Three key areas stand out in the relationship between a company’s board of directors and its chief executive officer (CEO): compensation, succession planning and performance evaluation. Unfortunately, this third item, performance evaluation, is given short shrift in far too many organizations.

Use of performance evaluations

Performance evaluations are familiar to virtually all executives, including CEOs in their rise to the top. Throughout their careers, CEOs have been rigorously evaluated and furnished feedback on areas and opportunities for improvement. Somewhat surprisingly, however, once an individual becomes a CEO, the quantity and quality of such input often diminishes. In our experience, the performance evaluation process commonly becomes less thorough and less meaningful the more senior the executive.

Why does this occur? The primary reason is that most boards do not have a structured process for evaluating the CEO’s performance and giving ongoing feedback. Providing this input to anyone is never easy; giving feedback to a CEO can be formidable and daunting.

Most modern CEOs developed in environments where performance feedback was provided in a relatively structured manner. That process should continue once an individual becomes a CEO. In fact, the quality of the performance evaluation process can directly affect the strength of the board-CEO relationship – as well as the success of the company.
Handling CEO performance evaluations

In consulting with boards, we have reviewed performance evaluations across a variety of industries for CEOs in public and private companies. Regardless of differences in the types of organizations, we found a common theme: over-reliance on financial metrics to evaluate the CEO. Perhaps this is to be expected; financials are the most obvious way to assess how the organization, and by association the CEO, is performing. Financials are usually easy to quantify and therefore less prone to generating debate about accuracy.

Hay Group reviewed the current proxies of 500 of the largest public companies in the U.S. to assess their disclosure around CEO performance evaluation. Our analysis shows that only 14% of companies provide any level of detail beyond simply stating that they annually review the CEO’s performance. For those that do offer additional information about the process, the most common category of evaluation is financials (93%), followed by strategic initiatives (72%) and operational objectives (48%). Other less frequently referenced categories include succession (27%), culture (24%) and board relations (8%).

However, in the current environment of heightened scrutiny and accountability, boards are increasingly concerned with both what was achieved and how it was accomplished. The 2013 CEO Performance Evaluation Survey conducted by the Stanford Graduate School of Business studied some difficult issues faced by many boards in addressing CEO performance:

- 83% of directors, but only 63% of CEOs, believe that the CEO performance process is effective in their companies, indicating a fairly frequent disconnect between the two parties.
- 10% of the participating companies say they have never formally evaluated their CEOs. We expect that this number is actually higher – probably closer to 15% or 20% – since survey participants may have perceived an informal executive session discussion to be a formal evaluation.
- Only 12% of CEOs believe that they are rated in a manner somehow unfitting of their performance, while almost half (49%) do not disagree with any aspect of their performance evaluation. This could indicate the challenge of building sufficient rigor and objectivity into the CEO evaluation process.
- Only two-thirds of CEOs believe their own performance evaluation is a meaningful exercise with respect to the company’s business matters.

Objectives of CEO performance evaluation

We believe boards should address the CEO’s performance by anchoring the evaluation process squarely in the company’s forward-looking strategic business and organizational priorities. By doing so, directors then become better able to manage the CEO Life Cycle™ consisting of performance evaluation, strategically-based CEO succession, and the alignment of the CEO’s compensation to short- and long-term performance objectives.

An effective CEO performance evaluation process:

- creates a shared understanding of CEO performance expectations between the board and the CEO;
- provides the platform for articulating goals, monitoring progress, and assessing performance;
- determines who should play what roles in the performance review process;
- sends a message to the CEO on what the board considers as important and therefore the areas on which the CEO’s performance is assessed;
- provides the foundation on which to conduct ongoing discussions on the CEO performance throughout the year; and
- enables the board and the CEO to communicate effectively on performance-related issues.

Use of non-financial metrics in a CEO performance dashboard

How do you know it’s time to part ways with a CEO who meets the organization’s financial targets, but whose behaviors are impacting organizational culture and performance in negative ways?

Financial measures, of course, are important. They reflect the growth and profitability of the company and determine the amount of dividends that can be distributed to shareholders; however, they are very limited in gauging the extent of the organization’s value creation process. By their nature, financials are lagging indicators. A CEO can decide to sub-optimize one area to “make the numbers;” however, such a short-term fix is not a sustainable strategy. Further, a CEO can underspend on research & development, reduce capital expenditures or even “sell market share” through profit-boosting higher prices; all of these actions potentially can destroy future value.
Other short-term solutions include underpaying key resources or not providing them with the right career opportunities. Eventually these individuals will quit, undermining the organization’s progress.

Board members need to track a variety of performance measures in the CEO’s scorecard, beyond the financials, such as shaping the culture, developing leadership capabilities, and working collaboratively with the board and other constituencies. This can help ensure that short-term financial gains are not incentivized over long-term performance and sustainability metrics.

Measures for the CEO evaluation dashboard

It’s important to recognize that non-financial metrics are different from non-quantitative measures. Even if a measure is not financially driven, it can still be quantified and assessed.

Potential categories for a CEO evaluation dashboard include:

- **Financial** – commonly used metrics include sales, growth in profit, stock price performance and return measures;
- **Strategic alignment** – measured by the execution of short and long-term strategic initiatives;
- **Sustainability** – a measurement of the organization’s ability to grow and thrive, including external concerns (such as the betterment of the community) and internal concerns (such as an energizing culture);
- **People** – measured by leadership continuity and broader capability building, including succession planning;
- **Governance** – measured, for example, by the quality of decision-making at all levels of management, the relationship between the CEO and the board, and the ability of the organization to comply with regulatory requirements; and
- **Crisis management** – robustness of a crisis management plan as well as the behaviors of the CEO in times of crisis.

Boards need to manage the gap between what they know and what they are equipped to oversee. This starts with a clearly articulated set of performance metrics. Once the metrics are identified, the process continues with:

- holding the CEO accountable to them;
- rewarding and incentivizing the successful accomplishment of these key indicators; and
- ultimately selecting a successor to carry out the business plan.

As the board becomes more engaged on strategy, the evaluation of the CEO can naturally become a continual process and a central focus of board activity on a year-round basis. Performance discussions should happen more than once a year and involve an ongoing dialogue, ideally scheduled on a quarterly basis. This approach can minimize some of the angst and emotion around having an annual milestone event. In addition, the process should be built into the board calendar.

Recent news stories show us far too many situations where the board, although concerned with the CEO’s performance, made only half-hearted efforts at providing feedback. Then sometime later the company has a crisis, resulting in the CEO’s dismissal and creating major trauma for the company and its people. In many cases this scenario is preventable through an appropriate CEO performance evaluation process.

Wrap-up

We believe that CEO performance evaluation provides a significant opportunity for boards. The development of a stronger process for evaluating and communicating CEO performance should yield greater clarity on role and expectations, which ultimately should produce improved, sustainable organization performance.

By devoting more attention to developing a strong CEO performance evaluation process, an organization should see the following benefits:

- improved and more constructive relationship between the board and CEO;
- clearer alignment of organization strategy with CEO capability;
- a shared understanding of expectations;
- a way to link to compensation and succession planning;
- the ability to correct the course before it’s too late – e.g., spot and address potential problem areas and CEO blind spots; and
- greater organizational stability and sustainability – as well as performance.

CEO evaluation should be a process, not a singular, time-abbreviated event. When feedback and dialogue occur regularly, the likelihood of mid-course corrections of actions or behavior increases. Also, by adding non-financial metrics to the mix, boards can gain a more holistic view of the CEO’s leadership and assess the critical factors that contribute to his or her long-term leadership effectiveness.

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