KORN/FERRY INTERNATIONAL

# BOARD MEETING IN SESSION

# Evaluating the Chief Executive Officer

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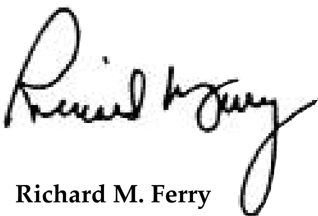
*There has been a significant increase in the number of boards tha formally evaluating their chief executives. Almost 70 percent of companies in Korn/Ferry's latest* Annual Board of Directors Study *report that they have a formal CEO evaluation in place.*

*This study summarizes current best practices in the formal evaluation of CEOs in America's large publicly held corporations. It provides a step-by-step guide on how to set up a well-functioning CEO evaluation process, including sample performance targets and appraisal forms. For the growing number of companies that already have a formal CEO evaluation in place, the study serves as a useful benchmark for comparing their process with the practices of leading companies.*

*The project is a partnership between Korn/Ferry International and two research centers at University of Southern California's Marshall School of Business: Center for Effective Organizations and The Leadership Institute. The report is based on the results of a major study of the factors that contribute to effective corporate governance and a decade of research on the performance appraisal process, including recent interviews with a dozen companies that have been leaders in developing new corporate governance practices.*



**Richard M. Ferry**
*Chairman*

## The Growth in CEO Evaluations

The growing use of CEO evaluations can be linked to pressure from both within the company and outside:

- ***Internal company pressure.*** Organizations have become far more sophisticated about their performance management systems over the past decade. There has been a dramatic increase, for example, in the use of 360-degree feedback and pay for performance at all levels of the organization. As these practices have spread, it is much more difficult to justify why the company's most important employee—the chief executive—should not also be subject to a formal evaluation, particularly when research suggests that including the CEO in the process can have a critical influence on the overall effectiveness of the appraisal system.
- ***External pressure.*** The growth in shareholder activism and a related increase in attention to effective board governance practices have also encouraged many companies to adopt a more formal evaluation of CEO performance. This has intensified with the waves of publicity surrounding chief executive compensation; the greater focus on the governance information included in proxy statements; and the media spotlight on the firings of CEOs at large companies.

## Why Do It? The Benefits of a CEO Evaluation

Introducing a careful CEO evaluation process demands considerable effort from both the chief executive and the board. In all of the companies we studied, however, the process has produced benefits that clearly justify the investment. Below are the top 10 positive results that CEOs and board members point to:

1. ***Clearer strategic objectives.*** Specifying a set of strategic targets at the beginning of the year, along with quantifiable measures for each, helps focus the CEO and board on key objectives.

2. ***Improved communications.*** The process of establishing these targets encourages increased dialogue between the CEO and board about long-term strategy. The targets also provide a means of communicating concrete objectives to the top management team. Few boards, however, take the opportunity to share these objectives with outside stakeholders.
3. ***Increased board independence.*** The formal evaluation reinforces the proper power balance between the CEO and the board, helping establish the board's independence and influence over the executive compensation process and the CEO.
4. ***Improved pay-for-performance decisions.*** Establishing well-defined targets makes administering CEO pay easier and more objective. It provides a basis for salary and bonus decisions, eliminating debates about how performance should be measured and what the CEO contributed.
5. ***Greater focus on the long term.*** All the board members we interviewed agree that one of their greatest needs is to devote more time and attention to long-term strategy and organizational capabilities and to focus more on the nonfinancial aspects of CEO performance. Progress in these areas is measured most effectively by using a formal appraisal process.
6. ***Enhanced feedback to the CEO.*** Without a formal evaluation, the CEO often receives very little candid feedback on performance. The evaluation process ensures that, at least once a year, all board members have the opportunity to provide this feedback, in addition to the more informal contacts that inevitably occur.
7. ***Better early warning system.*** By measuring performance against set targets, boards can better anticipate problems, often before they impact the financial results. Where a CEO is consistently underperforming as compared to peers and the targets that have been set, the evaluation process can provide concrete support for helping make the difficult decision to change the chief executive.
8. ***Improved board operations.*** By including the CEO's role as chairman (where appropriate) in the evaluation process, many companies have surfaced useful suggestions—such as changing the agenda for board

meetings or creating special sessions on long-term strategy—that help improve the way the board operates.

9. ***Increased accountability.*** With formal, mutually agreed-on targets in place, both the chief executive and the board know what specific objectives they must meet—so that changes in circumstances have less weight.
10. ***An institutionalized process.*** Typically, CEOs who take the initiative to put a formal evaluation process in place are already scoring well on other dimensions of board effectiveness. Once the process has been established, however, a company is more likely to continue the evaluations long term; they will have become part of the ongoing corporate culture.

## A Step-by-Step Guide to CEO Evaluation

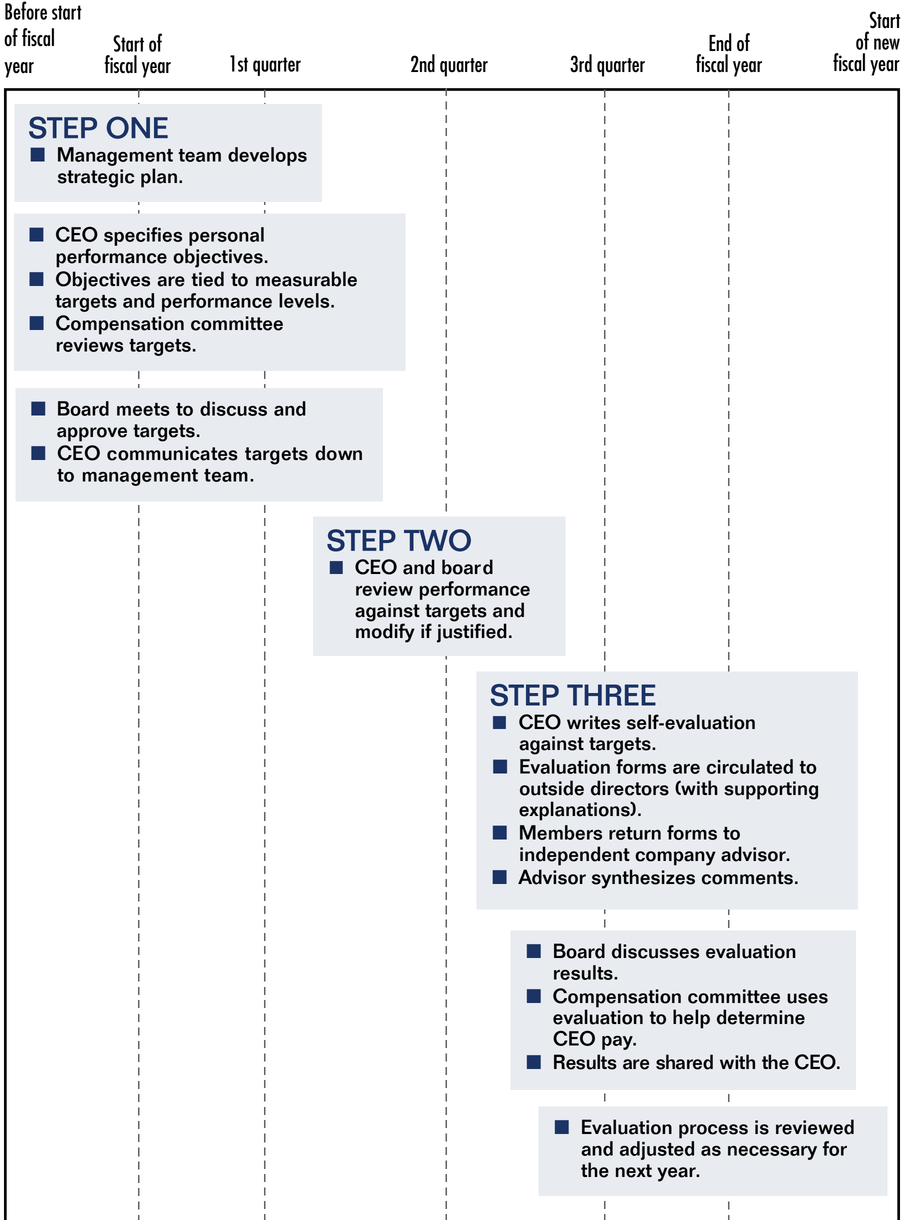
The key to successfully evaluating CEO performance is establishing the right appraisal process. All too often, companies assume that they can just follow a generic form. Agood form is important, but it must be tailored to the needs of each company—and should be the outcome of a carefully designed appraisal process. Here we describe the three key steps in this process—defining the CEO's objectives, mid-year review and year-end assessment—and provide a timeline *(see page 9)* showing how these steps fall in the annual cycle of board operations.

### Step One: Defining the CEO's Objectives

Before the start of the fiscal year, the top management team works with the board to develop a strategic plan and key long- and short-term business objectives for the coming year. Once the company's strategy has been defined, the CEO uses it to formulate a set of personal performance targets, specifying how progress against each one will be measured.

The CEO then gives the proposed targets to a committee of the board—normally compensation or board governance. The external directors of the committee review and, if needed, amend these targets. They are then presented to the board for discussion and final approval. Once the CEO's targets have been set, they can be communicated down through the

## CEO Evaluation Timeline



organization to ensure that other managers' objectives are aligned with the corporate strategy (*see appendix for a sample form*).

## Step Two: Mid-Year Review

Mid-year review 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. Although many of the boards we studied skip this step or do it informally, we believe some form of mid-year review is essential if the process is to remain well integrated with the business objectives. And, in some cases, CEOs may want to propose that targets be modified in light of new

### Setting the Right Objectives

The specific list of CEO performance objectives will vary for each company, but there are some general rules that leading companies follow in setting performance targets:

- ***Go beyond financial operating performance.*** Many large companies already have a well-established process for linking CEO compensation to achieving clearly specified annual operating objectives and stock market performance. Hitting these targets, however, is only one part of the chief executive's job. The CEO evaluation process should include—plus go beyond—these short-term objectives to capture longer range targets and nonfinancial measures of performance.
- ***Focus on a manageable number of objectives.*** It is important to get the number of targets right: too few, and the process is likely to be dominated by short-term financial indicators; too many, and the CEO and the management team risk losing focus, as the weight attached to any one target is diluted. The companies included in our case studies generally set between five and 10 targets each year.
- ***Include separate targets for chairman and CEO performance (where appropriate).*** In over 80 percent of large U.S. corporations, the same

circumstances. For example, in rapidly changing businesses, such as high tech, more frequent checks against the targets will be essential.

## Step Three: Year-End Assessment

The final stage of the evaluation occurs at the end of the fiscal year, when actual performance is measured against the objectives. As with the start of the year, this process should begin with the CEO's self-evaluation, including explanations for under-performance. This should then be circulated to all external directors, along with a guide for assessing the CEO's performance overall and against each of the key objectives.

individual serves as chairman and CEO. It is vital to ensure that both of these roles are adequately covered in the evaluation process. Companies that also have instituted a formal board evaluation will often include the assessment of the chairman as part of that. In companies that don't have a board evaluation, the appraisal of the chief executive should include separate sections on the CEO's and chairman's responsibilities.

- ***Define measures for each target.*** For performance objectives that are not financial, it is still possible to establish concrete measures that indicate whether the CEO has met the target. A company focused on improving product quality, for example, can measure internal and external reject rates and customer perceptions of the quality of goods delivered. Internal employee surveys can also be used to measure progress against such goals as improving diversity or trust within the organization, or changing the corporate culture.
- ***Specify performance levels for each rating measure.*** In the process of defining measures, it is useful to identify in advance what constitutes poor, acceptable and outstanding levels of performance. This is particularly important if pay decisions are linked to the CEO evaluation.

These evaluation forms can follow several options for each performance dimension—open-ended questions to very detailed breakdowns (*see box below for examples*). It is usually best for directors to provide their assessments to an independent company advisor (e.g., the outside legal counsel), who compiles and summarizes the comments so that the anonymity of individual directors is preserved.

Once these evaluations have been summarized, the compensation committee should use the results to determine the portion of the CEO's pay that is linked

## Rating CEO Performance: Three Options for Getting Director Feedback

*The forms that companies provide each outside director to rate the CEO's performance vary from general to specific. Below are three possible approaches a company can follow. Whatever method is ultimately adopted, the board must feel comfortable with the chosen format. In all cases, each board member should have a description of the CEO's main roles and responsibilities, along with the CEO's targets and self-assessment against these targets. Directors should also receive additional data relating to CEO or company performance from within and outside the company.*

- ***Open-ended***. Ask each member to rate the CEO's performance as chief executive and chairman (if relevant) on a 1-to-10 scale, explaining the rating and identifying any development needs. Comments can be made in writing or by phone.
- ***Semi-structured.*** Identify the five to 10 main areas of CEO performance, describing each briefly. Ask directors to rate the CEO along each of these dimensions, using a three-point scale, and provide a reason for their assessment. For example:

to performance. These recommendations and the results of the evaluation process should be discussed by the board, without the CEO or other inside directors present. The final step is for the CEO to receive the feedback.

The appraisal process is repeated the following year with a new set of targets. Ideally, the committee responsible for corporate governance will also periodically review the evaluation process itself and seek ways to improve it.

*Strategic planning and implementation.* Develops and executes a long-term strategy that meets the needs of all key stakeholders; implements the plan on schedule; provides clear, adequate information to the board on progress against the plan.

1 = Below expectations, 2 = Meets expectations, 3 = Exceeds expectations

***Comments:***

________________________________________

________________________________________

| **CEO Role as Chairman of the Board** | **Strongly Disagree** | | | | **Strongly Agree** |
|---|---|---|---|---|---|
| Actively solicits views of all directors | 1 | 2 | 3 | 4 | 5 |
| Provides clear, concise information in advance of meetings | 1 | 2 | 3 | 4 | 5 |
| Spends sufficient time in meetings on long-term strategy | 1 | 2 | 3 | 4 | 5 |
| Seeks outside directors' input to help shape meeting agenda | 1 | 2 | 3 | 4 | 5 |

## Key Questions About CEO Evaluations

While the use of formal CEO performance evaluations is growing rapidly among large corporations and has received near universal acceptance by both the board members and the chief executives we interviewed, there are many unresolved questions.

### *How will CEO evaluations work when performance is poor?*

Most companies have instituted a formal CEO evaluation process in the 1990s, when corporate profits and stock market performance have been very healthy. This may be one reason why we found a very positive reaction from both CEOs and board members to the assessment process, in contrast with the less favorable views that research has generally found about performance appraisal systems of other employees. It remains to be seen how well accepted and effective the evaluation process will be in years when CEOs fail to meet their performance objectives.

### *How much credit or blame should the CEO receive for corporate performance?*

The implicit assumption running through the entire evaluation process is that the performance of chief executives and their corporations is synonymous. While the two are obviously closely related, the evaluation process should try, wherever possible, to separate the two, focusing on behaviors and areas where the CEO has the most direct control. The process should also recognize changes in the industry and economy, so that CEOs are not unfairly punished for economic downturns, nor over-compensated when a buoyant market "lifts all boats."

### *Does the board receive adequate independent information?*

One potential flaw in many of the evaluation processes we studied is that board members rely heavily on information provided by the company, in particular the CEO's self-evaluation, to make their performance assessments. While a self-assessment is a vital element of any good performance appraisal, it

should be balanced by other sources of information—such as ratings from customers, institutional investors and employees, plus benchmarking performance against leaders inside and outside the industry.

### *Are the CEO and board members committed to the process?*

Ultimately, the success of the formal evaluation process depends on the full commitment of both the board and the CEO. CEOs need to demonstrate their receptiveness to the process by displaying a willingness both to receive candid, constructive feedback from their directors and to act on it. Independent board members must take the lead in running the process to ensure its credibility—and be willing to enforce the results.

### *How closely should performance evaluation be tied to CEO pay?*

In some companies, there is a very precisely defined formula, specifying how much of the CEO's compensation will be determined by the evaluation and how much weight will be assigned to each target. In other organizations, a portion of the CEO's bonus is tied to performance evaluation, but the link is more subjective, based on the overall assessment of CEO performance by the board. Still other companies elect to separate the CEO evaluation process completely from compensation, tying rewards instead to hard financial indicators. The approach a company adopts should be closely linked to the purposes of the evaluation. If it is seen as an integral part of pay-for-performance, then the first or second method may be most appropriate. If it is intended primarily as a means of fostering CEO development and improving the operations of the board, the last option may make more sense.

### *Does the process continue to justify the time involved?*

One of the major constraints that all corporate boards face is how to find the time needed to monitor short-term financial performance, to shape long-term strategy and to fulfill the many other duties of the board. A well-designed CEO evaluation can help achieve all these missions, but the process should be carefully monitored to ensure that it does not become stale and unproductive.

# Appendix

## Sample CEO Performance Targets and Ratings

The board should identify six to 10 categories that it views as critical to the CEO's role and performance and focus the evaluation on these areas. Below are samples of these categories culled from the CEO evaluation process in leading companies, an example of an objective under each category and ratings to measure performance against that objective. In addition to the more qualitative objectives listed here, the CEO should be evaluated and rewarded based on specific financial indicators.

# Long-Term Strategy

## Objective

To regain the number one position in the company's core market.

## Measurement

*Outstanding*—By December 31, 200X, overtake the industry leader, Company Y, to become the number one seller of widgets with at least 25 percent of the total market.

*Satisfactory*—Match Company Y's sales with 22 percent to 24 percent of the core market.

*Needs improvement*—Fail to increase market share in core market above 20 percent.

## Comments:

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## Strategy Implementation

### Objective

To complete the development of crucial new Product X slated for release in 200X on time and on budget.

### Measurement

*Outstanding*—Complete Phase 1 of the development cycle ahead of schedule (December 1, 200X) and below the project budget of $230 million.

*Satisfactory*—Complete Phase 1 of project on time and on budget, demonstrating the prototype meets all crucial performance specifications.

*Needs improvement*—Fail to meet budget, performance or schedule targets (explain to board reasons for failure and any corrective steps that have been taken).

### Comments:

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## Leadership/Corporate Culture

### Objective

To increase the diversity of the executive team and the board.

### Measurement

*Outstanding*—Within three years, increase the percentage of women, minorities and foreign nationals in position of Vice President or above by at least 15 percent. Will have improved the board's global expertise by adding at least one board member with substantial experience in the Asian market.

*Satisfactory*—Increase the percentage of women, minorities and foreign nationals on the top management team by 10 percent to 14 percent. Will have added an Asian expert to the board.

*Needs improvement*—Fail to meet the 10 percent target for greater top management team diversity or fail to recruit an Asian expert to the board.

### Comments:

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## Succession Planning

### Objective

To ensure that a successor has been identified to become CEO and has been named President by July 1, 200X, so that individuals can be ready when the current CEO is scheduled to retire on January 1, 200X. Activities to achieve this goal should include:

- Ensuring that all five candidates on the current short list from the executive team brief the board at least once during the fiscal year.
- Gathering extensive 360-degree feedback data on all candidates and identifying any areas for improvement, particularly with regard to leadership skills.
- Setting stretch assignments for each candidate and carefully tracking their progress against these objectives.
- Conducting a search of possible outside candidates to ensure that a member of the internal team is indeed best qualified to run the company.

### Measurement

*Outstanding*—Perform all of the above tasks, identifying a clear front runner to become CEO.

*Satisfactory*—Perform most of the above tasks, narrowing the list of potential candidates.

*Needs improvement*—Fail to perform the above tasks or to help develop a successor.

### Comments:

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## Personal Development

In the next year, what one or two areas should be the focus for the CEO's personal development efforts?

### Comments:

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