CEO performance reviews that work

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- CEOs' key objectives should include both financial and non-financial indicators, and ongoing communication is critical
- Reviews of CEOs should be critical, but not confrontational
- Provision of feedback is the final vital step and it is important that emotional factors are neutralised

A recent survey of chief executive officer (CEO) turnover in Australia by Booz & Company revealed that 20 per cent of CEO departures in 2011 were due to the board removing the CEO because of 'poor financial performance or irreconcilable differences', while the median tenure in the job for CEOs who departed in the years from 2009 to 2011 was 4.4 years.[1]

The removal of a CEO is costly because of the instability it engenders in the organisation along with any termination payments and costs associated with hiring a new CEO. While this is often a result of poor recruitment, it can also be caused by boards not having established clear expectations for the CEO from the outset or regularly evaluating the CEO's performance.

Boards have solid business reasons for undertaking CEO evaluations. Apart from helping directors to meet their fiduciary responsibilities, CEO evaluations can bring benefits that include:

- aligning the strategic direction set by the board with the CEO's capabilities
- promoting better board and CEO relations to ensure an appropriate and productive collaboration
- allowing boards to have greater objectivity about CEO remuneration
- setting an example of accountability for the organisation as a whole — signalling that performance management is a core culture of the organisation
- encouraging the CEO's personal development
- providing an early warning system for possible problems.

However, there is often a CEO performance evaluation paradox to overcome in reviewing the organisation's top employee.

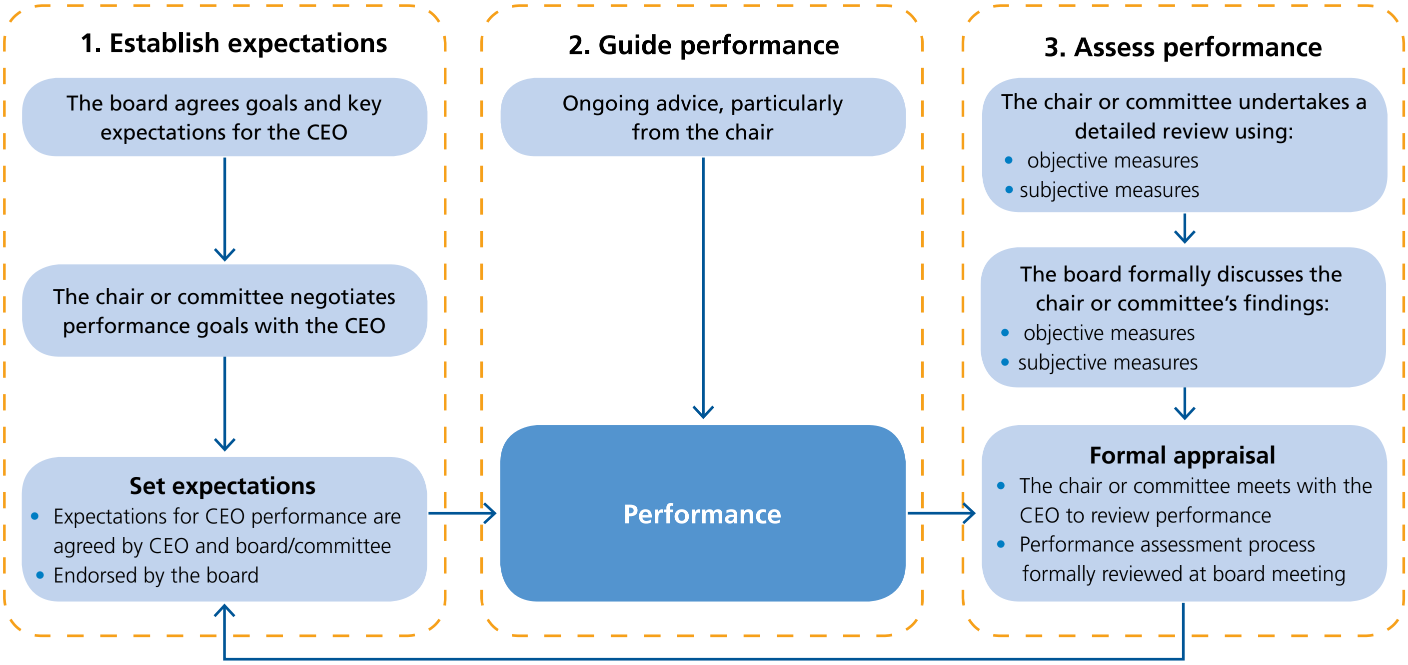
> The more senior the executive, the greater their impact on the organization's performance, the less rigorous the evaluation process. In many companies, front-line supervisors are subjected to yearly painstaking reviews in which they're systematically graded on a detailed set of performance goals. As you go up the ladder, the reviews become more conversational, informal, and sometimes downright perfunctory. [2]

Thus, it is the board's responsibility to ensure that a CEO performance review happens, since the board has the ultimate responsibility for the strategy and performance of an organisation. The board exercises this responsibility through its only employee, the CEO, who is entrusted with the organisation's day-to-day management, within the guidelines and direction set by the board. As such, a unique relationship exists between the CEO and the board, and the evaluation of CEO performance can strengthen or jeopardise this relationship. Therefore, we believe a CEO evaluation process should be built around a number of leading practice principles.

These principles are that any CEO evaluation must:

- align CEO performance with the objectives of the organisation

Figure 1: Generic CEO evaluation cycle[3]



- be based on clear expectations developed and agreed in advance with the CEO
- have a clear, transparent and agreed link between performance outcomes and remuneration
- encourage the CEO to set developmental goals and plans and provide specific direction as necessary from the outcomes of the evaluation process
- be conducted in a manner conducive to ongoing good governance
- be tailored to the specific needs of the organisation and
- comply with relevant standards for accountability and communication of the results for the organisation.

Adopting a more formalised, structured approach to the CEO evaluation gives boards a greater likelihood of not only optimising their relationship with the CEO, but also improving the overall performance of the organisation.

Too often, CEO performance evaluation is limited to judgments regarding an organisation's financial achievements or disappointments of the previous year. While this is important, it is only part of the story. Such a limited view tends to dwell too much on the past, where little can be done to change things. In reality, the most significant effects produced by assessing the CEO should relate to both the organisation's and the CEO's future. Thus, measuring a CEO's abilities to establish strategic direction, build a management team and lead effectively are also critical measures of performance.

It is important to emphasise that, in our opinion, it is both the process and output of CEO evaluations that are important. Any such process needs to be part of an ongoing discussion with the CEO about their performance that uses continual feedback to shape behaviour, with the formal evaluation just one part of a continual process. Similarly, if the board is to harness the advantages of an early warning system provided by the evaluation process, it needs to be monitoring the performance of the CEO on an ongoing basis. Thus, as illustrated in Figure 1, we see CEO evaluation as being part of a continuous cycle.

1. Establish performance expectations.
2. Guide performance.
3. Assess performance.

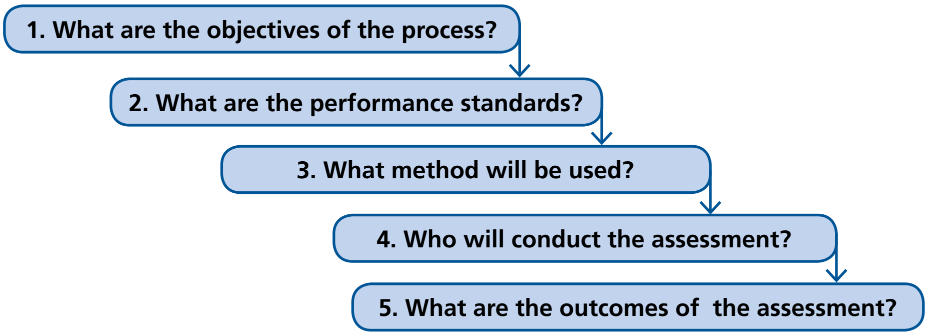
Establishing expectations

Clear expectations form the basis for all good performance relationships. While boards should feel free to develop their own categorisation of expectations — often called key performance areas (KPAs), key results areas (KRAs) or critical performance areas (CPAs) — we find that a holistic evaluation of the CEO's performance will generally include some targets or expectations with respect to:

- leadership and management
- strategy
- working with the board
- financial performance
- human resource management
- personal qualities and
- communication.

Categorisation provides the board with the opportunity to assess the balance of its measures. Are there enough lead indicators to ensure the board will be able to see problems as they emerge

Figure 2: CEO evaluation framework[4]



rather than after they happen? Do the targets balance organisational and personal outcomes for the CEO? And very importantly, do they match the board's objectives for the evaluation process and for the organisation's strategic direction?

A key problem that emerges throughout the discussion of goals is setting an appropriate number of objectives for the CEO. Too few and you risk concentrating on financial goals or one element of the business; too many and you risk the CEO and management team losing focus. Our experience is that between five and ten key objectives is an appropriate balance.

These key objectives should include both financial and non-financial indicators, since financial indicators tell only part of the CEO's performance 'story' and are often lagging indicators of performance.

It is important to remember that the key purpose of any CEO evaluation process should be performance improvement.

Guiding and assessing performance

Meeting expectations, particularly those of the board, remains one of the persistent challenges facing many CEOs. Therefore, once the board and CEO have discussed and set the board's expectations for the CEO's performance including interaction with the board, ongoing communication is critical. At regular intervals, data can be collected to inform the board on the CEO's progress against these objectives.

If the board, preferably through the chair, is able to furnish input to the CEO on their performance on an ongoing basis, the CEO will be able to correct any performance issue midcourse. For example, the board may suggest coaching or mentoring for a new CEO, if aspects of their leadership are found wanting. Also critical are touch points for formal milestones. Formal, annual goal setting and feedback sessions, for example, should be supported by additional formal, semi-annual feedback.

CEO evaluation process

An effective CEO evaluation process is one where performance expectations for the CEO are aligned with the strategy of the organisation. This is more likely to occur if the CEO evaluation process is integrated with the board's strategic planning cycle. It is easier to establish meaningful goals for the CEO's performance when they are considered in the context of goals set for overall corporate performance.

One way of ensuring that strategic planning and the CEO evaluation process are in alignment is to develop board processes that reinforce the relationship. For example, the board calendar is a useful tool for ensuring the two planning processes are aligned. As soon as the strategic plan is agreed, work begins on the development of the CEO evaluation plan. The calendar is also useful for ensuring that the board provides regular feedback to the CEO on their performance so that, by the time the official performance evaluation arrives, there will be no surprises.

A leading practice CEO evaluation process must be tailored to an organisation. There are a number of major decisions required for the CEO evaluation process. In establishing the CEO evaluation process for your organisation, the board, or board committee, should consider the questions asked in Figure 2.

A successful CEO evaluation process will have a number of key traits. It should:

- be critical, but not adversarial
- have both a past and future focus
- provide sufficient mechanisms to bring directors' instincts to the surface
- provide for multiple sources of input
- allow for (re)setting of future CEO goals and
- emphasise the CEO's personal development.

What are the objectives?

The process adopted for a CEO assessment is influenced by what the assessment needs to achieve. It is imperative that the objectives of the assessment are clearly documented to provide a foundation for a shared understanding between the board and CEO of the process itself. The major factors to consider when defining the objectives are:

- how the evaluation will affect CEO remuneration, both base salary and any at-risk component
- the balance between CEO individual development targets and overall organisation goals
- the fit between the CEO's capabilities and the organisation's future needs and
- the required focus on strengthening the board-CEO relationship.

What are the performance standards?

Once a board has determined the focus of the evaluation, it is in a position to agree or review the board's performance expectations (or objectives or targets), if it has not already done so. As discussed, it is not possible to objectively measure CEO performance until a framework against which to evaluate performance has been agreed — what we term 'CEO expectations'. For boards that have never conducted a CEO evaluation previously, this may involve obtaining the views of interested parties apart from the board and CEO (for example, management and key stakeholders), by means of interviews and/or surveys to establish current and future expectations for the CEO's performance.

There are a number of ways in which CEO performance can be measured. A key question for the board is the weighting between organisational and individual objectives (commonly 50/50). In considering the objectives to be evaluated, both outcome measures (result-based) and strategic measures (behaviour-focused) need to be considered.

What method will be used?

For each objective, it is necessary to determine whether it will be measured objectively or subjectively and whether quantitative and/or qualitative data will be used. Subjective measures are subject to the perceptions of those doing the reviewing, whereas objective measures are not subject to those perceptions. Quantitative data uses numbers to measure KPIs, while qualitative data may measure achieving the implementation of an agreed strategy or the views of directors on an aspect of management such as leadership, which might be measured by employee surveys and 360° degree feedback questionnaires completed by the senior management team.

We recommend the methodology include written assessments (including questionnaires that gather quantitative and qualitative data) and discussions. There should be agreement in advance on how the differences of views between the directors on both quantitative and qualitative goals/targets are to be moderated. The key is to ensure the results accurately reflect the board's (collective) view. Consensus should be the aim and other mechanisms, such as calculating averages or means, should be used only as a last resort.

In addition, as another objective of the CEO assessment process should be to supply feedback for the CEO to assist in their personal growth and development, the rationale for giving a particular rating should be provided through the gathering of qualitative data.

Who will conduct the assessment?

Traditionally, the CEO assessment has been carried out by a small group of directors, usually as a committee, or an individual (often the chair). For example, the chair may canvass directors for their views on CEO performance. This method has the advantage of providing an informal and potentially more open discussion, but it also means that all discussions may be coloured by the chair's perspective. Similarly, it will not be practicable in situations where one person fills both the CEO and the chair roles.

Another method is to delegate the role to an appropriate committee such as the nomination committee. The committee can then meet to review and synthesise its findings before formal discussion at a board meeting. This process retains the informality of the previous approach, with the added advantage of sharing the task among several people, which reduces the potential for bias and the workload.

Some boards, especially where there are more emotional and subjective influences, may find a structured process more useful, and the use of governance consultants with expertise in CEO assessments should also be considered due the complexities of such processes. Using an independent third-party consultant who collects confidential data allows for a greater degree of confidentiality than where the process is conducted internally. Under this scenario, directors — and in some cases senior managers — will complete questionnaires and participate in one-on-one interviews with the consultant relating to the performance of the CEO.

In determining who will conduct the CEO's assessment, key considerations are that:

- the smaller the group, the greater the potential for bias — it is safer to err on the side of more rather than less board involvement
- the CEO reports to the whole board, not to an individual director. The whole board should have an opportunity to comment at some point.
- the assessors should be permitted to meet both independently of the CEO and with the CEO.

Since the CEO reports to the board as a whole, we recommend that all directors should be involved, at least in agreeing the total process and a full board discussion of the evaluation prior to communicating the results to the CEO.

What are the outcomes?

There is substantial variation in CEO evaluation processes and approaches, spanning open-ended questions, rating scales, self-evaluations and interviews.[5]

Meeting expectations, particularly those of the board, remains one of the persistent challenges facing many CEOs.

The outcomes of the CEO evaluation process can be to:

- determine overall performance for the previous 12 months
- assist in determining remuneration levels for the next 12 months
- assist in determining the amount of performance bonus and
- enhance the CEO's performance through personal development.

Determining overall performance forms the foundation for the other outcomes of the evaluation. It is critical the board reach a consensus on the overall performance of the CEO. This is obviously best done in a closed forum without the CEO (or other managers) present and may be a separate meeting either prior to, or following, a formal board meeting or a 'directors' only' section of a regular board meeting.

Apart from the evaluation of the CEO's performance over a 12-month period, an annual CEO remuneration review may also take into consideration:

- movements in the consumer price index (CPI) and
- current market rates of pay for CEOs in similar jobs.

In deciding on any changes to the CEO's pay, boards can seek guidance from external advisers — chiefly specialist remuneration consultants, but also legal or taxation advisers. In reviewing the CEO's remuneration, these consultants will compare the CEO's pay with positions of similar scope and responsibility (generally meaning businesses in the same or a similar industry), of similar size and complexity.

The true value of a CEO evaluation is not in the individual's ratings or scores, but in the opportunity it provides for the CEO to enhance their performance through ongoing personal development. In general, the CEO's personal development plan (PDP) should:

- reflect the individual's personal aspirations
- be based on development objectives for the next 12 months
- have the commitment of the board and
- be properly resourced.

The CEO's PDP should highlight the particular learning needs of the individual as the top manager in the organisation. The plan could include, for example:

- counselling or coaching
- emotional intelligence program
- mentoring or
- further education/management development program.

Debriefing the CEO

The CEO feedback process belongs to the entire board and all should be involved; it is not a chair's or a committee's responsibility. However, an initial briefing from the chair and another non-executive director or external adviser will give the CEO time to formulate a response to the full board on the evaluation findings.

One of the primary inhibitors of candid feedback on performance is the emotional element of these processes. One way to overcome this hurdle is to design a system that allows for a less formal and more considered approach to providing the feedback. Again, we cannot reiterate enough that a process or procedure is no substitute for a good working relationship between the board and the CEO.

However, there are some guidelines for delivering the feedback that may make the task easier. Charan recommends a two-step approach.[6]

1. The first stage involves two directors discussing the feedback with the CEO in private. This allows the CEO to absorb and respond to the review in a less threatening or pressured environment. The presence of a second director is useful because it ensures that the feedback is communicated clearly and limits the possibility of any one director's personality clouding the process.
2. The second stage in the process involves a repeat and elaboration of

the feedback in a full board meeting. This provides a forum for the CEO to respond to all directors as well as to ensure that the information communicated in the first stage was accurate.

We will leave you with a quote from one chair whose board and CEO went through an evaluation process we facilitated. Prior to the review, the relationship between the board and management verged on dysfunctional, and the CEO in question had not had a formal evaluation for a number of years. Worse still, the CEO failed to recognise that he was not meeting the board's performance expectations. Upon receiving feedback from the chair and an external adviser, the CEO quickly adjusted his approach to leadership and governance. The chair subsequently commented to us that, 'The process reinvigorated our CEO, we literally have a new CEO in attitude and approach — an excellent outcome'.

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Notes

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3 Adapted from Kiel G, Nicholson G, Tunny JA and Beck J, 2012, *Directors at Work: A Practical Guide for Boards*, Thomson Reuters, Sydney, p 314
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5 Kiel GC, Nicholson GJ and Barclay MA, 2005, *Board, Director and CEO Evaluation*, McGraw-Hill, Sydney
6 Charan R, 1998, *Boards at Work: How Corporate Boards Create Competitive Advantage*, Jossey-Bass, San Francisco