

# DIRECTORS & BOARDS

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## Assessing CEO Performance: It Goes Beyond the Numbers

by Seymour J. Burchman and Craig E. Schneier

It happens all too often. A major corporation experiences a record year in earnings. Sales are up too. And when it is time to tell the CEO "how he's doing," the compensation committee of the board of directors usually pats him on the back and rewards him with a handsome bonus and thousands of stock options.

Obviously, the CEO did an excellent job. Or did he? And, if earnings dropped, did the CEO do an unacceptable job, warranting withholding the pat on the back, and the stock options too?

Given the ever-changing business environment in which we live, the CEO's job has become increasingly complex. With LBOs, spin-offs, mergers and acquisitions, and increased foreign competition, today's CEOs must be financial wizards, strategic thinkers, and, most of all, effective leaders.

The challenge facing boards today goes beyond selecting the right CEO. Boards must know how to determine whether it is the CEO who is per-

forming well, not just whether the corporation is meeting financial targets, and be prepared to discuss performance and future development needs with him. When the task is discussing less than stellar individual performance, most boards fall short.

By their own admission, many compensation committee members agree that measuring a CEO's ability to establish strategic direction, build a management team, and lead is more critical than certain quantitative measures, particularly in the long run. Yet, most boards still rely solely on the corporation's financial performance rather than attempting to evaluate a CEO's individual performance.

Most boards have a difficult time with measuring *qualitative* performance. First of all, they are reluctant to confront the CEO about qualitative performance. The CEO is usually a power on the board. In many companies, the CEO is also the chairman and may have "handpicked" the directors. Telling the guy who gave you a directorship that he's not a leader is a challenge most directors would prefer to forgo.

Second, many directors are CEOs themselves and they empathize with the demands put upon the CEO. It is difficult for them to define and evaluate leadership. It is easier to analyze

the financials. Poor performance is more obvious when the numbers are bad.

Directors also may be wary of tarnishing with success, particularly if the company has been experiencing strong financial health. While the CEO may lack certain leadership qualities, he must be doing something right, and that something *is* important after all. Providing constructive feedback in this case is too close to criticism in many directors' eyes — criticism they believe is not justified if the financials are sound.

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### What to judge?

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Finally, directors face the dilemma of what to judge. It is hard to develop a data base for qualitative performance. Subjective measures are tough to define, behavior is difficult to capture. An added problem is who can supply nonfinancial performance data. An obvious source — those who report directly to the CEO — may be just as hesitant to get involved as the directors. Unless the company endorses and practices highly participative management, few people will be forthcoming with a surfeit of information on the CEO's developmental needs.

Effective CEO performance appraisal starts with the board's com-

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mitment. It also requires a well-designed system and a clear implementation plan. Implementation is where the system, regardless of elegance in design, succeeds, or fails. If the board is unwilling to accept its responsibility to set clear expectations, gather data, judge, and feed back results, the system becomes simply an exercise in paperwork. Worse, those at the top send a clear signal that accountability for performance is shaky.

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## Six key steps

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Designing an effective CEO performance appraisal system includes *six* key steps.

**Select Measures and Indicators.** CEO performance can be measured across two broad dimensions. The first is how well the company, for which the CEO is ultimately responsible, performs financially, strategically, and in the stock market. Obviously, factors (e.g., currency fluctuations) beyond the CEO's control affect performance here. The second is how well the CEO performs as a leader and manager.

This second dimension addresses

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### Exhibit 1: CEO Performance Assessment

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Below is a sample of performance areas that can be the basis for assessing the CEO's personal strengths and weaknesses.

- Provides leadership
  - Provides strategic direction
  - Proactively manages change
  - Organizes, develops, and utilizes management team
  - Creates an appropriate organization environment
  - Provides effective external representation
  - Monitors and evaluates company performance and takes corrective action
  - Maintains positive relationship with board of directors
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the CEO's own major individual responsibilities for improving company performance and represents that aspect of performance within his control. As an example, eight of these performance areas are presented in exhibit 1. These performance areas become the basis for assessing the CEO's personal strengths and weaknesses and provide a framework for the board to provide constructive performance feedback.

But how can leadership, for example, actually be measured? Each performance area should contain "elements of accountability," which define the specific accountabilities within each broad area of CEO responsibility. The performance areas and elements of accountability should be affirmed (or reaffirmed) by the board and CEO prior to the start of each year.

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### Specific 'indicators'

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To make measurement less subjective, the board and CEO should also agree on the specific "indicators" of performance in each area. (More than one indicator may be developed in each area of responsibility.) These indicators can be either quantitative measures (e.g., results of employee surveys) or observable qualitative evidence (e.g., observations of the CEO's behavior in presentations to financial analysts). Indicators clearly define performance expectations up front and provide the facts needed to accurately appraise performance at year end. Of course, the board will still need to exercise considerable judgment in applying these facts.

Some companies prefer to use a rating scale to evaluate the CEO for each performance area. Such scales should contain few levels. "Needs Improvement," "Meets Expectations," and "Exceeds Expectations" are sufficient. The purpose is to provide feedback on strengths and developmental needs, not rank order or to compare the CEO with others.

Elements of accountability and illustrative indicators for one performance measure are provided in exhibit 2.

**Identify Resources and Mechanisms.** In order to evaluate the CEO's success in each performance area, the board must determine the resources necessary to gather data and the mechanisms it will use.

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### Relevant data sources

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The most effective systems rely on data from many relevant sources. The board should attempt to gather data in a systematic manner. Random comments, overheard conversations, and infrequent observations will provide a weak case if a CEO must be confronted with poor performance.

If the board decides to measure, for example, a CEO's leadership style, directors' perceptions, based on their observations, are useful. But they should be augmented by data gathered via surveys, interviews, and/or focus group discussions among those reporting to the CEO, employees at lower levels, customers, suppliers, or even other directors, particularly inside directors. In addition, reviewing plans, policies, and reports can be helpful. The key is to gather enough data to rule out bias or overemphasis (positive or negative) on a single event. Surveys can help to take the pulse of an organization, particularly when strategy changes have necessitated a revision in shared values or managerial style.

**Determine Relative Importance of Measures.** Certainly only the few, salient aspects of CEO performance are included in the appraisal system. Yet, among this *small* group there may be relative priorities. The relative importance of the financial to nonfinancial performance measures must be determined at the outset.

A few boards count both financial and nonfinancial almost equally. Most, however, use nonfinancial measures to "modify" the appraisal of financial

measures. This is consistent with the notion, espoused here, that financial measures are necessary but not sufficient to describe, and hence to assess, CEO performance.

One CEO of a large consumer goods company met financial targets, but failed for the second year to develop a viable top management decisionmaking team, choose a successor, or deal effectively with the press. What judgment should the board reach about this CEO's performance? If the nonfinancial aspects of performance were deemed important by the board, and their importance was communicated to the CEO, the board must judge this CEO's individual performance as only adequate, perhaps

even marginal.

Whatever the relative emphasis of the measures, there should be no mathematical system, no computed weights. This would add unnecessary complexity. The critical point is setting and communicating relative priorities, not agreeing on a numerical or percentage weight.

**Provide for Changes in Priorities.** No CEO appraisal plan, no matter how detailed, will survive a year intact. Internal and external events are too numerous, complex, and unpredictable. The measures, the indicators, and the targets may change. Certainly, the relative importance attached to various measures may require revision. Periodic reviews, per-

haps twice a year, can be helpful to reorder priorities. If takeover becomes a threat, if a new tax law is enacted, if an acquisition suddenly presents itself, or if financial conditions change appreciably, so must the rules of the CEO appraisal game.

In a mature durable goods company, the CEO was told to look for acquisitions that would complement the company's strong national brand awareness. Halfway through the year, a proposed hostile takeover loomed. The acquisition goal was shelved in favor of a stock buyback plan and a search for a "white knight." A key nonfinancial performance measure for the CEO became his ability to negotiate effectively with other

## Exhibit 2: Elements of Accountability and Performance Indicators\*

Element of Accountability	Performance Indicators
Establishes, evaluates, and, as necessary, changes the management structure to improve organizational effectiveness and efficiency.	Ratio of overhead to operational costs is better than industry norms. Number of management layers is below industry norms. Management structure supports business strategy.
Attracts, selects, grows, and keeps the best available management talent.	Voluntary management turnover is below industry norms. Quality of management team, as reflected through appraisal process and financial/nonfinancial results for each business unit, consistently exceeds standards. When necessary to recruit from the outside, company is consistently able to hire leading candidates for open positions. Management development plans are in place and being executed for all management positions.
Ensures continuity in the management team through appropriate succession plans.	Management succession plans are in place for all key executive positions. Company is able to fill key positions with quality candidates from within the organization.
Successfully utilizes the management team through effective and appropriate delegation and empowerment and involvement in overall corporate decisionmaking.	Decisionmaking roles for key decisions have been clearly articulated in writing to executives. Decisions are made at the lowest possible organizational level without sacrificing corporate interests (e.g., as evidenced by the decisionmaking roles described above and a retrospective analysis of key decisions made during the prior year). Senior executives actively participate in corporate decisionmaking (e.g., as evidenced retrospectively by the degree of involvement of senior executives in key corporate decisions during the prior year).
Stimulates collaboration and cooperation among members of the management team.	Potential synergies among business units have been clearly identified and exploited (e.g., joint strategies have been developed among two or more business units). Where feasible, resources are consistently shared among business units; management succession plans cut across business unit lines; where feasible, duplicative systems have been eliminated; cross-selling is the norm, rather than the exception.
Sets clear performance expectations for the management team, provides appropriate feedback and coaching, and acts decisively to terminate executives who do not meet standards.	A performance management system is in place for senior executives that establishes performance expectations in writing and formal feedback at least once per year on a timely basis (results of which are transmitted to the board). Nonperforming executives have been terminated.

\*For the performance assessment area, "Organizes, Develops, and Utilizes Management Team" (see Exhibit 1), this is an illustration of elements of accountability and performance indicators.

CEOs, who could become “white knights” and position the company as a solid, long-term performer in the financial community.

**Determine Uses of Results.** To make any attempt at CEO appraisal effective, the results of the appraisal must be linked to consequences. For the CEO, these consequences are largely financial, but, of course, could include continued employment in the most severe cases. The objectives of a CEO appraisal system are not only to hold the CEO accountable for individual performance but also to foster a better working relationship between the CEO and the board, focus the CEO’s attention on those key financial and nonfinancial areas that will facilitate strategy implementation, and help enhance the CEO’s ability to lead the company.

The formal assessment of nonfinancial measures should be undertaken each year by the board and feedback should be given to the CEO. In those areas where improvement is needed, a goal, complete with target and indicators, can be established for the subsequent year. The attainment of this goal, along with any others, both financial and nonfinancial, should have an impact on CEO compensation.

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#### The board’s goal

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One CEO of a financial services company was found to have problems with delegating authority, even to business unit heads. Consequently, implementation of strategy suffered. The strategy called for the positioning of its different units to provide services to specific markets. To do so, business unit heads had to understand and respond quickly to changes in those markets. By requiring all decisions to be pushed to the top, time and market share were lost in two business units. The board set a goal for the following year that required the CEO to develop and implement a plan for revising the decisionmaking process and delegating certain mar-

keting decisions to business unit heads. After one year, the board did not feel, based on data gathered in a systematic fashion, that the CEO made significant progress in this area. The CEO’s annual incentive was decreased even though short-term financial targets were met. If the board feels a measure is important enough to include in a CEO’s goals, it is important enough to have a bearing on compensation.

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#### Forced interaction

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**Communicate.** The importance of reaching an understanding between the board and CEO regarding performance measurement cannot be overstated. Telling a CEO how he or she will be appraised and providing a realistic assessment is vital. In fact, developing a CEO appraisal system forces the board and the CEO to interact frequently and discuss issues that are often controversial.

The dynamics of CEO-board communications reflect relative power, personal style, competence, and a company’s culture. The operation of any CEO appraisal system may challenge all of these. Today’s competitive environment requires that this challenge be met if a board and its CEOs are to become a team.

Once the system has been designed, successful implementation can be carried out in four steps:

**Determine Timing.** Ideally, a CEO appraisal system begins with the appointment of the CEO. Changing the rules of the appraisal game for an incumbent CEO can be difficult. Yet, steps can be taken prior to the start of the fiscal year that begin to address the issue of an incumbent CEO’s appraisal. If problems are anticipated, the board should ask the CEO for input in preparing an approach to appraisal.

Boards often take the initiative to implement a CEO appraisal program as a result of a shift in strategy, competitive environment, growth, or

some other significant event. Beginning to address CEO appraisal when performance is good is of course the best case scenario. But putting off this task, especially when performance is a problem, will only worsen the situation when and if decisive action must be taken.

**Determine Roles/Responsibilities.** Directors who will take primary responsibility for the appraisal process must be identified. Typically, this is the compensation committee. But roles for other relevant parties exist (see exhibit 3 for general guidelines). Above all, only those with relevant data should participate in the process. The roles must be spelled out in advance of the system’s implementation. The normal operation of the board and its key committees will determine how much participation, if any, each director will have.

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#### Speaking with one voice

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It is important that all those on the board who participate speak with one voice. Disagreements over how high to set targets or how well a CEO performed must be resolved prior to providing the CEO with feedback. The often delicate process of reviewing performance with the CEO should be done by two board members.

**Determine Relationship to Other Systems.** As the CEO appraisal system is implemented, its impact on CEO compensation, and on other systems such as strategic planning and CEO succession, must be determined. The linkage from CEO appraisal to CEO compensation also must be spelled out in advance. If the board decides to make an incentive adjustment for performance on certain nonfinancial goals, this must be communicated to the CEO.

CEO performance areas should be consistent with appraisal criteria for executives below the CEO level. Likewise, data the board considers as it reviews succession plans and identifies high potentials must be consistent

## Exhibit 3: CEO Appraisal: Roles and Responsibilities

Participants*	Major Roles/Responsibilities						
	Design System	Determine Measures, Set Targets	Gather Performance Data	Provide Performance Data	Appraise Performance	Provide Feedback	Determine Consequences
Entire Board	Some	Some	Some	Some	Some	None	Some
Board Compensation Committee	Major	Major	Major	Some	Major	Major	Major
Board Executive/Management Committee	Some	Some	Some	Some	Some	None	Some
CEO	Major	Major	Major	Major	Major	None	Some
CEO Direct Reports	None	None	Some	None	Some	Some	None
Various Levels of Employees	None	None	None	Some	None	None	None
Outside Parties	None	None	None	Some	None	None	None

\*Members of some participant categories overlap.

with CEO assessment areas. In this way, a common, well-articulated, and specific picture of success emerges for the company. What it takes to “make it” becomes less of a mystery, and the shared values top executives must adopt to drive strategy are shaped.

□ **Review Strategy.** The CEO appraisal system must be tied to the company’s strategy. As the chief architect and implementor of corporate strategy, the CEO’s goals must come

directly from this strategy. Each year, prior to establishing the CEO’s individual performance goals, a review of strategy is required. Those aspects of CEO performance that drive strategy in the nonfinancial arena (e.g., how well the CEO delegates decisions, values the CEO espouses) should be emphasized. When strategy shifts, additional goal areas surface, but each goal set for a CEO must be traced to strategy implementation.

Designing and implementing a per-

formance appraisal system that provides the board with an instrument to capture CEO performance, evaluate it, and feed the evaluation back to the CEO is not a simple undertaking. It requires commitment on behalf of directors and the CEO. It must be founded on a well-designed, practical system, and the mechanisms to make it work must be firmly rooted in the company’s strategy and culture. But the benefits of such a system outweigh the difficulties. ■