Comments
10. Is there a clearly defined role (or external consultant) for the collecting and compiling of performance data, ratings, etc.?		
11. Is the CEO considered a partner at each stage of the process, with ample opportunity for input?		
12. Are the people with the most valid information about the CEO's actions and leadership impact given the opportunity to provide feedback?		
13. Has the feedback deliverer been identified? Does this person have the skills required to effectively deliver CEO performance feedback?		

Content and Measures

Criteria	Rating	Comments
14. Have performance standards and criteria for evaluating the CEO been identified and made explicit?		
15. Are all relevant aspects of CEO performance included in the performance criteria?		
16 Do the performance criteria encompass both the CEO and Chairman roles?		
17. Is there a clear link between the performance criteria that make up the evaluation and the company's strategic objectives and business requirements?		
18. Can a business rationale be articulated for each performance criterion?		
19. Is there a valid, feasible measure identified for each relevant performance criterion?		
20. Are statistically sound methods used to gather and interpret performance data?		

About Nadler Advisory Services

Nadler Advisory Services offers highly specialized consultation to CEOs, boards of directors, and senior teams to help enhance the quality of executive leadership, corporate governance, and organizational performance. Nadler Advisory Services is firmly focused on high-level, close-in advice and consultation to CEOs, boards and senior teams in the following areas:

- CEO Advisory Services
  - Personal leadership effectiveness
  - Building an effective leadership team
  - Organizing the leadership of the enterprise
  - Collaborative strategy development
  - Effective communications
- Board Advisory Services
  - Assessment of overall board performance
  - Analysis of board composition
  - Evaluation of individual director performance
- CEO Succession Planning Services
  - Navigating all phases of the succession process: initiating the conversation, identifying and developing candidates, selection, transition planning, and supporting the new CEO

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