

C

E



Center for
Effective
Organizations

CEO PERFORMANCE APPRAISAL

**CEO Publication
G 97-15 (327)**

**JAY CONGER
DAVID FINEGOLD
EDWARD E. LAWLER III**

*Marshall School of Business
University of Southern California*

October, 1997

Performance appraisals of employees are a well established and extensively used practice in most corporations. Supervisors appraise their subordinates at virtually all levels in most organizations. But, who appraises the CEO? How should it be done? What results does it produce? The answers to these questions are important in determining whether a firm is effectively governed as well as in determining how to reward, develop and hold accountable CEOs.

There are three important forces which are creating a growing interest in CEO evaluations and making it likely that we will see more and more corporations turning to formal appraisals of their CEOs. One is the increased focus on the critical roles that CEOs play in corporations. The management literature is awash with books which argue that leadership at the top of corporations is critical to implementing strategy, creating successful corporate transformations and so on. Further, each year for over a decade, CEO compensation levels have increased by at least ten percent. Given their importance and their pay levels, it is only natural to ask who is judging CEO performance.

A second force for CEO evaluation is pressure from the investment community. In the last decade, we have witnessed a major rise in shareholder activism. Its roots can be traced back to the 1980's when global competition and the wave of corporate acquisitions and restructurings called into question the effectiveness of a number of CEOs and their boards. Numerous Fortune 500 companies began bleeding red ink as a result of poor strategic, financial, and operational decisions. Questions were raised as to who was minding the store and holding the CEO accountable. Naturally, attention turned to the board.

Feeling pressured by public scrutiny in the 1990s, boards began to react more quickly to poorly performing CEOs. For example, in the years of 1992 and 1993 alone, boards pushed out a remarkable list of well-known CEOs: James Robinson III of American Express, Anthony D'Amato of Borden, Kay Whitmore of Eastman Kodak, Robert Stempel of General Motors, John Akers of IBM, Paul Lego of Westinghouse and Philip Lippincott of Scott Paper. More recent oustings include Gil Amelio of Apple and John Walters of AT&T.

The performance problems of corporations and CEOs raise important fundamental questions about how boards operate and whether their governance structures can be designed to be more vigilant and proactive. Formal evaluation of the CEO is one practice that has the potential to make governance structures more effective. At the very least, it can establish pre-determined, tangible objectives by which the CEO's performance can be tracked. Thus, it offers the prospect of more powerful boards that can effectively deal with poorly performing CEOs.

A set of events within companies has also contributed to the popularity of formal CEO evaluations. Over the last decade, performance management systems have become increasingly more sophisticated and popular. For example, there has been a dramatic expansion in the use of 360-degree feedback and bonuses that are based on performance appraisal measures. As the use of these practices has become commonplace, it is harder and harder to justify why the company's most important employee — the chief executive officer — should not also be subject to a performance evaluation. This is especially true given research at the Center for Effective Organizations which

suggests that the inclusion of the CEO in a company's evaluation process has a positive influence on the overall effectiveness of the company's appraisal system.

Research Focus

Over the last two years, we have been studying organizations which are leaders in boardroom appraisals. We have interviewed and collected questionnaire data from their CEOs, board members, and outside experts. We have also worked with Korn/Ferry on their annual corporate governance survey of the directors of Fortune 1000 companies. Our research suggests that board effectiveness is very much dependent on how the board is designed and managed. It also suggests that its relationship to the CEO is a critical determinant of its performance.

The results of the 1996 Korn/Ferry survey indicate that roughly 70% of the U.S.'s largest companies have adopted a formal CEO evaluation. The results of the survey and our case studies of leading firms also indicate that adoption of a CEO evaluation process can produce real benefits. The challenge is doing it well. It is not enough to ask a few evaluative questions or to set performance targets that are checked off every year. In companies where CEO appraisals work and work well, there are specific, clearly defined steps and objectives that are followed to overcome the typical pitfalls of performance appraisals. They require a special commitment from the CEO and from board members. Without the right practices and commitments in place, evaluations can easily become mechanical events where everyone simply "goes through the motions," or worse yet, one that creates a major explosion and rift between the board and the CEO.

In the discussion which follows, we will first describe the positive outcomes that occur when CEO evaluations are implemented well. We will then look at what is needed in order for a board to be effective and able to carry out an evaluation. Next, we will walk through the steps that make for an effective CEO evaluation process using examples from our research as illustrations. Finally, we will consider the implementation challenges.

Results of Evaluations

A key finding of our analysis of individual director's rating of their boards is that all three forms of appraisal — CEO, board and individual director — have a positive, independent effect on board members' ratings of overall board effectiveness. It also shows that these evaluation processes have a strong impact on certain board roles — e.g., attention to long-term strategy development and implementation — and little or no impact on others, such as "the company's image," "building networks with strategic partners" and "enhancing government relations."

In our research on companies successfully using CEO evaluations, we found positive outcomes in four areas. Specifically, appraisals were described as 1) heightening performance accountability and the

link between performance and rewards, 2) clarifying strategic direction, 3) promoting better CEO-board relations, and 4) fostering the development of the CEO.

The outcome most expected from a CEO evaluation process is greater accountability for performance. And indeed we found that with a system of formal, mutually agreed targets in place, it appears to be far more difficult for a CEO to find “excuses” for poor performance. Having well-defined targets also makes it easier to determine CEO pay. With pay levels tied to predetermined objective measures of performance, there is little doubt about the level of achievement needed for a bonus or stock award.

By specifying a set of strategic targets at the start of each year along with quantifiable measures for each, the CEO and the board develop a clearer focus on the company’s strategic goals. This focus can then be flowed down the organization so that goals and accountabilities at multiple levels support the strategic direction of the organization. As one CEO explained: “The appraisal process has created basically a centerpiece of performance expectations that all board members have an opportunity to comment on and then cast in concrete. There is very little wiggle room on the board’s behalf to say ‘We didn’t want you to be doing what you are doing; we wanted you to do something else.’ As a result, we have a very tight agreement in terms of what my emphasis ought to be for the coming twelve months.” Just as importantly, the board now has in place an early warning system. The measurable targets set by the CEO become benchmarks for board members to determine whether the CEO is under performing his or her own goals and those of industry peers.

Appraisals can also improve relations between the CEO and board members. For example, we found that going through the process of establishing targets fosters greater dialogue, especially around the firm’s long-term strategy. Board members felt that formalizing the evaluation process helped establish a healthy balance of power between the board and the CEO. With the proper procedures, appraisals increased the board’s independence and control over the CEO and the compensation process. Once institutionalized, formalized evaluations are also likely to present an important constraint on future successors of the CEO who might be more reluctant to share power with the board.

A final benefit of a CEO evaluation process is contributing to the chief executive’s ongoing development. For many boards this is the main purpose of adopting a formal appraisal process instead of just a pay-for-performance plan. One of the problems that comes with the power and prestige associated with the chief executive position is that these CEOs rarely receive candid feedback, and when they do get it, it is typically from only a select few directors with whom they have a close personal relationship. Adoption of a formal appraisal process can increase the level, candor and detail of the feedback CEOs receive, with particular attention to any areas for personal development. Several of the CEOs and board members we interviewed singled out the benefits of the 360-degree feedback process associated with the appraisal as particularly useful.

Table 1 shows the average questionnaire scores for board members in two companies that have well developed CEO evaluation processes. They were asked to indicate the degree to which a number of objectives were accomplished in their CEO evaluation process. Though the results are somewhat more favorable in Company A, the results are relatively similar across the two companies. In both

cases, the board members feel that the appraisal does a good job of evaluating and focusing on the CEO's performance. They also indicate that it does a reasonably good job of discussing ways to improve the performance of the CEO.

Insert Table 1 About Here

An additional question asked whether the appraisal actually improved the performance of the CEO, and the answer was generally positive. Both boards felt that the CEO received performance feedback. There was some difference in the degree to which the appraisal was seen as facilitating the implementation of business strategy. The first board clearly saw it as accomplishing this, and the second board felt that it did this to a somewhat lesser degree. Overall, in other responses to the questionnaire, the boards indicated that the appraisal was very much worth doing and that it should be continued. Our interviews with the CEOs who were evaluated generally confirmed the reactions of the board members. The CEOs felt that the process went well, and that it gave them valuable feedback.

Determinants of Board Effectiveness

The research on knowledge work groups suggests that in order to deal with complex issues such as CEO appraisal, groups need the right mix of: 1) knowledge, 2) information, 3) power, 4) motivation, and 5) time. Specific factors in each of these need to be present in order to have an effective board appraisal of a CEO.

Knowledge. It is critical that the combined knowledge and experience of the board members match the strategic demands facing the company. Because today's business environments are so complex, it is virtually impossible for a single person or a small groups of individuals to understand all of the issues that come before a board. This argues for constructing a board around complimentary skills and backgrounds. Without the right mix it is impossible for the board to go through an informed goal setting and evaluation process.

An aerospace company we studied, for example, employs a simple matrix highlighting director capabilities to assess not only the composition of its board but of individual committees. Capabilities are clustered around categories such as a director's understanding of company customers, government relations, international markets, creating shareholder value, and so on. The CEO explains its purpose: "We use it to evaluate what disciplines we want to have on the board, what is important, what capabilities we currently have, what capabilities we now have that may rotate off the board because of retirement or other things, what types of people we should be looking for to fill in. With candidates, we try to maximize the matrix. Now we do the same thing with the composition of our board committees. We want to make sure the committees have the right kind of breadth as well as continuity of experience. We really try to move people around so that the capabilities we want to have on that committee are covered. It's a chess game that needs to be played and gets played every year."

In the ideal case, a board also needs to optimize the mix of expertise a single individual brings as a director. So when matching directors against strategic requirements, it is particularly important that the board carefully set its top priorities and look for individuals that satisfy multiple needs wherever possible; otherwise, the board runs the risk of becoming too large, and thus undermining group effectiveness.

Information. The quality and quantity of data that a board receives on its business issues and whether this information is received in a timely manner is crucial to all aspects of the CEO evaluation process. To be truly effective in evaluating the CEO, boards also need multiple information sources: outside stakeholders, the directors' own observations, and customer and employee surveys. It is not a situation where the board can or should rely only on data provided by the CEO. Since the appraisal needs to look at strategic direction and leadership, it is important for the board to have information other than just financial and operational results. Market research data are important, as is attitude survey data from customers and employees.

Power. An effective board needs the power to make key decisions and to hold the CEO accountable for his or her performance. Board power is influenced by a number of factors. Perhaps the most important is its membership, particularly the number of independent directors. Business or family ties to the CEO and the company may make it difficult for directors to exercise independent judgment. Long-term friends of the CEO create a similar predicament. Similarly, board members who sit on one another's boards create potential conflicts of interest. Directors who are independent of the CEO should be in charge of determining CEO pay and selection of all board members, including the next CEO. Finally, board power tends to be increased when it has a leader who is not the CEO. This can be accomplished by appointing a lead director or having a separate chair.

Motivation. In the case of CEO appraisal, motivation concerns whether the right incentives are in place to motivate directors to do a good job of appraising the CEO. Along with the director selection process, the reward system is a primary lever to shape the motivation of board members. As a result, issues of director compensation have risen to prominence in discussions of effective corporate governance, with a growing number of firms requiring directors to own shares, paying directors all or partially in stock, and eliminating pension plans and other perks. For rewarding directors it makes more sense to have a long-term orientation with options exercisable only after several years or on retirement to ensure the CEO is not incented to raise short-term stock price by sacrificing the future health of the company. It also makes sense to evaluate individual directors so they will be held accountable for how they perform. With the right kinds of incentives and evaluations in place, directors should be motivated to do a good job of appraising the CEO. If it is their money that is on the line then they are likely to behave more like investors and owners than pawns of the CEO.

Time. Time literally refers to directors, as a group, having the time to make effective decisions, to be well informed and to contribute effectively. Even the best run board meetings often lack sufficient time for in-depth discussion of corporate strategy, a particularly crucial issue in CEO evaluations. Many companies are dealing with this issue by scheduling special annual retreats devoted exclusively to

discussing long-term strategy. In other cases, however, this may be inappropriate. In rapidly moving high technology sectors, for example, product life cycles can be completed between annual strategy meetings with profound consequences for the organization. Thus, Compaq has never had special strategy sessions, instead devoting a couple of hours at every session to some part of the business which is going to impact the strategy. In addition to time for strategy development and clarification, boards need time to review performance data and discuss them with the CEO. If time is not set aside for this activity, it is likely to be neglected, like feedback at any level in the organization.

Steps in Conducting An Effective CEO Evaluation

In all of the effective boards we studied, board members had an opportunity to discuss proposed approaches to CEO appraisal and often participated in the design of the appraisal process. It is important, at a minimum, to discuss the range of possibilities and to get board members' feedback before choosing a design. Comfort with the process and a sense of shared ownership in its design help the transition to a formalized procedure. With this caveat in place, let's look at the steps in an effective evaluation. There are typically three: 1) establishing evaluation targets at the start of the fiscal year, 2) reviewing performance mid-course, and 3) assessing final results at year-end.

Just before the start of the company's fiscal year, the CEO and his or her direct reports need to work with the board to develop the annual strategic plan. Key short-term and long-term objectives are established for the coming year. Once these objectives are defined, the CEO "translates" these into a set of personal performance targets specifying how his or her progress will be measured against each. These objectives should include the usual financial and budget objectives, and they should include strategic and personal development objectives.

The objectives are then presented to a committee of the board — normally the compensation committee or a board governance committee, ideally composed solely of outside directors. In essence, this becomes a "pre-review" of the objectives before the full board review. It provides an opportunity for the committee members to assess and, if necessary, to amend the CEO's targets. It is a good time to establish the financial rewards that will result from meeting the targets. It is here that gaps in perceptions between the CEO and outside directors surface and should be resolved. This is a critical phase and the committee members must work collaboratively with the CEO, ensuring that the targets are realistic but also challenging. If directors simply rubber stamp what is presented to them, it can undo whatever good intentions exist. When final agreement on objectives is reached between the CEO and the committee members, the targets are presented to the full board for further discussion and final approval.

William Steere, CEO of Pfizer, drafts an initial set of both quantitative and qualitative objectives in December for the coming fiscal year. These are sent to his direct reports for their comments. This is one of several opportunities his subordinates have to influence the shape of the firm's annual goals. In reality it is already a mutual process since some of Steere's objectives are themselves derived from his reports' own operating plans. This is also an opportunity to clearly assign responsibility down the chain

of command for certain objectives. For example, senior managers at this stage learn which of their CEO's performance objectives they will be held accountable for. In this way, the evaluation process ensures that the objectives set at the top align with operational and tactical goals further down the organization.

After incorporating his subordinates' comments, Steere's objectives are put into a final draft. It is forwarded to the compensation committee. A meeting is held with the committee in early or middle February, both to review the prior year's performance and to establish the coming year's goals. Composed of three company outsiders, the committee reviews the two sets of objectives for the CEO along with those of his seven direct reports. Afterwards, they meet with the CEO face-to-face for several hours to discuss his performance and his goals for the year. In addition to the CEO and the three committee members, the Vice President of Human Resources is present to facilitate the discussion.

The Pfizer example illustrates how the initial stage of a CEO evaluation involves both the board and the company's senior management in setting the CEO's performance targets. In doing so, at least two outcomes are achieved. One, the evaluation becomes a powerful tool for focusing management throughout the firm on clear and well-defined goals. Second, rigor is achieved in setting performance standards for the CEO and for the corporation.

The next step in the evaluation process is a mid-course review. Here the aim is to assess how well the CEO is achieving his or her objectives. This provides the board with an opportunity to assess where the CEO is meeting or exceeding agreed upon goals and where there are problems. It also encourages them to act before major problems develop and assure that the objectives are relevant. Such a review is particularly important and may need to occur more frequently in companies where products and market conditions change rapidly.

At Honeywell, CEO Mike Bonsignore highlights at board meetings when a particular milestone for one of his objectives is achieved. In several other cases that we examined, CEOs kept a close check on how they were performing in the eyes of board members by scheduling meetings with individual directors during the year for candid discussions on performance.

A number of the boards we studied skipped the mid-course review step or else held only an informal review. We feel that this is a mistake. Some form of progress check is essential if the process is to remain well integrated with the company's business objectives and year end "surprises" are to be avoided.

The final stage of the CEO evaluation occurs at the end of the fiscal year when the CEO's actual performance is measured against targets and compensation is determined. This step often begins with a written self-evaluation by the CEO assessing how he or she has performed over the year.

In a number of companies, this final step is combined with the goal-setting step. For example, at Dayton Hudson, one of the companies most frequently cited as a leader in corporate governance, both the chief executive's self assessment of the past year's performance and his targets for the coming year

are presented to the executive committee of the board at its March meeting. Similarly, at Honeywell, in mid-January, CEO Bonsignore prepares a written self-assessment of the previous year's performance against objectives and a set of written objectives for the coming year. These are circulated among all the board members who in turn send individual written comments to the chairperson of the governance committee. The committee prepares a written summary of director feedback and provides the CEO with a copy to review. A few weeks later, the governance committee meets with Bonsignore to review the upcoming year's objectives, provide feedback, and suggest modifications. The very next morning, there is a full board session where Bonsignore hands out a summary of his plan and holds a general discussion. Though he discusses the prior year's performance, the majority of this meeting is spent on the coming year's objectives. Board members then have until the end of the month to provide additional feedback or suggest changes. In February, a general board meeting is held that focuses on the prior year's results and signs off on the upcoming year's plan.

Since objectives set at senior management levels tend to build upon prior years, it makes some sense to combine the assessment of the prior year with objective setting for the coming year. It is also a time efficient process. At the same time, it is important that boards see these activities as separate. If they are too "combined," there is a risk that one may receive a disproportionate amount of attention in a single board meeting. Most likely it will be past performance since it is far more tangible and likely to produce emotional and defensive reactions. The Honeywell example illustrates an effective use of integrating the two activities while ensuring that each receives its fair share of attention. Though the CEO presents both his past year's review and his upcoming plan simultaneously, the January board meeting is devoted largely to a discussion of the coming year's objectives, while the February board meeting focuses on the CEO's performance over the past year.

Ideally, in the final performance review stage, board members receive a short questionnaire to assess the CEO's performance against key objectives (Exhibit 1 provides an example of the areas that should be covered). While we discovered a good deal of variation in the appraisal forms that were employed, some had open-ended questions and others had rating scales or a combination. We recommend a combination. Rating scales make for easier comparisons over time and among board member evaluations and highlight clearly where perceptions vary widely. Open-ended questions provide a flexibility to consider additional factors overlooked by fixed scales and targets.

To ensure confidentiality in the assessment process, directors can hand off their evaluations to a trusted independent source such as a consultant or the legal counsel to the board. This individual compiles and summarizes all the comments to provide general feedback that also preserves the anonymity of individual directors. The report is then made available to the compensation or governance committee for their review with the CEO.

In many companies, the appraisal is kept more informal by using only oral feedback among directors. Our analysis of the Korn/Ferry survey data, however, indicates that directors consider the evaluation process to be more effective when directors give the CEO written as well as verbal feedback. Committing thoughts to paper encourages a certain clarity and deeper reflection on the CEO's performance. It also gives CEOs feedback that can be reviewed after the meeting. Finally,

written appraisals ensure that every director is heard. Oral feedback can usefully follow the written, taking place either during full board meetings or in one-on-one or small group meetings with the CEO.

The next step is to have the board's compensation committee make its recommendation using the CEO's self-assessment and pertinent outside information. Following this, a meeting of all outside directors should be held to discuss the CEO's evaluation results and approve a final compensation package. An effective evaluation process can and should make the link to compensation a straight forward one. For example, at Pfizer, the compensation committee makes a final decision on the CEO's overall performance by assigning rankings to his ten objectives for that year. These are averaged together to produce a single numerical ranking from 1 to 6 (6 being the highest level of performance). So for example, they might conclude that his performance ranks a 5.7 for the year. This number is tied to a compensation scale that determines his pay for that year.

At Dayton Hudson, each board member produces an individual written assessment of the CEO's performance and then assigns a numerical score. In this case, the CEO is also the chairman. He receives scores for both roles, seventy percent of his performance being graded on the CEO's role and thirty percent on the chairman's. The two scores are combined to produce a single number. This figure comprises fifty percent of the CEO's final performance score. The remaining fifty percent results from a calculation of the company's performance vis-à-vis a control group of retailing companies along the dimensions of earnings growth and return on investment. The salary and the bonus of the CEO are then designed so that a score of "80" places the CEO's compensation at the 80th percentile of CEO's of the retail comparison group.

Setting the Right Objectives

A very important part of the CEO evaluation process is finding the right objectives to measure and setting targets that reflect realistic and high levels of performance. Objective-setting is critical because it is an arena for determining what the board will focus on as well as the level of detail the board will be involved in. Objectives that are too focused on day-to-day managing can encourage inappropriate micro-managing by the board. For example, how many managers are trained in the company's intra-net is more of an operational issue best left to management and not to a CEO evaluation. On the other hand, a multibillion dollar oil exploration project in China is a major strategic issue that needs to be evaluated at some point.

The challenge in setting objectives is to assess and accurately measure the most important aspects of corporate performance, for which the CEO is ultimately responsible. An assumption behind many pay-for-performance plans is that the CEO's performance and the corporation's performance are synonymous. In reality, this often is not the case. An effective evaluation uses objectives that focus on behaviors and actions that the CEO can control directly. It should also employ measures that adjust for changes in the industry and economy so that the CEO is neither punished for an unexpected downturn in the economy nor rewarded excessively by an exuberant market.

Evaluations should separate the performance targets for the CEO role and the chairman role. In over 80% of large U.S. companies, the same person plays both roles. Yet each has different objectives. If a formal evaluation of the board is done, it may be best to include the assessment of the chairman's role as part of the board appraisal process.

When setting objectives it is important to set the right number. Too few, and performance is likely to be centered completely around financial indicators. Too many, and the CEO and their senior team risk losing a clear focus as the weight attached to each target is diluted; the result may be the functional equivalent of having none. Our best-practice companies kept their lists to five to ten objectives.

It is also important to ensure that the objectives are not just financial ones. Many companies have built their CEO's compensation package around annual financial objectives and stock market performance. While critical, they fail to capture important effectiveness issues that are not so easily measured. For example, issues like succession planning, involvement in lobbying efforts, trade association involvement, communications within the company, board relations, union relations, and leadership are all critical qualitative areas of CEO responsibility that need to be assessed in some manner depending on the company and its strategic priorities. Taking time for the CEO and board to review carefully "big picture" qualitative objectives that impact the company's long term performance is critical. Targets such as return on equity and company profitability can only marginally and indirectly capture these important activities. In some cases they may work against these activities by producing a focus on short term results.

Texaco splits its appraisals into two sets of objectives. Objective financial indicators are tied by formula to CEO pay. On the other hand, subjective objectives are also set but are not directly tied to pay. They are only used for development and feedback purposes.

Once a board has an idea of the areas it wants to target it needs to be able to measure them in some concrete fashion that shows whether the CEO has indeed met his or her targets. For example, leadership might be measured by internal employee surveys and 360-degree feedback questionnaires or outside analysts' reports. Diversity in the workplace can be measured using staffing statistics over time. Improvements in product quality can be measured using internal and external reject rates as well as with customer satisfaction surveys.

A desirable next step, which very few boards take, is to carefully define at least three levels of performance for each measure — poor, acceptable, and outstanding. These levels become the benchmarks for differing pay packages. They also help the board and CEO develop a shared understanding of the performance standards and can provide the groundwork for an early warning system if the CEO's performance is poor.

Scoring is always a difficult issue in evaluation. As we have seen, companies like Dayton Hudson and Pfizer employ a numerical score. Others prefer letter grades such as "A", "B" or "C" and others have categories like "outstanding", "excellent" or "satisfactory". The advantage of a numerical grade is

that it allows a board to compare perceptions among its members in a more fine-grained manner and to make more differentiated links to pay. No scoring method is always right. It depends on the situation. It is important, however, to always use some scoring approach and to avoid vague written or oral “feedback” that makes it impossible to deliver a clear message. It can also help to avoid the upward creep in CEO ratings and salary. It is easier to say “no” or cut a bonus in a tough year when objective measures of performance are agreed to and used as the basis for determining rewards.

Key Issues in CEO Evaluation

Four important additional issues need to be mentioned here. One concerns the information and measures used in assessment. The second concerns the atmosphere surrounding the evaluation process. The third involves leadership on the board, and the fourth involves evaluating the appraisal process.

A common problem we found in CEO performance assessments was that boards relied almost entirely upon the information from the CEO’s self-evaluation and the company’s financial reports. While self-evaluation should be a vital part of a performance appraisal, it is not enough. When individuals are in a position of being judged on their performance, certain biases may come up which influence how they rate themselves. For example, one CEO admitted to us that he purposely lowers his self-evaluation — preferring to be “pulled up” by his board’s evaluation rather than to be “put down.” We suspect that he is not alone in trying to ‘game’ the rating process. It is critical that self-assessment data be balanced by other information. Ratings from customers, institutional investors, employee satisfaction surveys, as well as benchmarking of the CEO’s performance against leaders both inside and outside the industry, are all useful sources of information.

The second issue involves boardroom norms towards the CEO appraisal process and the role that the CEO’s own behavior plays in shaping them. Time and time again, board members told us that the CEO’s attitude and behavior are the critical linchpins in any evaluation procedure — and that both are relatively easy to read. Directors are quickly able to discern whether evaluations are a serious process or simply window-dressing for public relations. For example, if the CEO shows defensiveness toward critical but constructive and accurate feedback, it sends a message about the level of candor that he or she will tolerate. Similarly if the CEO manipulates the goal setting process so that the goals are easy or unimportant, the whole appraisal process is of no value. As the legal counsel to one board told us in a matter-of-fact tone: “If a CEO is open and honest with the board about the process and encouraging everyone to participate, it’s going to work. If he is not, it won’t.”

Repeated defensiveness by a CEO can stifle honesty and constructive challenges. The evaluation then simply becomes a yearly, mechanical ritual that is not worth doing. Similarly, if a CEO controls all phases of the evaluation, it establishes a low level of trust and credibility. Ideally, a CEO should willingly assign responsibility for the evaluation process to independent directors or the Board Chair, where a separate chair exists.

The majority of the CEOs that we studied wanted the evaluation process to be done effectively because they felt it would make their job easier and that it was an important part of the corporate governance process. Thus, the issue of who on the board provided leadership for the process was not critical. It is critical, however, in those cases where the CEO is either resistant to the appraisal process or needs to be removed or replaced because of a poor performance appraisal. Power is the critical issue. As a result, the evaluation is likely to be effective only if there is leadership on the board by an outsider or group of outsiders.

There are a number of possible ways to provide outside leadership on a board. Probably the most effective is for the chairman to be an outsider and to be the one that leads the evaluation of the CEO. This approach has been used at Compaq since its inception where Ben Rosen, the chairman, is an outsider and takes the lead in the evaluation of the president and CEO. The alternative is to have a lead outside director, or perhaps the chair of the Corporate Governance Committee, take on the role of leading the evaluation of the CEO. There is a possibility that this can be an adequate substitute for an independent chair, but there is always a question about whether simply being the lead outside director or committee chair is a sufficiently powerful enough position if the CEO either resists the evaluation, or resists actions that are suggested by the evaluation.

One final issue concerns periodic review of the CEO evaluation procedure itself. Most boards we studied did it and found it improved the process. The typical areas they questioned included: Does the board have sufficient information to effectively evaluate CEO performance? Is communication throughout the entire process effective? Is the balance between the board's policy role and the CEO operating role correct? Are the right measures being used? How can the process be improved?

Conclusions and Future Issues for Board Governance

As the pressure mounts on publicly owned companies to improve their corporate governance practices, we are likely to see more and more firms adopting formal CEO and board evaluations. Compaq has adopted formal CEO, board and individual director evaluations along with most other recommended "best board practices," but considers them all of relatively minor importance compared to having a separate chairman and CEO. According to board chairman Rosen, "This is the single most important factor in providing the company with the right balance of power needed for effective governance...Our country has this separation of powers, why shouldn't companies?" The separation of chairman and CEO, which is a common model among firms that began with venture capital, is unlikely to be adopted in the U.S., concedes Rosen, because "there is so much peer pressure on CEOs to keep the two roles together."

In the absence of such a formal separation of power, what evaluations can accomplish if done carefully, is to create a new dynamic for the CEO-board relationship: providing a means for the board and CEO to hold each other accountable for clearly defined performance expectations, while avoiding the dangers of board involvement in day-to-day management. Evaluations can also provide the CEO

with candid feedback and targeted areas for personal development, to improve the operations of the board, to clarify the respective roles of the two parties and to ensure that they consistently focus on their responsibilities.

It may still be too early to assess the ultimate success of formal CEO evaluations. Many U.S. firms have adopted these appraisals in the last five years, a time of unprecedented profitability and stock market growth for corporate America. When times are good, it is easy to conduct evaluations and make everybody happy. The real test will come with the next bear market.

As with the strategy setting process, the key to effective governance in general, and evaluations in particular, may lie with an emphasis on continuous improvement. Like any procedure that is used repeatedly, evaluation formats can become stale and lose their effectiveness after several years of use. Varying some of the evaluation objectives and formats every few years keeps the process from becoming routinized and losing its overall effectiveness. The CEO of one company put it very nicely when he said: “These processes need to be renewed. They have to reflect living situations and in turn be open to change in the future. You have to think on an ongoing basis about the structure of the committees, their makeup, the makeup of the board, and so. It needs to be a living process.”

SELECTED BIBLIOGRAPHY

For a general discussion of board effectiveness:

Lorsch, J. & McIver (1989). *Pawns or Potentates: The Reality of America's Corporate Boards*. Boston, MA: Harvard Business School Press.

Mohrman, S., Galbraith, J. and Lawler, E. (1998). *Tomorrow's Organization: Creating Winning Competencies*. San Francisco: Jossey-Bass.

A useful survey of board practices is:

Korn/Ferry International (1997). *Board Meeting in Session. 24th Annual Board of Directors Study*. New York: Korn/Ferry.

For team effectiveness see:

Mohrman, S. A., Cohen, S. G. and Mohrman, A.M. (1995). *Designing Team-Based Organizations: New Forms for Knowledge Work*. San Francisco: Jossey-Bass.

Mohrman, A. M., Resnick-West, S. M. and Lawler, E. E. (1989). *Designing Performance Appraisal Systems*. San Francisco: Jossey-Bass. (Provides an overview of appraisal issues.)

For a focus on CEO appraisal, see:

National Association of Corporate Directors (NACD) (1994, 1995). *Performance Evaluation of Chief Executive Officers, Boards, and Directors. Report of The NACD Blue Ribbon Commission*. Washington, D.C.: NACD.

Table 1

Mean Scores¹ on Appraisal Effectiveness Survey

	Was accomplished in the appraisal process	
	<u>Company A</u>	<u>Company B</u>
1. Accurately evaluate the CEO's performance	4.8	3.9
2. Compare CEO's accomplishments against his goals	4.8	3.9
3. Recognize the CEO for past performance	4.6	3.9
4. Set future business goals	4.4	3.1
5. Communicate and explain pay decisions	3.2	2.9
6. Plan developmental activities for the CEO (e.g., training, new duties)	2.8	1.8
7. Clarify job duties, requirements and responsibilities	3.2	2.3
8. Link pay with performance	3.6	3.6
9. Discuss ways to improve the performance of the CEO	4.0	3.8
10. Discuss ways to improve the performance of CEO as Chairman	3.6	3.8
11. Flow down performance targets to senior executives	3.4	2.4
12. Provide the CEO with performance feedback	5.0	4.2
13. Facilitate implementation of the business strategy	4.2	3.3

¹ Five point scale: 1 = not at all, 5 = to a very great extent

Exhibit 1

Sample CEO Evaluation Areas

Strategy Formulation - The CEO has been effective in developing a long term, sound strategy for the company that meets the needs of shareholders, clients, employees and other corporate stakeholders; the CEO has in place processes that encourage effective strategic planning.

Strategy Implementation - The CEO has been effective in ensuring that company strategies are effectively implemented and that benchmarks have been met; the CEO has made timely adjustments in strategies when market conditions and other forces demand a change.

Financial Performance - The company's overall financial performance has been competitive overall relative to industry peers; the company is making strong progress towards meeting its longer-term financial goals; the CEO has managed well the impact of external market factors on the organization's financial performance.

Controls - The CEO has ensured that the company has strong auditing and financial control processes in place; the CEO fosters a culture of ethical behavior for the firm through effective compliance programs at all levels of the company; the CEO proactively ensures that the company complies with all of its legal obligations for this year.

Leadership - The CEO has exercised an appropriate level of leadership for the organization; the CEO has effectively communicated a vision, management philosophy, and business strategy to the company's employees; the CEO has actively sought to motivate and inspire employees to realize the company's vision; the CEO is an effective role model for the organization.

External Relations - The CEO effectively communicates the company's financial performance and future prospects to the investment community; the CEO is visible and proactive in representing the company in both community and industry affairs; public relations issues involving the CEO this year have been handled in a manner that builds goodwill for the company and is sensitive to various stakeholder concerns.

Succession - An updated plan for CEO succession was developed for this year; the CEO has ensured that potential candidates have had adequate exposure to the board; key developmental assignments

were made during the year which are consistent with the succession plan; there is an effective plan for developing candidates for senior management positions for the long-term success of the organization.

Board Relations - The CEO has kept the board fully informed of all important aspects of the company; sufficient and appropriate information has been distributed to board members throughout the year to effectively assess company strategies, their implementation, and other performance outcomes; the CEO has demonstrated sound knowledge of board governance procedures and has followed them; there is an effective balance between the CEO and the board; board members are able to initiate contact with the CEO whenever necessary; the CEO encourages candid debate and challenges in boardroom discussions; the CEO exercises the appropriate measure of board leadership.