EXECUTIVE REWARDS & PERFORMANCE EFFECTIVENESS PERSPECTIVE

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BLUEPRINT FOR A BETTER CEO EVALUATION PROCESS: UNLOCKING REAL VALUE

Boards of public companies face unremitting pressure to step up to the challenge of corporate governance. How have they responded? By all indications, boards are more independent today, with stronger lead director and nonexecutive chair roles, meaningful independent director meetings, and increasingly rigorous risk management, audit, compensation, and governance practices. Although boards have clearly

This article represents our 100th issue — we have been bringing you insight and information about current executive rewards developments since 1999. We are proud of this accomplishment and look forward to publishing more thought-provoking articles in the years ahead. Compensation committees’ scope of responsibilities continues to increase, and we will follow suit by expanding our topics (as demonstrated in this issue) and changing our publication’s title to Executive Rewards & Performance Effectiveness Perspective.

IN THIS ISSUE, ANSWERS TO:

What criteria should be used in evaluating CEO performance?

What roles should board members and executives play in the evaluation process?

What factors contribute most to an effective evaluation?

What are the organizational performance benefits of a robust evaluation process?

What are the inherent challenges of CEO evaluation and how can they be addressed?
raised their game, evaluating and rewarding CEO performance remain critical challenges for many. A key to meeting these challenges is putting in place a rigorous, performance-enhancing CEO evaluation process.

UNLOCKING REAL VALUE
Although most boards view CEO evaluation as a required year-end exercise, a growing number see it as a set of iterative steps in which the board and the CEO engage one another on issues affecting the health and performance of the enterprise. Approached in this way, the evaluation process creates a powerful ripple effect, unlocking performance opportunities and delivering value in the following ways.

Creates Alignment
A high-quality evaluation process increases accountability and alignment by establishing performance targets that measure the CEO’s performance against stated internal goals (and/or those of industry competitors/peers) that create shareholder value. Once the board and the CEO are aligned, a clear set of metrics can be cascaded down the organization, establishing organizational focus, alignment, and momentum. Additionally, the process of aligning performance targets sets a standard for evaluating and developing talent throughout the organization.

Builds Trust
There are few things more energizing to an organization than a CEO and board aligned around a shared strategy, with clear goals and a line of sight between performance and rewards. The process itself builds trust and, once established, moves beyond the bounds of the formal evaluation process, fostering a climate of openness that enriches the board-CEO relationship.

Avoids Surprises
Meaningful evaluations produce another benefit — they ward off unwanted surprises. An effective evaluation process limits the number of surprises by increasing the frequency and value of updates between the board and the CEO, creating an “early warning system” that alerts both parties to significant risks.

Surfaces Important Issues
Instituting a robust evaluation process often surfaces important strategic concerns and opportunities. For example, it helped one company snap out of its complacency and embark on an ambitious growth strategy led by a joint board-management task force. In another instance, it highlighted significant gaps in the company’s acquisition strategy, prompting a re-examination of the company’s
overall approach and assumptions. In another case, the evaluation process influenced how the CEO worked with the company’s top internal succession candidate.

Enhances CEO Development
Many CEOs fall victim to “appraisal paradox”; simply stated, the higher one’s position in an organization, the less likely he or she is to receive rigorous, constructive feedback. Effective evaluations overcome this problem by providing meaningful feedback on an ongoing basis. Constructive feedback is not a silver bullet — it cannot magically turn weaknesses into strengths or overcome deep-seated behavior patterns. But in an environment where meaningful performance feedback is rare, high-quality feedback delivered in the right way often produces unexpected, if not extraordinary, value. Finally, getting it right at the top makes it easier for others to follow suit, with the CEO as champion for a robust organization-wide performance evaluation and talent development process.

A BLUEPRINT FOR A BETTER EVALUATION PROCESS
Although there is extensive research on executive appraisals, relatively little has been written about how public companies evaluate CEO performance. Based on years working with CEOs and boards, and recent interviews we conducted with a cross-section of public company directors, CEOs, and CHROs, we have identified the building blocks of a rigorous yet pragmatic approach to CEO evaluation. Taken as a whole, it constitutes a markedly better approach than is commonly practiced, offering a six-step blueprint that can significantly enhance the quality, credibility, and impact of the CEO evaluation process.

1. Create Joint Accountability
The first principle of an effective evaluation is that boards and CEOs must share accountability for the overall quality and success of the process. Successful boards collaborate with their CEOs in every aspect of the evaluation process — from defining goals, to deciding how data will be collected, to determining how the results will impact compensation decisions. To make the process work, both parties must forge a meaningful partnership characterized by good faith, mutual respect, and genuine appreciation for the value each party brings to the evaluation process.

2. Set Balanced Performance Goals
Boards face a difficult dilemma. On the one hand, unrelenting pressure to deliver immediate performance has led many CEOs and boards to focus on near-term financial goals. At the same time, leading companies know that creating the right conditions for high performance and

“... in an environment where meaningful performance feedback is rare, high-quality feedback delivered in the right way often produces unexpected, if not extraordinary, value.”
sustainable shareholder value requires CEOs to attend to a host of operational, leadership, and talent challenges beyond acknowledged financial metrics. To address this dilemma, boards have taken the step of including long-term value-building goals to complement their near-term financial metrics. Two assessment methods in particular have proved especially useful in delivering long-term sustainable value.

- **CEO scorecards:** Scorecards measure enterprise and CEO performance against critical metrics defined at the beginning of each fiscal year. Aligned with a company’s strategy, scorecards include not only quantitative financial measures, such as revenue, profit margins, and other drivers of share price, but operational, customer, and human capital metrics as well. Additionally, scorecards look forward as well as backward — using indices of both future success (leading indicators) and past performance (lagging indicators). (See Figure 1 for illustrative scorecard metrics.)

- **360-degree surveys:** While CEO scorecards measure performance outcomes, 360-degree surveys evaluate “how” CEOs achieve their results. Short-term results matter, but so do the leadership behaviors required to deliver sustainable performance. What leadership capabilities and behaviors are needed for success now and in the future? Are some qualities, such as integrity and respect for others, non-negotiable? To assess such attributes, leading companies have incorporated 360-degree surveys and related assessment methods into their evaluation process, assessing their CEOs’ strengths and development needs in the context of an ever-changing environment.

“Two assessment methods in particular have proved especially useful in delivering long-term sustainable value.”

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**Figure 1. Illustrative CEO Scorecard**

<table>
<thead>
<tr>
<th>FINANCIAL</th>
<th>CUSTOMER</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Revenue growth, operating margin.</td>
<td>• Market share growth.</td>
</tr>
<tr>
<td>• Net sales.</td>
<td>• Customer acquisition, retention rates.</td>
</tr>
<tr>
<td>• Free cash flow.</td>
<td>• Customer mix and reach.</td>
</tr>
<tr>
<td>• Earnings per share.</td>
<td>• Technical service satisfaction.</td>
</tr>
<tr>
<td>• Shareholder returns.</td>
<td>• Overall customer experience, net promoter scores.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OPERATIONAL EXCELLENCE</th>
<th>HUMAN CAPITAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Supply chain metrics.</td>
<td>• Turnover of high-performer/mission-critical roles.</td>
</tr>
<tr>
<td>• Product/process quality.</td>
<td>• Employee engagement levels.</td>
</tr>
<tr>
<td>• Environmental/social impact.</td>
<td>• Quality of talent pipeline, succession planning.</td>
</tr>
<tr>
<td>• Productivity gains.</td>
<td>• Risk and ethics awareness.</td>
</tr>
<tr>
<td>• World-class risk-management controls.</td>
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</table>
3. Clarify Stakeholder Roles

Roles and responsibilities in the evaluation process must be crystal-clear. Although every situation is unique, it is critical that key stakeholders understand their respective responsibilities at each stage of the process. Figure 2 identifies how best-practice companies define each role.

**Figure 2. CEO Evaluation Roles and Responsibilities**

<table>
<thead>
<tr>
<th>Roles</th>
<th>Responsibilities</th>
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| Board leadership — for example, non-executive chair/lead director and/or chair of compensation or governance committee | • Establishes joint ownership with the CEO.  
• Manages the CEO evaluation process on behalf of the board.  
• Integrates board input and provides ongoing performance and development feedback to the CEO. |
| CEO                                                                   | • Shares ownership of the evaluation process with the board.  
• Provides input to scorecard goals and metrics; drafts CEO development plan; discusses with the board.  
• Completes self-evaluation scorecard, 360-degree survey, and CEO development plan.  
• Engages in year-end review and ongoing performance discussions with designated directors. |
| Independent directors                                                | • Provide input on the evaluation approach, CEO goals/performance metrics, and CEO development plan.  
• Complete scorecard and 360-degree feedback on the CEO’s performance.  
• Provide feedback on preliminary evaluation results.  
• Engage the CEO in regular performance discussions. |
| Chief human resources officer                                        | • Provides guidance and support to the CEO and board.  
• Determines human capital measures for the CEO scorecard and 360-degree survey; validates scorecard metrics. |
| Corporate functional executives*                                     | • Assists in retrieving and validating relevant scorecard metrics. |
| Senior management team                                               | • Provides 360-degree feedback, as appropriate. |

*For example, finance, risk, and compliance; customer experience; and corporate reputation executives*
4. Get the “Appraisal” Part Right

Many boards underestimate the importance — and difficulty — of appraising CEO performance. The appraisal process includes how performance criteria are measured, how data are collected, how the results will be analyzed, and, ultimately, how performance feedback will be delivered. Common pitfalls include vague performance criteria and difficulty interpreting ambiguous, if not conflicting, findings.

Additionally, boards often find it hard to impartially calibrate a CEO’s self-assessment, given board dynamics and the complexity of many board-management relationships. In fact, a host of technical, political, and emotional issues inherent in the CEO evaluation process pose a formidable challenge to many. How then can boards inject appropriate rigor and objectivity into the appraisal process? Some have looked to other boards and external advisors for guidance, adopting best practices from leading companies and learning how to avoid common problems and pitfalls. Others have turned to trusted outside firms while retaining full ownership of the evaluation process.

5. Ensure a Constructive Performance Review

The annual performance review is a critical link in the evaluation chain — if it fails, little else matters. At the same time, the annual review is not an isolated event but part of an ongoing exchange between the board and the CEO. As noted by one director, “The key is to have open dialogue between the CEO and the board — it doesn’t have to be perfect.” Combining regular informal feedback with the formal year-end review provides the CEO with constructive feedback on criteria ranging from his or her leadership style and behaviors, to critical strategic and operational issues.

6. Align Pay to Value-Building Metrics

The demand for greater transparency has increased the pressure on public companies to account for CEO performance in compensation decisions. Specifically, pressure from shareholders, combined with recent Securities and Exchange Commission rules giving shareholders a “say on pay” vote, has resulted in an escalating cycle of expectations, as explained by one of our executive rewards colleagues:

“Pressure from shareholders is creating a ‘domino effect’ pushing regulators and legislators into faster and deeper guidance on executive reward issues … forcing companies to improve their responsiveness … Overall, defining performance remains the priority focus and is being tied ever closer to all elements of rewards.”
Not surprisingly, increased regulatory and shareholder pressures have led many boards to adopt CEO pay-for-performance approaches based solely on financial criteria — a common trap, as one director explains:

“CEO performance and compensation should be correlated, but not on a one-to-one basis. Creating some separation between the assessment of short-term financial results and that of long-term sustainable performance makes it easier to focus on the CEO’s development and future growth, while still providing a strong incentive for his current performance.”

As noted earlier, in recent years leading boards have moved beyond sole reliance on financial metrics to include a complementary set of operational, customer, and human capital goals. Over time, this approach may provide greater latitude to reward CEOs for actions that ensure the long-term health as well as the short-term performance of the enterprise.

RAISING THE BAR ON CEO EVALUATION
The time is right to take CEO evaluation to the next level. Boards and CEOs can achieve this goal by adopting a blueprint that markedly improves the CEO evaluation process. It calls for shared accountability, broader performance goals, clear roles, rigorous appraisal methods, constructive feedback, and pay tied to leadership actions that create sustainable shareholder value. Applying this blueprint delivers significant benefits: It increases accountability and builds trust, helps surface important issues, mitigates risks, and enhances CEO performance and development. Equally important, the know-how and practices required to implement a better evaluation process are readily available, so companies committed to conducting value-enhancing evaluations can do so immediately and with confidence.

“Over time, this approach may provide greater latitude to reward CEOs for actions that ensure the long-term health as well as the short-term performance of the enterprise.”
A BEST PRACTICE CHECKLIST FOR THE CEO EVALUATION PROCESS

1. The board and the CEO assume joint accountability for the evaluation process.
2. The performance criteria include a broad set of scorecard metrics and desired leadership attributes.
3. CEO leadership development is an integral part of the evaluation process.
4. Key stakeholders — the CEO, the board leadership, the independent directors, and the management team — have clear roles and responsibilities.
5. Data collection and analysis is rigorous and objective.
6. There are periodic performance discussions between the CEO and appropriate board members.
7. Independent directors review year-end evaluation results before they are formally discussed with the CEO.
8. The board prepares a written year-end performance report for the CEO.
9. The annual review involves a meaningful, face-to-face meeting between the CEO and designated board leaders.
10. The link between CEO performance and pay is clear and compelling.

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Additional resources

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