BEHIND THE STORY: AN AGENDA QUARTERLY REPORT

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Assessing Appraisals: How Boards Evaluate Their CEOs

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CEO evaluations are becoming a more time-consuming — but also more valuable — part of a board's duties, according to the findings of a non-scientific survey conducted by *Agenda* and **Hay Group**. Throughout September and October, directors and executives were asked how their boards assess their CEOs. The results and analysis of the survey's findings can be found in the following pages.

The survey results suggest boards are divided over how frequently they carry out formal evaluations. Just over half of respondents stated that formal assessments occur once a year or less often at their companies, with the rest carrying out more frequent formal discussions with their CEOs. One in 10 respondents said they planned to increase the frequency of their CEO performance evaluations in the coming year. But anecdotal evidence suggests boards are increasing the use of informal discussions with their CEOs over performance.˜

As reporter **Lindsay Frost** writes in an article on page 8, a growing number of directors feel that it is important to have regular, informal check-ins with their CEOs throughout the year to make sure that the annual review does not come as a surprise.

In fact, some CEOs are receiving feedback almost continuously. In senior reporter **Amanda Gerut**'s article on page 4, she talks to **Dinesh Paliwal**, CEO of audio electronic company **Harman International** and a board member at **Bristol-Myers Squibb**. He reveals that he receives feedback from board members about 20 times a year. The feedback goes both ways, with Paliwal providing reviews to his board on its performance. The article also looks into how boards are seeking input on their CEOs' evaluations from an ever wider pool of stakeholders. While 94% of respondents said board members provided feedback as part of the process, 68% said CEOs' self-evaluations were also factored in. Nearly a third reported that executives just below the CEO were also asked for their views.

Elsewhere in this special report, senior reporter **Melissa Anderson** looks at the metrics that boards use when evaluating their CEOs. In her article on page 2, she finds that while easily quantifiable measures such as financial, strategic and operational metrics are used by most boards, more than three quarters of respondents also reported using the less tangible skill of leadership.

On page 6, associate editor **Lisa Botter** examines the use of CEO evaluations by compensation committees when they set pay. The survey found that 97% of respondents reported some link between their company's CEO evaluation and their pay package, with 58% saying they were formally tied. Meanwhile, on page 10, senior reporter **Tony Chapelle** looks at how boards tend to choose their chairs and heads of compensation committees to lead the evaluation process. ■

AGENDA

Q4 SPECIAL REPORT

Please visit AgendaWeek.com for additional analysis of the CEO evaluation survey, including exclusive video.

Boards Say Leadership Is a Key CEO Performance Metric

CEOs who are coachable and react well to feedback are most desired

by Melissa J. Anderson

More than three quarters of directors and executives surveyed by *Agenda* and **Hay Group** say leadership is a key category by which they evaluate their CEO.

At 77%, leadership was cited just behind metrics on financial (98%), strategic (92%) and operational (88%) performance as the most popular way to assess the chief executive.

Experts say there has been an increase in the past decade in the importance that boards place on the CEO's ability to lead their team and other soft skills, alongside the hard numbers.

"The capabilities of the team are what deliver the results," says **Jane Stevenson**, global leader for CEO succession and vice chairman of board and CEO services at **Korn Ferry**. "Boards today are more understanding of that interrelatedness; the stronger the team, the greater the odds of delivering the business results."

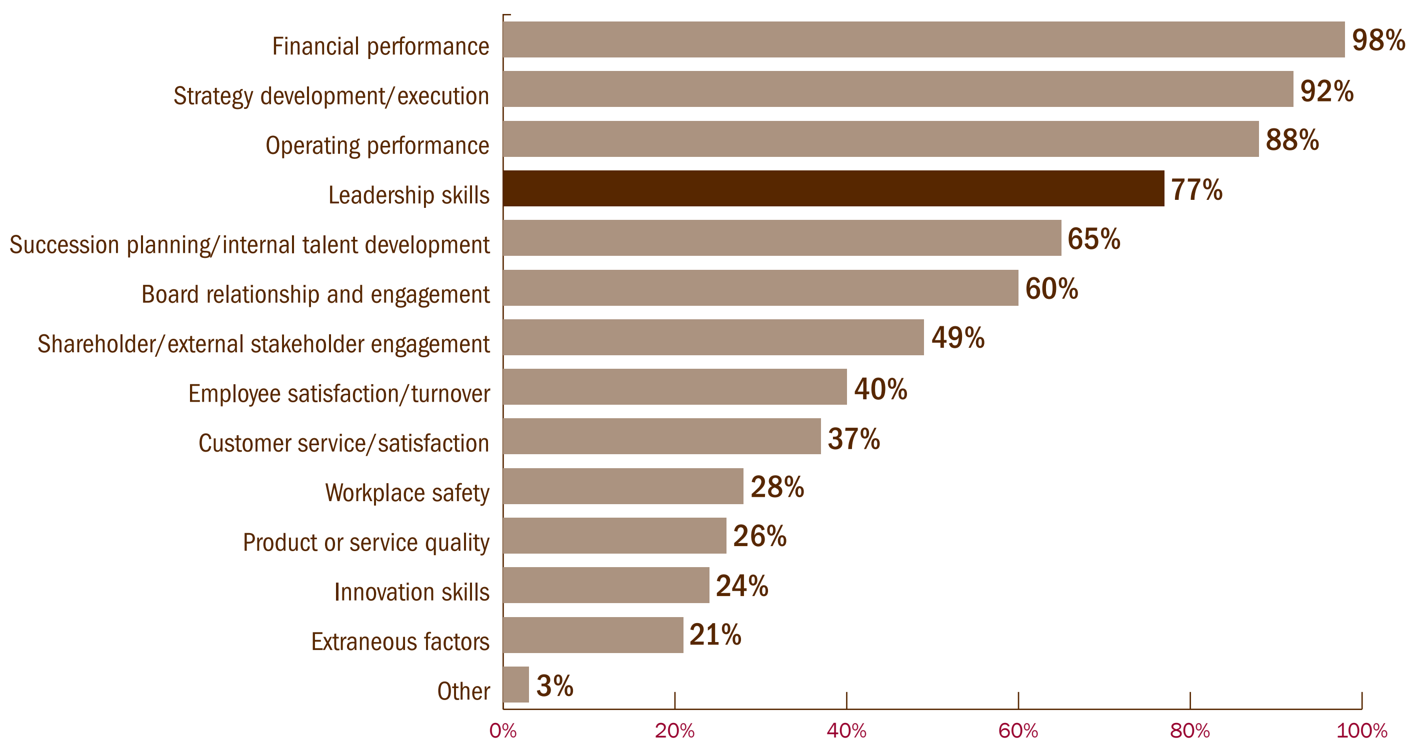
More than two thirds (69%) of directors said the effectiveness of the top team factors into the way they evaluate their CEO's human resources performance.

Public Accountability

Public demands for more accountability of business leaders and transparency around their decisions have shifted CEOs' responsibilities as well. Today's CEOs are also expected to be public figures, ready to convey their vision of the company not just to executives in the C-suite or the company's workforce, but also to shareholders, customers and the media. That means boards need to ensure their CEO is able to lead externally as well, Stevenson says.

"As the face of the organization, some of the softer skills around communication and the ability to be a spokesperson to garner the confidence of not just [Wall]

What are the primary categories for evaluating the CEO's performance?



Source: Agenda/Hay Group survey of 147 directors and executives; respondents could choose more than one option

Street but the customer set and others are part and parcel of the CEO's role," says Stevenson.

Meanwhile, the CEO's ability to lead is his or her biggest tool in driving the company's performance, argues **Mark Nadler**, principal and co-founder of **Nadler Advisory Services**, a board advisory and CEO succession planning boutique.

"You can certainly understand why the board … is looking very aggressively at how the company performs when it comes to wealth creation for investors, and there's more pressure than ever on the CEO about that," Nadler says. "The dilemma is that you're looking for immediate and dramatic results, and very often those are realistically beyond the CEO's capacity to affect the company in a dramatic way."

That's because the financial and operational performance metrics arise indirectly from the CEO's actions. Leadership is what the CEO actually puts into the job, Nadler says.

But while the CEO's performance in terms of financial or operational strength is quantifiable, leadership ability isn't easily scored with objective metrics. Depending on the company's health or position in the market, boards evaluate their CEO's ability to meet changing financial, strategic or operational targets. In order for the performance evaluation to be a meaningful exercise, experts say, boards need to set targets for leadership as well.

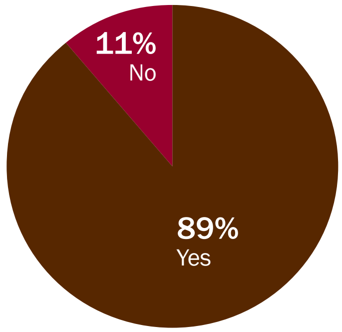
Quantifying Leadership

Several experts pointed out that boards can use 360-degree feedback exercises or interviews with senior staff to get a feel for the CEO's leadership performance. But they caution boards against relying too heavily on this type of work, because it doesn't necessarily factor in the board's vision for the company or leadership goals for the CEO. To evaluate the CEO's leadership, boards should take stock of what they want to achieve and how the CEO's leadership can get the company there, they say.

"What really matters is [whether] we defined the challenge in the right terms," says **Nigel Nicholson**, a professor at **London Business School** and author of *The I of Leadership*.

"The task of evaluating the leader has to be measured not in some easily generated questionnaire scale that is universally applied. It has to be a rigorous appraisal of what is going on in [an] organization's ecosystem, what you are trying to do and the role of the CEO in supporting the organization in attempting to be adaptive," he says.

Does the board conduct a formal annual review of the CEO's performance?



Source: Agenda/*Hay Group survey of 147 directors and executives*

Fred Foulkes, a director at **Panera Bread**, says one way to measure the CEO's leadership ability is to set goals around "the soft stuff" that the company wants to achieve.

"For example, on diversity and inclusion, can we show we actually did hire or promote these people, or we made the efforts and made the offers?" he says. A chemical company may factor steps to improve workforce safety into the CEO's evaluation as well, Foulkes says.

The board could also look at the CEO's relationship with the board, he says. In fact, 88% of directors and execs who participated in the survey say this is the top metric by which they evaluate the CEO's governance ability.

Boards may also find it useful to look back at their CEO search criteria from when they hired the CEO in the first place, says **Alicia Syrett**, founder and CEO of **Pantegrion Capital** and a director on several private company boards and advisory boards.

"I can't tell you how many job specs I've seen where we say things like, 'We want someone who's coachable, takes initiative, is detail oriented, is familiar with numbers, is a good manager and has integrity,'" Syrett says.

To evaluate the CEO's performance, often the board has to look for instances where he or she did not live up to the job spec.

"If you ask some questions about something that might have gone wrong or something you might feel needs some more work, and they're defensive, that's a sign they're not coachable. If you say, 'We want a CEO who takes initiative,' the way to quantifiably assess that is [to ask], 'Have we had to remind them to seek new part-

Leadership continued on page 12

Directors Cast the Net Wide When Fishing for CEO Feedback

Self-evaluations from CEOs are often among the most valuable feedback

by Amanda Gerut

The full board is the arbiter of the CEO's performance, but individual directors gather insights from constituencies both outside and inside the company — including CEOs themselves — in formulating their views.

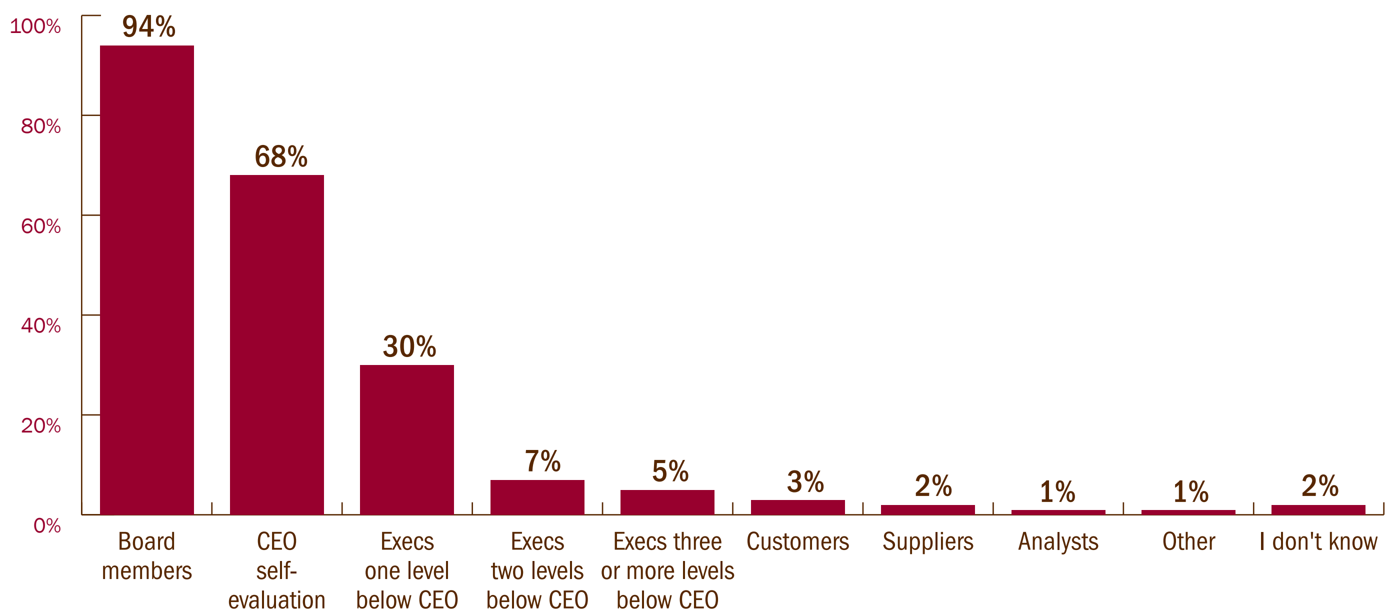
A survey of directors and executives carried out by *Agenda* and consulting firm **Hay Group** during September and October revealed that the vast majority of respondents (94%) see board members as a main source of feedback in CEOs' annual performance reviews. In addition, 68% report that CEOs' self-evaluations are used in the yearly review, while 30% say executives one level below the CEO weigh in on the chief executive's performance.

The question of where to turn for input in a CEO evaluation is complicated, directors and advisors say, and much depends on where the CEO is in their lifecycle with the company as well as how the company is faring. Very senior, seasoned CEOs a few years from retirement may not be receptive to feedback from sources outside the company. Meanwhile, brand-new, first-time CEOs in the midst of a turnaround may not benefit from feedback solicited from senior executive teams. Overlooking a relevant information source could lead to blind spots, observers say, but it's also important to consider the source.

For boards, that means directors have to decide where to seek input about a CEO's performance based on the circumstances the company is in, and the information has to be presented to the CEO in a meaningful way.

Directors and advisors say this translates into an ongoing process of constantly consuming information about their businesses, competitors and industries in order to formulate a view of how a CEO is measuring up to tangible and intangible goals. In addition, directors exchange feedback regularly in executive sessions. The lead director or independent board chair also has an important role in synthesizing feedback discussed in executive sessions and conveying a cohesive message to the CEO following board meetings and once a year in a formal performance review.

Which individuals provide feedback as part of the CEO performance review process?



Source: Agenda/Hay Group survey of 147 directors and executives; respondents could choose more than one option

One CEO's Feedback: Anxieties, Paranoias and More

Dinesh Paliwal, CEO and chairman at Harman International and a board member at **Bristol-Myers Squibb**, says he has found self-assessments so helpful in prompting dialogue with board members about his performance as CEO that he provides directors with regular, monthly reports.

The reports include business and financial updates, information about the competitive landscape, potential for disruption at the company and other information that "CEOs would usually be afraid to tell boards," Paliwal says.

"I tell them what makes me paranoid, what might make me nervous, my personal anxieties and what excites me," he says. "Every month I take the time to write what I know."

Paliwal says the report usually triggers a few e-mails and some short calls with directors.

In addition, each of the board's five meetings per year begins with an executive session in which Paliwal discusses what has happened since his last monthly report to the board.

Paliwal says he talks about everything from competitors to his misgivings. When he leaves, he asks the board to discuss things that are bothering them and information they feel they are not getting from him.

After the meeting, Paliwal meets with directors again. He often asks them if they think he's listening well, he says. He tells directors, "I don't want to be in the dark, and you will never be in the dark." **Ann Korologos**, who is lead director at Harman, follows up with him a day later to discuss feedback from the executive session.

Paliwal says he's comfortable with board members' talking with his direct reports as long as he's aware it's happening, and notes that the chairman of the compensation committee talks with investors annually to get their views on Paliwal, the chief financial officer and the effectiveness of the investor relations function. All in all, he gets feedback about 20 times a year, he says.

Paliwal says the culture of openness and transparency on the board also gives him the ability to provide feedback to the board on its performance. If a director asks repetitive questions, he's happy to point that out, he says.

While some boards — not to mention CEOs — might be uncomfortable with that level of openness, Paliwal says he's more comfortable knowing that he's not "managing the board," a phrase he finds troublesome. Paliwal says he and the board have worked hard to create a culture that values transparency above all else. For instance, a telltale sign is when division presidents are liberated when they present to the board, he says.

"They shouldn't feel constrained or hesitate in answering directors' questions because they want to balance their message between the boss — the CEO — and the board," he says.

"To me there is one message, whether it's good or bad."

"The board's evaluation is built up of lots of things," says **Linda Fayne Levinson**, non-executive chair of the **Hertz Global Holdings** board and director on the boards of **Ingram Micro**, **Jacobs Engineering Group**, **NCR** and **The Western Union Company**.

Boards take stock of how a company is performing, its financial metrics and feedback from its investors throughout the year.

In addition, board members focus closely on the CEO. The chief executive's conduct and integrity, C-suite turnover and its causes, and observations from meetings with senior management, committees and the board all create a composite view of performance, Fayne Levinson says.

In the rare but extreme situations in which board members get calls from large investors who question why the CEO still has a job, such feedback would carry weight. But under more routine circumstances, directors' individual evaluations involve "lots of inputs throughout the year," she says.

"If there are strong signals about real issues, obviously that all comes into play," she adds, "but essentially [the CEO evaluation] is the board's evaluation of all the signals they're getting."

Formal Evaluation

Depending on the board, the chair of the compensation committee, the lead director or the non-executive chair will circulate a questionnaire or hold one-on-one meetings to collect feedback from board members. *Agenda*'s reader survey found that 46% of respondents use a written or online survey tool, while 28% and 21% solicit feedback using meetings and phone calls, respectively. Executive sessions were cited by the majority of respondents (76%) as a vehicle for appraising CEO performance.

Feedback continued on page 14

Boards Urged to Weigh Soft Skills When Setting CEO Pay

CEO evaluations usually affect discretionary bonus, experts say

by Lisa Botter

Most companies have a formal link between CEO evaluations and setting compensation, data suggests. But the link should go beyond attainment of financial goals to incorporate softer CEO skills such as leadership, experts say.

This comes as compensation committees take a more active role in the CEO evaluation process.

Data compiled by **Hay Group** and *Agenda* found that 58% of survey respondents have a formal or formulaic link between CEO performance evaluations and compensation, 36% said there was an informal or discretionary link, and 3% said there was no link between evaluations and compensation.

The non-scientific survey was conducted in September and October and had 147 participants, most of whom were CEOs or directors.

The high proportion of companies using a formulaic link between compensation and performance may imply an overreliance on easily measurable metrics, Hay Group suggests, such as financial metrics. It could also indicate less reliance on organizational sustainability, such as leadership skill, succession planning or strategy implementation.

Robin Ferracone, CEO of compensation consultancy **Farient Advisors**, says that in practice the link between the evaluation and comp setting runs the gamut. Some companies like to keep the two processes separate, while others want to have a strong link between the evaluation and compensation.

"For the most part, there is a link, but it is implicit, not explicit," she says. The evaluation may have an effect on the pay increase from year to year, the bonus target and the long-term incentive package.

"Sometimes in short-term incentives there [is] a place for individual assessment, and it could play into that," she said. "It would tend [not to affect] quantitative incentive as much, but would play into the management-by-incentive piece."

Typically about 40% of an evaluation will be based on financial metrics, with the rest focusing on softer skills such as leadership. This breakdown can mean that it can be harder to base compensation on the evaluation. But in general, 20% to 25% of bonus targets will be discretionary and the evaluation can be used to determine this portion of the bonus, says Ferracone.

Cory Morrow, senior principal at Hay Group, says the link between evaluations and compensation should be less formulaic and more subjective.

If comp committees have a robust pay plan that takes financial performance metrics into account, the evaluation should play into the discretionary part of the bonus, he says.

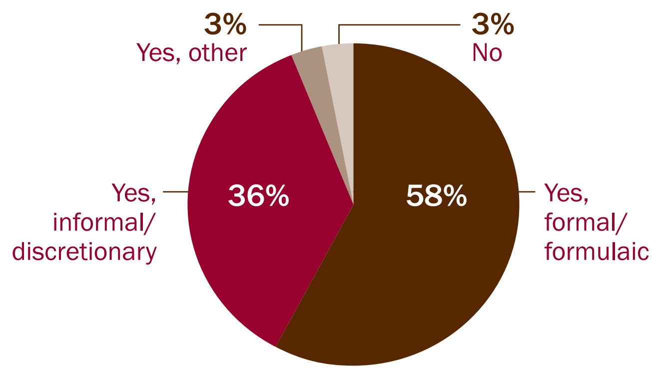
According to its 2015 proxy statement, released in October, **Broadridge Financial Solutions** uses the outcome of the CEO evaluation to set CEO **Richard Daly**'s compensation.

"The compensation committee considered this evaluation of Daly's performance while determining his fiscal year 2015 cash incentive achievement and his fiscal year 2016 base salary and incentive compensation targets," the proxy states.

Daly's performance was evaluated by the compensation committee on his ability to meet financial goals, achieve shareholder return in the top quartile of S&P 500 companies, drive strategic growth and develop successors.

The committee found that Daly had "very strong personal performance" in fiscal year 2015, due in part to achieving record revenues, net earnings and earnings per

Is there a link between the performance evaluation and the CEO's compensation?



Source: Agenda/Hay Group survey of 147 directors and executives share. The company also achieved a total shareholder return in the top quartile of S&P 500 companies.

"Based on these accomplishments and the compensation committee's assessment of his overall performance, the committee decided to pay Daly 130% of the target on the strategic and leadership goals portion of his cash incentive award," the proxy states.

At the **National Association of Corporate Directors'** recent annual conference, **Rajiv Gupta**, director at **Hewlett-Packard**, **Delphi Automotive** and **Tyco International**, said that for his boards there is a link between pay and evaluations, but not in a formal sense.

97%

Survey respondents who have some link between CEO performance and compensation

He explained how Delphi completes its CEO evaluations.

The board evaluates the financial performance of the CEO, but also the "softer skills," including relationships with outside stakeholders. Gupta said that the process has become more formal over the years and now includes a three-page self-evaluation, and that the CEO also has private sessions with the board.

"The process is not a one-time event," he said. "[The evaluation] is setting the tone for what the priorities are for the next year."

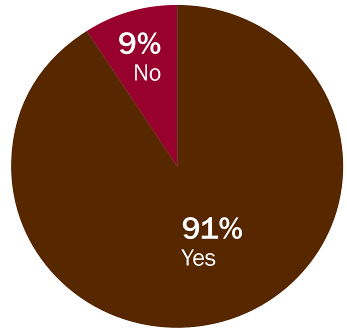
The head of the comp committee and the chairman will then sit down with the CEO to go over the results.

Gupta said there is no formal link between compensation and the evaluation due to the fact that performance is assessed throughout the year, whereas compensation is set once. However, when it comes to setting compensation, he will sit down with the full board with a benchmark assessment that plays into the pay program.

"Compensation is only one aspect of the message [about performance]. You can't tell them one thing in words and another in compensation," Gupta said.

He added that the typical process starts with setting objectives and targets for the CEO with the right priorities and metrics before the fiscal year starts. That sets the diary and objectives for the year. The board then gets updates from the CEO almost every quarter, but when the time comes to set the compensation there will be a more formal meeting with the CEO. "In the final meeting, we will look at all the data, including performance,

Do you think the feedback the board provides to the CEO is open, honest and direct?



Source: Agenda/Hay Group *survey of 147 directors and executives*

and figure out the compensation," he said.

Lawrence Costello, executive VP and chief human resources officer at Tyco, told delegates at the same conference that CEOs can have a perception about their value and that the evaluation helps the CEO put this into perspective. "When it works well, it keeps the balance," he said.

Gupta added, "I have had CEOs come to me and say, 'I didn't have a good year; I think I should be dinged.'"

There have been cases of CEOs' declining bonuses that were approved by the board. In February, **Richard Handler**, CEO of asset manager Jefferies and its parent company **Leucadia**, turned down a $2.2 million bonus due to poor performance by the firm.

In December 2014, **Rick Holley**, CEO of **Plum Creek Timber**, returned 44,445 restricted stock units that were granted in February 2014 because he did not "believe that he should receive such an award unless Plum Creek's stockholders see an increase in their investment return," a regulatory filing states.

At the time, the shares would have been worth $1.85 million.

Also last year, **Virginia Rometty**, CEO of **IBM**, and her top executives decided to forgo their personal incentive payments for 2013 due to poor full-year results. The board initially granted her the bonus because the formula heavily favored earnings growth and the earnings were higher than 10% per share.

In 2013, **Larry Ellison**, then-CEO of **Oracle**, declined a $1.2 million performance-based bonus because the company missed its internal financial targets.

Soft Skills continued on page 13

Informal Check-Ins Help With Tricky CEO Evaluations

Performance can be improved through more board and CEO discussions

by Lindsay Frost

The vast majority of boards formally evaluate their CEOs at least once a year, but governance experts say more frequent informal feedback is becoming integral to the evaluation process, especially in delicate situations.

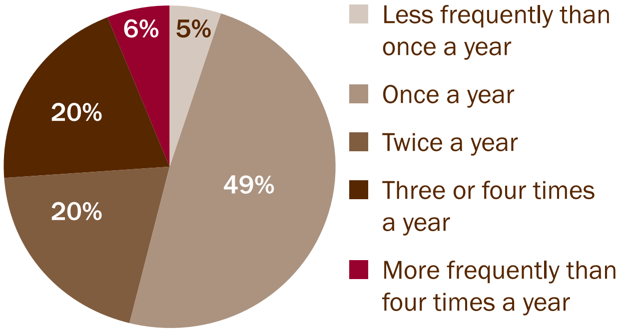
Directors and consultants say that informal, semi-frequent discussions about CEO performance can help improve the relationship between boards and their CEOs and mitigate unwelcome surprises at year-end reviews.

According to a survey conducted by *Agenda* and **Hay Group**, 49% of respondents said they formally evaluate their CEOs once a year, while 46% said they formally discuss their CEO's performance twice a year or more. The remaining 5% said they held formal CEO evaluations less frequently than once a year.

"It's never a great idea just to leave feedback for the end of the year — CEOs don't like surprises," says **John Stout**, a director on several public and nonprofit boards and former board member of the **National Association of Corporate Directors**. "The better process is to come up with ways to check in with the CEO on performance throughout the year. Not every week or every month, but certainly periodically."

One in 10 survey respondents said they planned to increase the frequency of their CEO performance evaluations in the coming year.

How often are there formal discussions with the CEO about their performance?



Source: Agenda/Hay Group survey of 147 directors and executives

One-and-Done Reviews

Patrick Shannon, a partner at **Mercer**, says quantitatively measuring the CEO only once a year can create divisions between the board and the CEO. He says he has worked with boards and CEOs who set up more frequent, informal feedback sessions throughout the year, which have led to a more relaxed and constructive environment for the annual review.

> **"New CEOs or leaders in very tight turnaround situations — including those under threat of or facing pressure from activist investors — typically require more frequent conversations between the board and CEO."**
>
> **Damon Beyer**
> Partner, A.T. Kearney

"We did a project for a health care organization in the Midwest and the CEO was concerned that with the more formal focus on year-end reviews some informal connections with the board would be cut off," Shannon says. "Both the CEO and the board wanted it reinforced that boards can reach out to the CEO during the year to provide input and CEOs have full access to the board."

When asked whether they set multi-year goals for their CEO, one in seven survey respondents said they look only at the previous year's performance when evaluating the CEO, which Hay Group says may be due to a continued emphasis on short-term results.

"In organizations focused on long-term targets, that value continuing professional development, we would expect to see much more frequent evaluations — perhaps as often as once per quarter for formal feedback and on a monthly basis for informal feedback," writes Hay Group in its analysis of the survey findings.

If directors do not tell CEOs about their concerns about performance goals throughout the year, the CEO will be ill-prepared to respond to them at the annual review, Shannon adds. A better way of addressing these concerns, he says, is a five-step process that boards should follow year-round.

"You set the criteria at the beginning of the year in what you want accomplished, have the CEO frequently review their own performance, gather additional input from the board, summarize the feedback and ensure there is a set stage for that year-end discussion with the CEO," Shannon says.

Stout says he has dealt with "dozens" of CEO terminations, and often the CEO is surprised due to the lack of ongoing feedback. He says directors privately tell lawyers their concerns about their CEO's performance outside of the annual review because they are unsure how the rest of the board or the CEO feels. They are typically hesitant to speak up, hoping the issue will somehow "fix itself," he adds.

"The board has got to be good at communicating about what needs improvement all year," Stout says. "When boards finally come to us with a termination letter, they often wished they had got to grips with the issue in a timelier manner."

However, **Damon Beyer**, leader of management consultancy **A.T. Kearney**'s organization and transformation practice, says that although informal feedback on improvement areas can be helpful throughout the year, "it's important to separate developmental conversations from actual evaluations."

Because the annual evaluation is linked to yearly compensation and performance goals, it is difficult to give quarterly updates in those areas, he adds. Almost 100% of survey respondents included financial performance as one of the primary categories for evaluating the CEO's performance, while 92% said strategy development was also a primary category.

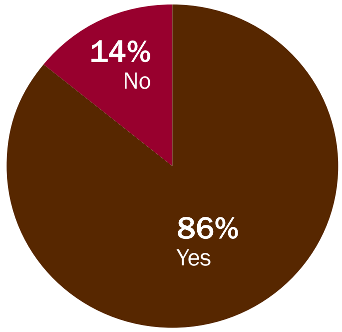
44%

Survey respondents who solicit feedback through informal discussions

"It's the CEO's job to not only manage quarterly performance, but to set long-term strategy and develop the next generation of leaders," Beyer says. "Progress on the last two topics is much harder to see quarter to quarter, and in fact progress on strategy is much more amendable in yearly reviews."

Rusty O'Kelley, head of **Russell Reynolds**'s board consulting and evaluation process, says that not only is the annual process in step with the "normal rhythm of evaluations in the professional world," but CEOs need a chance to accomplish a wide set of goals and may not be able to provide much of an update more frequently than once a year.

Do you ever establish multi-year goals?



Source: Agenda/Hay Group survey of 147 directors and executives

When to Increase Frequency

The majority of survey respondents (91%) said the feedback their board provides to the CEO is open, honest and direct, and 44% said they solicit and compile feedback on the CEO's performance through informal discussions. Consultants interviewed say these informal and frank discussions are critical to the evaluation process, especially for inexperienced CEOs or those in trying situations.

These discussions typically involve casual meals involving the CEO and the lead director or non-executive chairman, often soon after board meetings, says **Jim Citrin**, a consultant in **Spencer Stuart**'s North American CEO practice. If the CEO is facing media scrutiny, employee complaints or a lagging stock price, the discussions will tend to be more intense and formal, he adds.

A.T. Kearney's Beyer says major shifts in strategy and performance are the biggest reasons for increasing the evaluation frequency.

"New CEOs or leaders in very tight turnaround situations — including those under threat of or facing pressure from activist investors — typically require more frequent conversations between the board and CEO," Beyer adds.

Beyer says he is currently working with a CEO whose evaluation cycle is annual, but who needed more coach-

Informal continued on page 16

Chairs, Comp Committee Heads Entrusted to Lead Evaluations

Good listeners and tactful communicators are best for delivering feedback

by Tony Chapelle

Board chairs and heads of compensation committees typically lead evaluations of chief execs and then deliver the findings to the CEO, according to findings from a recent survey conducted by *Agenda* and compensation consultant **Hay Group**.

When asked who is primarily responsible for leading the process for the formal evaluation of CEO performance, 39% of survey respondents said the head of their compensation committees. Meanwhile, 27% said the person responsible was their board chairman, if different than the CEO.

As for who communicates back to the CEO, two thirds (65%) of respondents said board chairmen are most likely to inform chief executives about their reviews. Since more than one person can participate in those conversations, there were significant percentages for other responses as well. More than half (57%) of respondents said the chairman of the compensation committee is involved. Another 40% said the lead director would be the person speaking to, or included in discussions with, the CEO on behalf of the board.

Many Fortune 500 companies set clear rules on which board members should lead CEO evaluations. The proxy for **Goldman Sachs**, for example, states that its annual CEO evaluation process is conducted by its lead director, **Adebayo Ogunlesi**, along with the governance committee.

Caterpillar leaves the job to the full board, which currently is made up of all independent directors, save for chairman-CEO **Douglas Oberhelman**. However, Oberhelman does not participate as a board member in his own assessment.

Bill McCracken, former CEO and both non-executive and executive chairman at **CA Technologies**, says boards should turn over the formal CEO evaluation process to independent chairmen. McCracken, now a director at electric and natural gas distributor **MDU Resources Group** and vice chairman of the Millstein Center for Global Markets and Corporate Ownership at **Columbia Law School**, says lead directors should coordinate the proceedings when companies have combined CEO-chairmen.

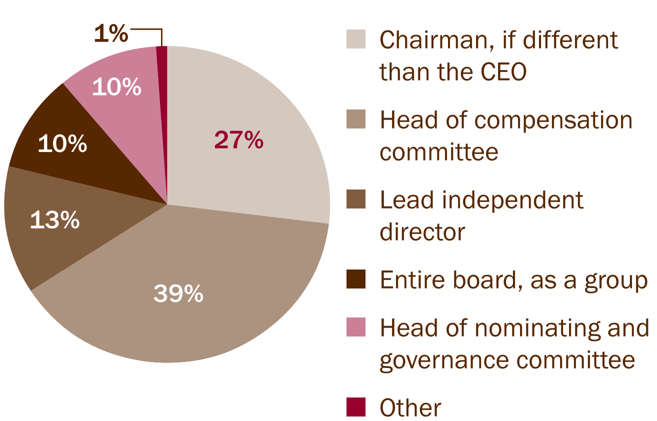
"In a board, leaders are leading leaders. Even if you task the lead director with the job, they are hopefully influential and boards do tend to follow them. Most directors would trust them. So you should be able to have the kind of dialogue that you need," McCracken says.

Meanwhile, some corporate proxies specify who is responsible for explaining the assessment to the chief on behalf of the board. At **Procter & Gamble**, for instance, lead director **James McNerney** is responsible — in tandem with the chair of the compensation and leadership development committee — to "review with the [CEO] the non-employee members' annual evaluation of the [CEO's] performance." After November, when P&G's chairman-CEO **A.G. Lafley** steps down as chief executive but remains executive chairman, he will replace the lead director. Lafley and the comp chair, also McNerney, will communicate the board's evaluation to the new CEO.

At **3M**, the lead director has a limited role in the conversation. The manufacturing conglomerate's proxy stipulates that its lead director, **Michael Eskew**, share board member feedback with chairman-CEO **Inge Thulin**, although the chair of the compensation committee leads the discussion.

Some corporations, on the other hand, do not clearly set out who runs the evaluation or later sits down with the CEO. **Wal-Mart Stores**' proxy devotes half a page to

Who is primarily responsible for leading the process for formal evaluation of CEO performance?



Source: Agenda/Hay Group survey of 147 directors and executives

> **"The person leading the process needs to be someone who commands the respect and accountability of fellow board members and also can be effective in providing feedback to the CEO. Many times, it's not just the message but how it's delivered that's equally important."**
>
> **Thomas Daniels**
> Senior director, Spencer Stuart

the evaluation process for the board and its committees. The passage discusses the interviews that the lead director engages in with senior managers and also explains the anonymous questionnaires they fill out to discuss board members' effectiveness. The proxy makes no mention, however, of who assesses the CEO.

Corporate boards are free to choose who carries out both duties. Governance experts say that, in some firms, the roles can change depending on the firm and personal characteristics.

"More importantly than the title or what's in the governing documents, it's important to have the right person in the process," says **Thomas Daniels**, senior director at executive search firm **Spencer Stuart**, who specializes in finding financial officers, board directors and CEOs.

"The person leading the process needs to be someone who commands the respect and accountability of fellow board members and also can be effective in providing feedback to the CEO," Daniels says. "Many times, it's not just the message but how it's delivered that's equally important. So that's why it depends upon each board. Hopefully, [whoever] leads the process — [whether it's the] non-executive chair [or] the head of the comp committee — [is] someone who's trusted, who's discreet, who cares about people and who has the time to invest in doing it the right way."

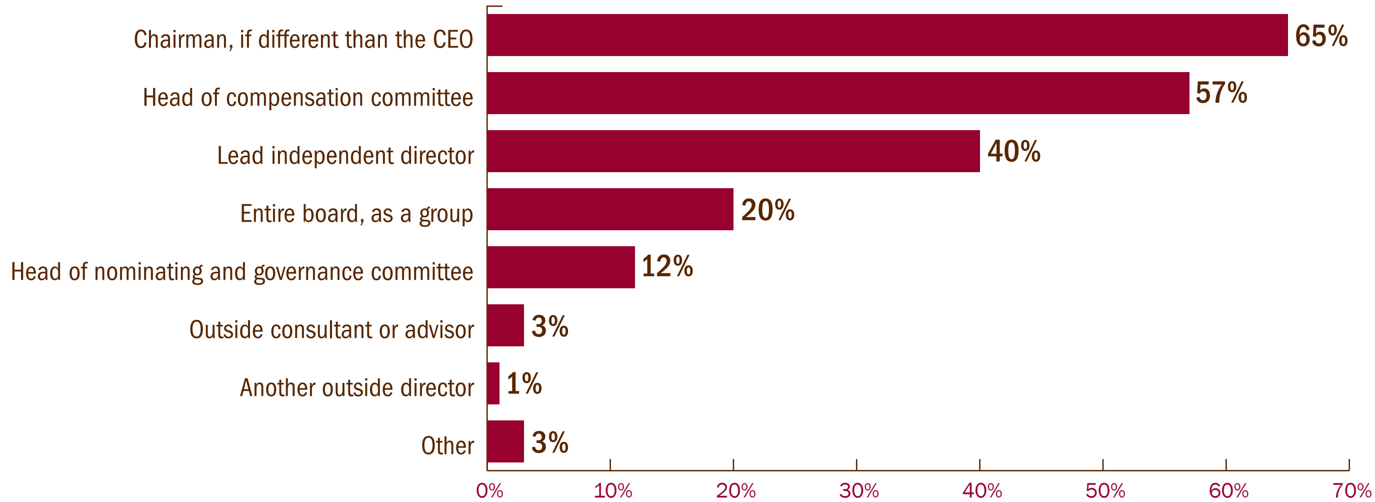
Curtis Crawford, nom-gov chairman at two companies and a former board member of **DuPont** and **ITT**, says he prefers to see the review message delivered to the CEO by a non-exec chairman if there is one. That person could either partner with the chairman of the corporate governance and nominating committee or the chair of the comp committee to deliver the message jointly.

"The advantage of that is you could add a broader perspective than by just one person delivering it. Some CEOs actually prefer that," says Crawford, who is also president of **XCEO**, a corporate board evaluation consulting company based in Santa Clara, Calif. In the case of board chairs and comp chairs' explaining a chief executive's review together, Crawford sees a natural fit. "Compensation and performance work in league with each other," he says.

Crawford advocates using anonymous questionnaires and essays that the leader of the process then brings back to be discussed between board members. During this executive session, the person overseeing the process points out key concerns raised in the feedback. Only if the au-

Entrusted continued on page 16

Who gives performance feedback to the CEO?



Source: Agenda/Hay Group survey of 147 directors and executives; respondents could choose more than one option

nerships or was this something they did on their own?'" Syrett says.

Measuring leadership often comes down to pinpointing failures or identifying moments when the CEO has not met the board's expectations of how an effective leader should behave, she says. The board can then decide if the issue can be corrected by a conversation or coaching, or if it should begin searching for a new CEO.

Boards also need to assess whether CEOs are improving over time, Nadler says.

"What's useful is to … have some benchmark and then the board can figure out whether the CEO is making progress in important areas or is dead in the water or sliding backwards," he says.

Finally, Stevenson says, boards should also factor succession planning and team building into an evaluation of the CEO's leadership skills.

"Boards are clearer than they've ever been that it's hard to deliver business results without a strong team and that no one person defines the full outcomes of an organization," she says.

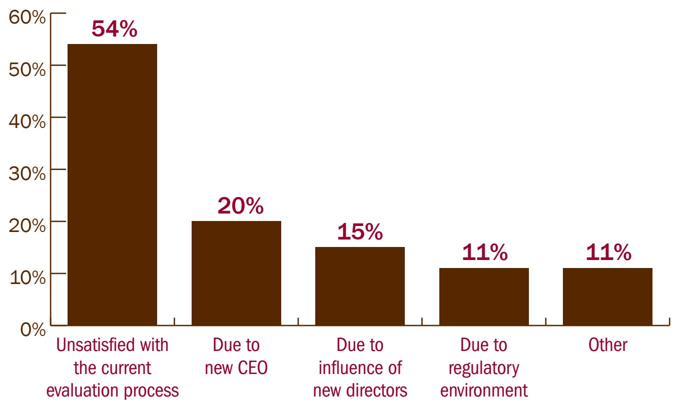
"I think the days of boards' solely focusing on the CEO without having involvement in and understanding of the strength of their team are numbered."

According to the survey, 61% of directors said they look at succession planning in CEO evaluations and 52% look at the quality of the leadership pipeline.

Likewise, Stevenson says, boards should use the same metrics by which they evaluate the CEO's performance to assess chief executive candidates in the talent pipeline, allowing emerging leaders to build an understanding of the board's strategic agenda and expectations.

What is the rationale for making changes to your CEO performance evaluation?

Based on the 31% of respondents who planned to change their process this year



Source: Agenda*/Hay Group survey of 147 directors and executives; respondents could choose more than one option*

Other Metrics

The *Agenda* and Hay Group survey also took a closer look at specific financial and operational metrics boards tend to use in evaluating the CEO.

"The goals have to be specific to the situation, and the board and CEO have to be in agreement about the reasonable goals and stretch goals in there," Foulkes says.

"[The metrics used] depend in any given situation on the company and the industry. In some cases, an important goal might be [to develop] a successor, complete an important merger or improve [the] company's safety and health record."

According to the survey, 58% of respondents said they used revenue and sales as a way to assess financial performance. The next most popular metrics were operating income or earnings before interest and tax (49%), earnings per share (48%) and total shareholder return (48%).

Total shareholder return could become a more popular CEO evaluation metric in the future, considering its popularity with proxy advisory firms such as **ISS** and **Glass Lewis** as well as with activists, Foulkes says.

At 61%, efficiency and savings was by far the most popular metric for evaluating operational performance, followed by quality at 39%.

Nadler and other experts say boards have grown considerably more specific and demanding on CEO performance evaluations in recent years. In the past, boards leaned heavily on the CEO's self-evaluation and the metrics they thought were important.

But now, the board's challenge is to pick out a limited number of metrics that are appropriate to its strategic goals, Nadler says.

"Part of the issue with the CEO's job is that the scope of responsibility is immense and [it] just keeps getting bigger. But you have to pick your spot. It's important for the CEO to [set goals] in collaboration with the board as they set out each year, to make sure they are in alignment on what the priorities are and what's most important for the CEO to be getting done," says Nadler. ■

Increased Use of Comp Committees

The Hay Group and *Agenda* survey also found that the head of the compensation committee was more likely to take a lead role in conducting CEO evaluations than any other board position. The data showed that 39% of respondents indicated that the head of the compensation committee was primarily responsible for leading a formal evaluation process. This was followed by 27% who said an independent chairman led the process and 13% who said the process fell primarily to the lead independent director. The entire board and head of the nominating and governance committee each received 10% of responses.

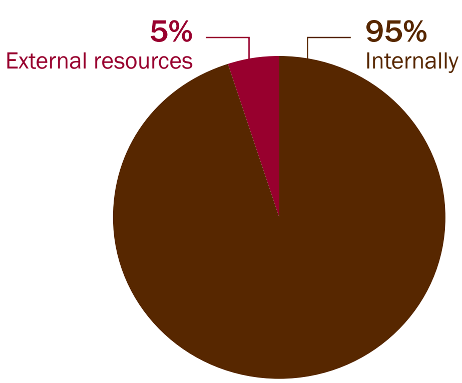
Matthews says that he isn't surprised that practices are mixed across the industry and that the higher use of comp committee chairs may be due to the high number of companies that have a combined CEO-chairman role.

Ferracone says that the person nominated to oversee the evaluation is usually someone with a good relationship with the CEO. But she suggests that this person should not be too close with the CEO.

"The reason the comp committee head makes sense is because the linkage then does happen to comp. If you have the head of the comp committee orchestrating the process, then that person also can orchestrate how the results of that process link to compensation. So it makes that step easier," Ferracone adds.

A study by **The Conference Board** released earlier this year found a majority of public companies now delegate CEO performance oversight to the compensation committee.

Do you conduct the annual evaluation of the CEO's performance internally or use other resources?



Source: Agenda/Hay Group *survey of 147 directors and executives*

The Conference Board compiled data on the succession planning of S&P 500 companies from public information such as regulatory filings and company websites.

"The scrutiny of the link between pay and performance and the increasing specialization of the compensation committee in defining the appropriate performance targets for the C-suite are the most likely explanation for this finding," the report states.

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>
> **Robin Ferracone**
> CEO, Farient Advisors

The data found that there was an increase in use of comp committees as the leader in CEO evaluations across every industry. Of companies with annual revenues of $20 billion or more, 42.9% gave the comp committee responsibility for CEO evaluation in 2014. This was up from 26.1% in 2013.

At **NXT-ID**, a provider of security technology for mobile devices, the compensation committee is responsible for overseeing the CEO's review, according to the company's 2015 proxy statement, filed in August. "The results of the annual CEO evaluation will be considered in setting CEO salary and other compensation," the proxy states.

The compensation committee also leads the CEO evaluation process at **Michael Kors**. The company's 2015 proxy states that the committee reviews the corporate goals and objectives of the chief creative officer and CEO, evaluates the executives' performance in respect to these goals and, in turn, approves their compensation levels, perquisites and other benefits in light of the evaluation.

The proxy states that the evaluation process has an emphasis on core competencies and leadership capabilities. ■

Feedback continued from page 5

Directors gave mixed responses on the subject of requesting formal feedback from the CEO's direct reports. While some interviewed by *Agenda* say both off-the-record and on-the-record conversations with senior executives shape their views, fewer than a third of directors surveyed reported that direct reports provided feedback as part of the formal review.

Jason Schloetzer, associate professor of accounting at **Georgetown University**'s McDonough School of Business, says information from CEOs' direct reports is biased to be positive, and not entirely useful in formal evaluations.

Criticizing a boss could hurt the executive in the future, but they could also be found not to be providing the board with useful information, Schloetzer says.

Directors surveyed were also lackluster about the inclusion of sources outside the company, such as analysts, investors, customers and suppliers, in the performance review process. Few directors reported relying on such sources.

However, directors in interviews say that while such sources wouldn't be part of a formal evaluation, their views are taken into account.

One of the difficulties in soliciting feedback outside the board and company is the inherent bias underlying the data, notes **Michael Franklin**, partner at **The River Group** and a longtime advisor to boards conducting CEO evaluations.

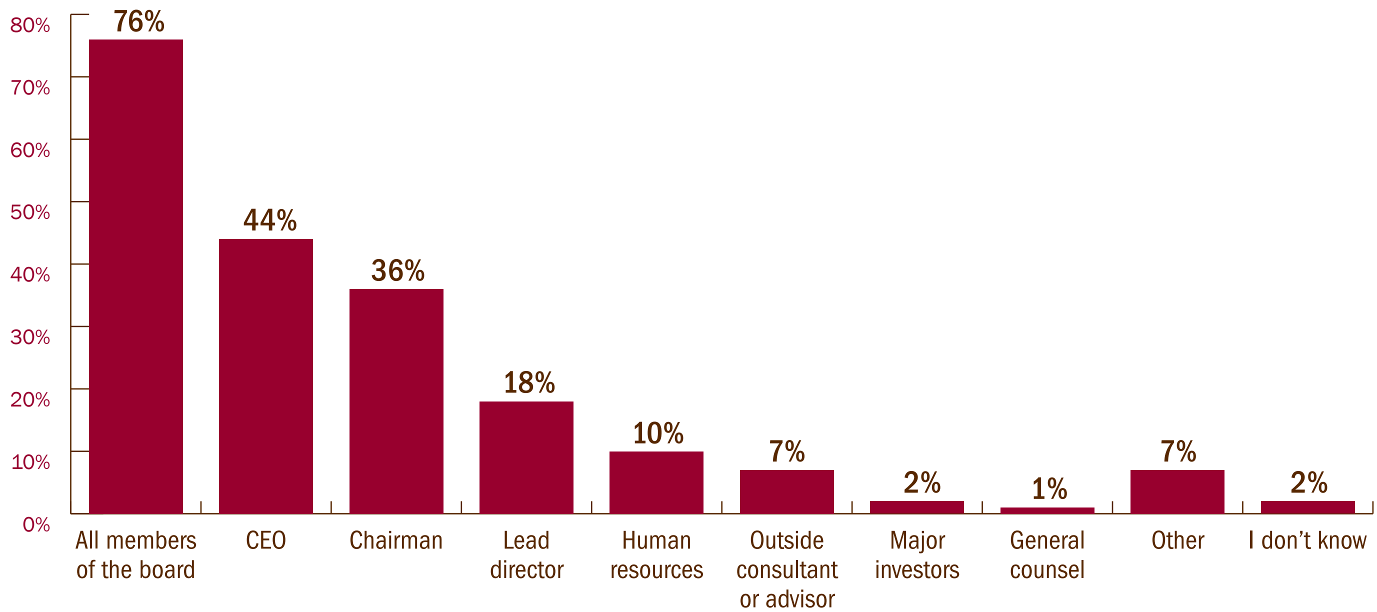
Those providing criticism on the CEO's performance, whether it's constructive or not, may have a vested interest in how the CEO is evaluated, he says.

"It's incumbent on the board of directors and whomever is helping facilitate and lead the process to sort out or understand the input and the context from which it is coming so that they can make accurate, objective evaluations of the CEO's performance," Franklin says.

If the board and CEO have a healthy relationship, the evaluation may help the two become better aligned on the CEO's performance. When the relationship is unhealthy, or the CEO has difficulties with their team members, CEOs may have concerns about whether or not they are getting a fair evaluation.

When Franklin helps board clients with CEO evaluations, his team conducts confidential interviews with numerous sources, occasionally including those outside the company. Themes will be presented as coming

Who provides input on developing the CEO's performance objectives at the beginning of the year?



Source: Agenda/Hay Group survey of 147 directors and executives; respondents could choose more than one option

from external feedback providers or from the board or senior team.

"You want to try to bucket the feedback providers into sets of constituencies that maintain anonymity but give [the CEO] the ability to understand the context from which the input is coming," Franklin says.

The CEO's Harshest Critic

In addition to the board, executive team and outside sources, one of the most important sources of information about how well a CEO is meeting the goals and objectives set out by the board is the CEO.

For the most part, the metrics speak for themselves and drive compensation decisions, directors say. However, the CEO's self-assessment adds context that underscores why the company is meeting the goals in both the annual business plan and the company's long-term and strategic plans or not, says **Ann Korologos**, a former U.S. secretary of labor and a director on the boards of **Harman International Industries**, **Host Hotels & Resorts**, **Kellogg Company**, **Michael Kors** and **Vulcan Materials**.

The self-assessment also typically covers leadership issues, the performance of the executive team, talent and cost management. Korologos says the boards she's familiar with ask the CEO to include a cover letter along with the self-assessment that serves as a more personal letter to the board. The cover letter discusses what could have been done better, or what the executive team hoped to achieve but didn't accomplish.

In addition to keeping the feedback loop running between the board and the CEO, self-assessments provide directors with more insight about the CEO's development as a leader. For instance, directors often praise the fact that CEOs are harder on themselves in their self-assessments than the board is.

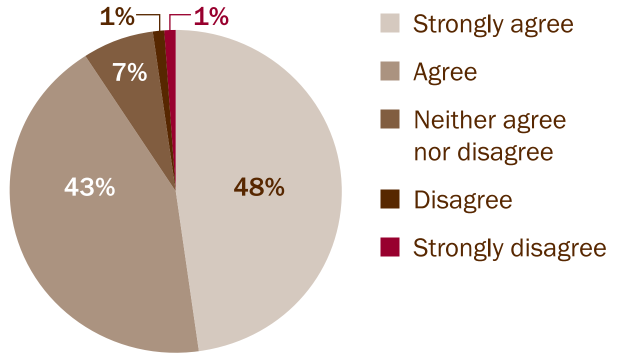
Korologos explains that boards want CEOs to be self-aware and to understand that they're "not king of the mountain" but working on behalf of shareholders and with the guidance and support of the board.

"It's not so much that you want your CEO [to be] humble and therefore he or she is acting appropriately," she says. "You want to know that they have the self-awareness that they're fallible."

Lead Director's Role

The role of the lead director or non-executive chair becomes particularly crucial in pulling together CEOs' assessments of their performance, views from the executive team and sources outside the company and individual directors' views.

Do you agree with the following statement: 'The CEO evaluation process is a meaningful and effective exercise'



Source: Agenda/Hay Group *survey of 147 directors and executives*

Korologos says it requires a combination of diligence in clarifying anything that comes up in executive sessions, while also separating hearsay from fact and thoughtfulness.

Indeed, **James Robinson**, former CEO of **American Express Company** and a former director at **The Coca-Cola Company**, says the lead director or board chair should encourage every member of the board to participate, while not crossing the line from facilitator to "super director."

He notes that problems occur when the board tries to micromanage the CEO or when directors violate the culture of openness that the CEO and board are striving to create.

"If you're going to have transparent and full discussions within the four walls of the boardroom, there better be confidentiality," Robinson says.

Ultimately, directors agree that more sources of information are better than fewer sources, although individual circumstances always dictate how boards present information and how feedback is conveyed.

"The board has to be engaged, supportive and pragmatic," says Robinson. "Challenge when they need to challenge, and never forget the mission of the board is to help the CEO build a hell of a company." ■

Informal continued from page 9

ing in terms of communicating with his board. Beyer says these conversations occur monthly and progress is reported to both the non-executive chairman and the head of the compensation committee.

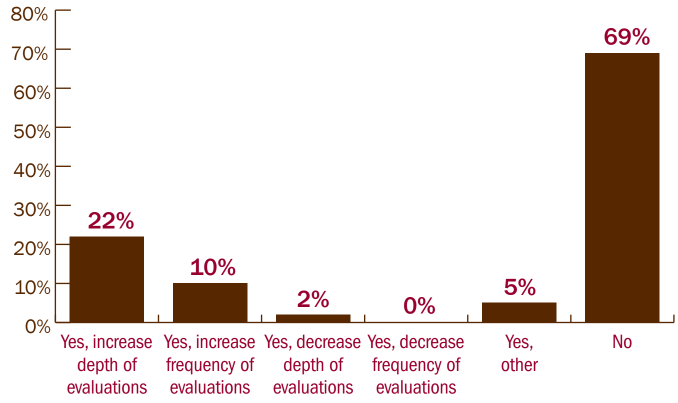
"The company has undergone a major shift in strategy, requiring new skills for the entire leadership team, including the CEO," Beyer says. "The frequency of these coaching conversations reflects the board's intent to help the CEO make the transition to the new vision for the organization."

Jim Bradford, director at **Cracker Barrel Old Country Store** and professor at **Vanderbilt University**'s Owen Graduate School of Management, says that a combination of the annual evaluation and these frequent discussions on performance is a best practice that should be adopted by more companies, not just those facing tricky situations.

"The sessions produce a clear dialogue between the CEO and board," Bradford says. "The best practice is to create a combination of an annual review with a frequent, frank and informal dialogue between CEO and independent directors. The process results in a CEO and board who respect each other's views and opinions and who share a common vision."

Boards should also speak up throughout the year, no matter how inconsequential the issue may seem, director

Do you plan to or would you like to make changes to your CEO performance evaluation in the coming year?



Source: Agenda/*Hay Group survey of 147 directors and executives; respondents could choose more than one option*

Stout adds. "From a board perspective, it shouldn't be silence until that [evaluation] once a year. It's better to be candid and give signals throughout the year," Stout says. "[CEO evaluations] are a big job and they have to be done really well for the best interest of the company and the owners." ■

Entrusted continued from page 11

thor of a particular statement feels comfortable do they discuss the matter in the meeting. "That allows you to not be influenced by what others say in an open meeting," Crawford says.

But Crawford adds that all board members have both the opportunity and obligation to be fully engaged in the process of evaluating the CEO. Crawford says every director's input needs to be sought and then reflected in the final document that goes to the CEO. "I don't think that should be an option," he says. "Sometimes I see in the work that I do, the evaluation can be left up to the committee to provide that back to the director rather than having an active engagement. That's not best practice. But it does happen."

Indeed, search consultant Daniels says that the process of reviewing how well CEOs are executing the corporate strategy never really stops, or even starts, for that matter.

"As a concept, CEO evaluation is a continuous process, not just a formalized event," Daniels says. "After every board meeting, there's typically an executive session both with and without the CEO to talk about issues relative to performance on a real-time basis and [to find] if there are any [other] issues."

As for who delivers the assessment, Daniels recommends that it be a board member "who's thoughtful, deliberative, empathetic but firm. It needs to be someone who's a good listener, who can provide candid and direct feedback in a way that's constructive and leads to better outcomes." That feedback ought to be motivating and rewarding, he says. "But if there is a tough message to be delivered, it needs to be done tactfully and with a game plan." ■