'Taking inventory' of the CEO

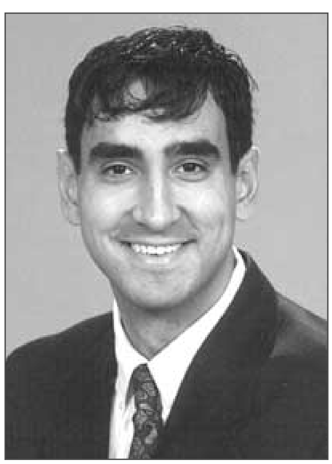
An effective assessment process will ensure the development of stronger CEOs. Here is a model of a comprehensive and fair process. **By Seymour Burchman and Jesse Purewal**

FACTS. OBJECTIVITY. Certainty. *Measurability* — the most critical tenet of management, right? Any student of economics can tell you that earnings are produced only when sales and costs are understood and well managed. The MBA graduate can expound on the merits of using management science and quantitative analysis as a support tool for making critical decisions. And the CEO of any corporation can speak to the importance of creating and measuring expectations of profitability — literally down to the penny.

But directors and chief executives will also suggest, if given the opportunity to speak about what's really important, that no manager can develop into an effective leader without requisite focus on professional development. Too often, scant attention is paid to evaluating a CEO's leadership and management capabilities because many boards (not to mention shareholders, investors, and the media) focus the bulk of their energies on financial results. While a focus on results is understandable, it is critical for boards to be aware of their CEO's strengths, weaknesses, and necessary areas for improvement in leadership and management.

Having worked with many CEOs over the past 25 years, we know that they have both incredible strengths and undeniable shortcomings. Boards are generally aware of the need for development at even the highest levels of corporate America. By their own admission, many board members agree that measuring a CEO's abilities to establish strategic direction, build a management team, and lead effectively are more critical than measures of operational performance. Yet most boards still tend to rely on financial and stock performance as the means for evaluation, rather than attempting to assess a CEO's individual performance. Surveys find that about two-thirds of companies have a formal process in place for evaluating the CEO, but few profess to formally assess the CEO's developmental needs.

A systematic approach to leadership/management assessment — coupled with a clear developmental plan — will help to ensure stronger CEOs and healthier long-term futures for organizations. We discuss below the challenges related to performing CEO assessments, the five key contributing factors to a successful assessment, a range of helpful assessment criteria, and the important considerations at each phase in the assessment cycle.



The main obstacles

Why do boards have a difficult time measuring leadership/management performance? First, defining and agreeing on the most appropriate assessment measures is a challenge. After all, how does one *define,* let alone *measure,* leadership or strategic ability? Assuming that a com-

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pensation committee chair can come up with definitions, who is to say that each director won't have his or her own views? A lack of accepted standards theoretically presents each board with an opportunity to uniquely define its standards for the leadership/management performance of its CEO, but it also creates the challenge of requiring the board to reach consensus on both *competencies* for assessment and specific behavioral *indicators* that evidence these areas.

Determining who should participate is the second challenge. Though all directors should certainly participate in any assessment of CEO performance, we believe that boards should also include a separate evaluation by a group of selected members of senior management (typically at least the CEO's direct reports). This is because management is often able to provide more detailed observations and insights — based on day-to-day exposure — than those that are attainable at the board level. Because it is not always easy to find a group that will be completely unbiased and representative, the board or committee administering the assessment process needs to be sensible — but fair — in its selection of respondents.

Determining who should participate is one of the significant challenges.

A self-appraisal

In our experience, the most successful assessments also include a CEO's appraisal of his own performance. This is true for several reasons:

• The comparison between the CEO's view of himself and the view held by the board/management is a valuable source of insight. To the extent that there are differing perceptions and assessments of performance, the board has an opportunity to review whether it is clearly and fairly setting expectations of the CEO. Similarly, the CEO has the opportunity to question whether he is being completely honest and open-minded about his areas for improvement.

• The CEO is ultimately responsible for her own performance, and this opinion certainly should be expressed. Most CEOs have earned their responsibilities by having an appreciable amount of self-awareness, and their opinions — backed up by specific evidence — deserve a "place at the table."

• Most CEOs are aware that they have some room for improvement. Our experience suggests that these CEOs are often likely to identify these developmental areas if simply given an adequate forum in which to do so. This can save the board from performing the often difficult task of "revealing" weaknesses to a CEO — who in many cases is also the board chair — and allows the board to focus more of its time with the CEO on future developmental plans rather than assessments of past performance.

Assuming the board identifies the right assessment criteria and appropriate evaluators, there is still a human tendency to want to avoid confrontation. That's the third obstacle. Because many directors are CEOs themselves, they empathize with the expectations and demands that come with being a CEO. But there is a solution. When implementing an assessment, the board should convey the message that there is no "right" or "wrong" definition, but rather that the board will work with the CEO to make sure that mutually agreed-upon expectations are met. This collaboration helps the board signal its intention to use the assessment as a catalyst for development rather than merely a grading exercise.

Fourth, directors also may be wary of tampering with success, particularly if a company has been experiencing strong financial health. If the numbers are where they need to be, there is a tendency to assume that all is going well, and that rocking the boat would slow momentum and possibly create defensiveness on the CEO's part.

Finally, compensation committees — which typically administer CEO assessments — have recently needed to increase the time and effort devoted to compensation-related responsibilities as a result of changing accounting standards and a spotlight on executive pay. As a result, these committees' ability to initiate a leadership/management assessment process has been especially constrained.

Keys to success

Despite these challenges, it is possible for boards to perform a comprehensive, fair, and timely leadership/management assessment of the CEO. We have found that five factors are key to the success of these assessments.

• *Accountability.* First, clear accountability for assessment design, administration, and management should be assigned to one committee (typically the compensation or governance committee). This committee can then allow time on its meeting agendas for discussion of the assessment:

— What are the goals?
— When will it need to be complete?
— Against what should the CEO be measured?
— Who should participate?

— Should the board involve an outside third party to maintain confidentiality and deflate bias?

— How will outcomes be communicated to the CEO, and what specific actions could be taken, given the range of probable outcomes?

This range of considerations is best left to a single committee that can involve the board when the assessment results are available.

• *Communication.* The committee in charge of the assessment is also accountable for ensuring that the CEO fully understands the objectives, process, and intended outcomes of the assessment. The board and CEO should reach agreement at the start of the process as to specific expectations and measures of individual performance that will be used, and should agree that these measures comprehensively outline the CEO's universe of responsibilities as both a leader and a manager. Further, to the extent that boards decide to link assessment results to potential actions, including compensation actions, CEOs should be made aware of the connection and the possible range of outcomes.

• *Balance.* Committees need to decide how to integrate leadership/management assessments with the more traditional elements of CEO performance evaluation (e.g., financial performance and operational results). Among organizations having a CEO assessment process, we have found that the more traditional areas — because of their measurability — should generally drive incentive pay and conversations about whether the CEO has demonstrated the skills required of the job. Results of leadership/management assessments are most effective when used to highlight and address developmental opportunities, and to help the board and CEO set nonfinancial goals that will increase the effectiveness of the senior management team and the business.

• *Perspective.* The ability to assimilate multiple perspectives is often the greatest value of an assessment. As discussed earlier, CEOs should be evaluated by the full board, by themselves, and by selected members of senior management. The number of respondents should be sufficient to minimize bias and maintain confidentiality but should not be so large as to cause diminishing returns or incorporate uninformed views.

• *Development.* The true value of assessment is not in the CEO's ratings or scores, but in the developmental needs it serves to highlight. The ability of this type of assessment to create change is precisely what sets it apart from its more traditional counterparts: Whereas evaluations of company financials and strategic objectives are backward-looking, leadership/management assessments strive to illustrate a CEO's developmental needs so that a board can outline specific areas for future improvement. Boards implementing (or refining) a CEO assessment process must be committed to jointly creating, with the CEO, a developmental plan that addresses the CEO's shortcomings and identifies milestones for demonstrating improvement.

Criteria for assessment

We have found that successful CEO assessments contain an evaluation of performance along two basic dimensions: the demonstration of key general leadership/management attributes and the effective execution of the CEO role. Each of these dimensions may feature a number of *competencies* for assessment. Examples are provided in Exhibit 1.

Though each board will have its own competency definitions (and assessment needs), and though

EXHIBIT 1: CEO competencies for assessment

We have found the universe of topics addressed through these eight competencies to be fairly indicative of the CEO's roles and responsibilities in most types of organizations.

General Management

Leadership — Acts in the best interests of the corporation, its employees, and shareholders while demonstrating accountability for behaviors and results.

Strategic Vision — Crafts and continually refines the organization's strategic plans and vision in connection with changing market, industry, and economic trends and in the best interest of all stakeholders.

Planning, Execution and Problem Solving — Makes progress against goals by adhering to strategic plans, obtaining leverage from senior management, and providing quality solutions to address the organization's challenges.

Ethics/Integrity — Works within, and exemplifies, high standards of ethical conduct.

Chief Executive Role

Financial Acumen — Understands and applies economic drivers of the company and industry to decision analysis and problem solving, and works with senior management to establish and track progress against realistic, appropriate financial goals.

Board Relations — Has a healthy working relationship with the board, seeking their counsel and keeping them informed of external and internal developments as needed.

External Relations — Represents the company honestly, accurately, and in a timely manner to external groups (shareholders, investors, media, etc.).

Human Capital Development — Develops and addresses the growth opportunities for senior management, and maintains a succession plan for the CEO office and other key roles.

the list presented here is by no means exhaustive, we have found the universe of topics addressed through these eight competencies to be fairly indicative of the CEO's roles and responsibilities in most types of organizations.

In order to operationalize these competencies, it is important to develop specific indicators against which to assess performance. Indicators allow individuals completing the assessment to put their experiences in context and compare them to specified standards, as illustrated in Exhibit 2 for two competencies, *Leadership* and *Human Capital Development.*

Respondents to this type of assessment would be asked to rate the CEO's performance against each of the indicators by using a scale (e.g., 1 through 5 or "needs improvement" through "outstanding"). The scale should also include an option to answer with an "insufficient basis for judgment" response, so that directors or executives who feel unable to fairly answer the question do not answer arbitrarily.

Our experience also suggests that this "ratings-based" approach to assessment should be complemented by an opportunity for respondents to provide qualitative "free-response" feedback on the CEO's performance. This feedback should be provided within the context of the competency being asked about (i.e., respondents should comment on the CEO's strategic vision in the section on that subject), so that responses will translate to a developmental message for the board to share with the CEO.

Where the emphasis lies

When designing a CEO assessment, boards must make decisions about the relative importance of each competency. In our experience, most tend to find that a more or less equal emphasis on each competency is prudent. In no case should certain competencies or indicators be given relative "weights," as this adds unnecessary complexity to a fairly sensitive process.

Boards conducting leadership/management CEO assessments on a regular basis may discover that a less-structured process is needed to discern developmental messages for the CEO. Even if boards choose to loosen the structure of an assessment, care should be taken to ensure that it is still based on a framework of key competencies.

It is important to note that these assessments may have many possible outcomes. Regardless of whether the assessment results are tied to compensation, the board may have difficult messages to deliver. To the extent that these messages can be accompanied by developmental action plans, they should be. The responses to some indicators may trigger "red flags" (e.g., there is a question about the CEO's ethics) that need more immediate attention and require abrupt changes to behavior. It is also possible that the assessment will lead to the tentative conclusion that the individual being assessed is not the right fit for the CEO role at a certain company. The board should be prepared for a range of potential outcomes.

Not just forms

In our experience, boards have been most successful at implementing a leadership/management CEO assessment (or annexing such an assessment to an evaluation of financial results) when they have identified and committed to an assessment *process.* It is not enough to conduct one assessment, affirm that everything seems to be in order, and move on. In the absence of a specific process to ensure that these messages are followed up on — and revisited with each assessment cycle — a busy board will focus its energies on those roles and responsibilities that already have associated processes (e.g., succession, compensation, audit) and unwittingly leave on the table an opportunity to communicate developmental messages to the CEO.

While the process will undoubtedly look quite different for each board depending on its position on the five success factors presented earlier, we have found that most successful CEO assessments:

— Are conducted on an annual basis, typically in connection with an evaluation of financial results and achievement

EXHIBIT 2: Examples of competency indicators

Leadership

- The CEO demonstrates accountability for his own performance, the performance of the management team, and the company's results, basing judgments about performance on clearly defined standards.
- The CEO defines and initiates change efforts in response to industry, economic, and internal issues, and works with management and the board to implement such efforts.
- The CEO exhibits decisive behavior yet proceeds carefully and obtains relevant counsel, as needed, on certain issues.

Human Capital Development

- The CEO works with the board to maintain a continually up-to-date succession plan for the CEO office and for other key positions.
- The CEO takes a requisite amount of time to focus on the development of senior management, and continually provides candid feedback to ensure that their areas for growth and improvement are addressed.
- The CEO appropriately delegates authority and continually searches for more effective ways to complete tasks.

against other strategic objectives;

— Are the accountability of a single committee;

— Include a periodic review of the appropriateness of competencies and indicators;

— Involve the board, the CEO, and selected members of management;

— Require the board's consensus as to the developmental messages; and

— Communicate results to the CEO in an effective and timely manner.

A thoughtful assessment process generally has three phases of dialogue between the board and the CEO: initial expectation-setting, in-cycle appraisals, and year-end assessments. At the start of the assessment cycle (i.e., at the beginning of the year), the board and CEO need to agree on the board's expectations for leadership/management contributions and behaviors. They also should have a mutual understanding of the range of assessment outcomes. To the extent that any extreme deficiencies in CEO performance are evidenced during the course of the year, the committee in charge of the process would need to intervene and take immediate action. Finally, the cycle ends with a complete assessment of the CEO's leadership/management performance and evaluation of financial/strategic results. Exhibit 3 presents an illustrative CEO assessment process that conforms with the principles and communication milestones described above.

A win-win

Though designing and implementing a leadership/management assessment process that outlines and addresses the developmental needs of CEOs is certainly difficult, perhaps no responsibility incumbent upon the board is more important in the long run than ensuring the quality of the company's leadership. Continually taking inventory of the CEO's strengths — and providing a roadmap for addressing developmental needs — should be top of mind for boards. The challenge facing boards today is to do something about it. ■

EXHIBIT 3: A model CEO assessment process

While the CEO assessment process will look different for each board, we have found that many successful assessments follow the type of schedule described below:

General

➢ Assessment should be completed once per year, preferably in Q1 before CEO compensation decisions are made by the compensation committee.

➢ One committee should have accountability for managing the assessment process.

Beginning of assessment cycle

➢ Review competencies and indicators to ensure completeness, relevance, and proper weight/focus.

➢ Discuss competencies and indicators with CEO.

During assessment cycle

➢ Address any significant problems or deficiencies relative to the performance criteria outlined in the assessment.

- Would include conversation between appropriate committee members and CEO.
- Necessary only for significant issues.

End of assessment cycle

➢ Identify members of senior management who will complete the assessments.

- Assessment completed by management may include a different set of measures and indicators (e.g., will not ask about the CEO's relationship to the board, but may probe more deeply into day-to-day management effectiveness).

➢ Distribute assessment form to board, CEO, and senior management, including date and method (e.g., mail, fax, etc.) by which responses need to be returned to the committee or third party.

➢ Obtain an objective, anonymous analysis of assessment results.

- Summary of findings.
- Clear comparison of CEO, board, and management responses.
- Identification of assessment themes, CEO strengths and developmental opportunities.

➢ Review of results by committee.

- Agreement on themes, CEO strengths, and areas for development
- Presentation of summary results to the board.
- Full board input and approval as to messages to share with CEO.

➢ Meet with CEO to discuss assessment results and set goals for improvement based on identified developmental opportunities.

- At least two members of the committee should meet with the CEO.

➢ Recommend to the full board, following initial meeting and discussion with CEO, actions regarding compensation.

- Compensation decisions must be made in the context of both the assessment and evaluation of financial/strategic results.
- The board must approve the committee's recommendation(s).

➢ Communicate to CEO the assessment outcomes related to compensation and any other matters.