Get serious to make CEO evaluations work

The review process should be rigorous, objective, and fair, and the end result should be a stronger relationship between the CEO and the board.

By Susan S. Boren and Robert L. Heidrick

As the need to avoid even a hint of boardroom impropriety grows, it is not surprising that boards increasingly are concerned about not only regularly assessing the performance of the CEO, but also utilizing a process that demonstrates the board's independence. Today, there is a growing expectation that CEO evaluations, like board evaluations, should be done using a more formalized approach.

CEO evaluations must be handled carefully and with regard for the changing governance environment and the sensitivity of the board's relationship with the CEO.

We have worked with a number of boards that have initiated a CEO evaluation process and have seen firsthand what works and what the potential pitfalls are. To help your board improve its CEO evaluation process, we have outlined the benefits of conducting evaluations. We also discuss how to best engage the CEO in the process and, most important, how to structure the evaluation to produce the most effective outcome for the CEO, the board, and the entire company.

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Benefits of the process

By implementing a thorough CEO evaluation process, the board can achieve numerous objectives, such as:

- Engaging the board in a discussion of the CEO's goals and objectives.
- Enhancing dialogue and candor between the CEO and the board.
- Providing meaningful performance feedback to the CEO.
- Reinforcing a positive "tone at the top."
- Providing important information to the board's compensation committee.
- Executing a key fiduciary responsibility on behalf of shareholders.
- Setting an example of accountability and dialogue for the entire management team.

The goal of a CEO evaluation process should be to enhance the relationship between the CEO and the board, in addition to improving the overall performance of the company, as a result of candid conversations around goal setting and performance measurement. Many of our CEO clients are pleased with recent interest on the part of their boards in providing a meaningful evaluation. They view this as a way to involve the board in the company's annual goal-setting process and to ensure that they are in touch with the board's opinions. For most CEOs, this is a much more desirable relationship than being blindsided with surprise feedback from the board or feedback that is unrelated to agreed-upon goals and objectives.

According to the 2003 *Spencer Stuart Board Index,* approximately 72 percent of S&P 500 boards that responded to the survey reported having some type of formal CEO evaluation process. However, through our close working relationships with many boards and CEOs, we have found that while most companies say they are conducting formalized evaluations, in reality they are continuing to use a rather informal feedback mechanism.

CEO's role in the process

A CEO evaluation is a sensitive topic, especially because it is most often closely tied to CEO compensation. To avoid confrontation or misunderstanding between the board and the CEO, it is critical to engage the CEO from the very beginning. Working with the nonexecutive chair or the lead director, the CEO should offer his opinion on the appropriate goals and objectives to be measured, the best metrics to be used, and the best process for soliciting input from all directors. The most successful evaluations include a self-evaluation from the CEO sent to the board and a process (such as a questionnaire or one-on-one interviews facilitated by a third party) for seeking input from each of the directors. The process should be designed to be rigorous, objective, and fair. The most effective processes are those that include a written evaluation and a full report to the board on the outcomes of the evaluation. When these elements are present, we find CEOs welcome the opportunity to receive feedback from the board.

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Increasingly, CEOs are sharing the board's process of evaluation with their management teams. They find that the more visible the board's process of evaluation is, the more likely the company's executives are to accept a rigorous review process from the CEO.

Structuring the evaluation

When conducting CEO evaluations, there is never a one-size-fits-all approach. For boards that are addressing CEO evaluations for the first time, our advice is to "walk before you run." It is much more effective to master a simpler evaluation process, building on successes for the next year, than to try to conduct a complex evaluation, only to make a misstep that damages the relationship between the CEO and the board.

Over the last few years, we have observed a number of best practices and general guidelines that boards can follow when conducting a CEO evaluation:

Establishing Format: From the outset, the board and the CEO need to agree on the format, timing, and responsibilities for the evaluation. Typically, an evaluation should be done once a year in order to establish consistent benchmark measures. The process should be led by the presiding/lead director, the chair of the governance/nominating committee, or the nonexecutive chair.

In the past, 75 percent of S&P 500 companies that conducted CEO evaluations said the compensation committee was responsible for the evaluation. However, nearly 30 percent said they anticipate that the nominating/governance committee will take on this responsibility in the future. This decision should depend on the board's leadership structure.

Agreeing on the Measures: To be able to evaluate what sort of job the CEO is doing, the strategy and goals have to be established for an individual company. It

Role of the outside facilitator

Outside facilitators are a tool that boards can take advantage of to ensure the most positive outcome for the evaluation process.

Facilitators should be able to take the temperature of the organization and help the board determine which approach will work best for them. At the very least, CEO evaluations provide an opportunity to enhance communication between the CEO and the board, and it is the facilitator's duty to promote this. Approximately 21 percent of S&P 500 companies reported using an outside consultant to help with the CEO evaluation process.

The responsibilities of the outside governance consultant typically include the following:

• Meet with the CEO, and separately with the director responsible for the evaluation, to understand the climate of the company and the board.

• Assist in the process design; meet with the board committee to discuss the objectives of the evaluation.

• Develop the questionnaire and interview questions.

• Interview directors.

• Synthesize the findings and prepare a report.

• Facilitate discussion with the board committee and/or the full board.

• Recommend process improvements for the following year.

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is critical for both the quantitative and qualitative measurements to be agreed upon by the board and the CEO before the start of the year. The most effective way to determine measures is not to employ a laundry list of goals, but to start with an umbrella concept — those aspects that the CEO has control of and where his or her efforts can be measured. By taking a snapshot of the company at the start of the year and then again at the end, the evaluation can assess: Is the company in better shape?

But in order to make that assessment, the board and the CEO must decide on the definition of "better shape." The following categories provide a good overview of what elements typically are included in the definition, though the precise definition and measurements will vary from one company to another:

— Achievement of corporate goals and objectives;

— Achievement of personal goals and objectives;

— Succession planning and strength of the management team;

— Relationship to key constituents, both internal and external;

— Relationship to the board;

— Stock performance, if a public company; and

— Assessment of key leadership qualities.

Impact on CEO Compensation: The board and the CEO need to determine how the CEO evaluation will influence or contribute to the compensation committee's consideration of CEO compensation. Tying the CEO's incentive compensation to his or her performance simply makes good business sense and reassures shareholders that directors' decisions in sensitive areas are based on quantitative measures and sound business understanding. It is important that only the agreed-upon quantitative aspects of the evaluation be used during the annual compensation review.

CEO Self-Evaluation: Once the quantitative information is available, the CEO should prepare a written self-evaluation based on the objectives and agreed-upon goals. Like all activities that the CEO and board undertake, the evaluation should be an interactive, iterative process. By reaching out to the CEO to conduct a self-evaluation, the CEO also will be more comfortable receiving feedback from the board, knowing he or she has a voice in the process. It's interesting to note that of those S&P 500 companies doing CEO evaluations, only 65 percent report asking the CEO for a self-evaluation.

Conducting Surveys and Interviews: The director who is responsible for leading the evaluation process should work independently or with an outside firm to poll the directors through interviews and/or a questionnaire to gain their input on both quantitative and qualitative measures. In addition to the experience a governance consultant can bring to a board conducting a CEO evaluation, this outside facilitator also can provide a more objective approach to the interviewing process (see sidebar). This information is then synthesized, in conjunction with the CEO's self-evaluation. Our work with a broad range of clients suggests that the best feedback is gained through interviews facilitated by a third party and synthesized for the board and CEO.

Presenting the Findings: The director leading the evaluation discusses it with the CEO, and together they agree on action steps. Again, the person leading the evaluation needs to be sensitive in presenting the feedback from directors in a way that the CEO will be able to hear and appreciate. Often, a third-party facilitator can be helpful when it comes to delivering the feedback, especially when it is not positive. Either way, it is important that the CEO respect the person leading the evaluation. A report is then made to the board regarding the evaluation and outlining the follow-up actions.

Commitment ensures success

Ultimately, the success of the CEO evaluation process hinges on the level of commitment of both the board and the CEO. If boards are honest as well as specific in their feedback, and CEOs are open to receiving candid and constructive feedback, the process can be a positive experience for all parties. And by adopting a more formalized, structured approach to the CEO evaluation, boards have a greater chance of not only optimizing their relationship with the CEO, but also improving the overall performance of the company. ■