As CEO appraisals become more common, the question is not "Should such evaluations be done?" but rather "How can they be done well?"

CEO Appraisals: Holding Corporate Leadership Accountable

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In most corporations, managers at virtually all levels evaluate the performance of employees reporting to them. But who appraises the CEO? How should it be done, and what results does it produce? The answers to these questions are important in determining whether a firm is effectively governed, how to reward and develop the CEO, and how to hold the CEO accountable.

Three important forces are nurturing a growing interest in CEO evaluations, making it likely that we will see more and more corporations turn to formal appraisals of their chief executives. One force is an increased awareness of the critical roles CEOs play in corporations. The management literature is awash with books arguing that leadership at the top is critical to implementing strategy, creating successful corporate transformations, and so on. Add to this the increase in CEO compensation levels—averaging 10 percent annually over the past decade—and it is only natural to ask who is judging CEO performance.

A second force comes from the investment community, demonstrated by the rise in shareholder activism during the past decade. Its roots can be traced back to the 1980s 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, raising questions as to who was minding the store. Naturally, attention turned to the board.

Feeling pressured by public scrutiny, boards began to react more quickly to poorly performing CEOs. In 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.

Corporate and CEO performance problems raise 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 for making governance structures more effective. At the very least, it can establish predetermined, tangible objectives for tracking the CEO's performance. As such, it offers the prospect of strengthening the board's ability to deal with poorly performing CEOs.

A third force, related to 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. The use of 360-degree feedback, for example, has expanded dramatically, as have employee bonuses based on performance appraisal measures. As these practices become more commonplace, it is harder and harder to justify a system that does not subject the company's most important employee—the chief executive officer—to a performance evaluation. Moreover, research conducted by the Center for Effective Organizations 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.

THE STATUS OF CEO APPRAISALS

Over the last two years, the Center for Effective Organizations has been studying organizations considered to be leaders in the field of boardroom appraisals. We have interviewed and collected questionnaire data from CEOs and board members at these companies, as well as from outside experts, and we worked with Korn/Ferry on that organization's annual corporate governance survey of the directors of *Fortune* 1000 companies.

The results of the 1996 Korn/Ferry survey indicate that roughly 70 percent of the U.S.'s largest companies have adopted a formal CEO evaluation. The challenge, however, 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. Companies that make CEO appraisals work—and work well—follow specific, clearly defined steps to avoid the typical pitfalls of performance appraisals. This requires 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, events that create major explosions and rifts between the board and the CEO.

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

THE POSITIVE IMPACT OF CEO APPRAISALS

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

In examining 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 that people would most

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EXHIBIT 1

HOW BOARDS FROM TWO CORPORATIONS RATED APPRAISAL EFFECTIVENESS

Board members used a 5-point scale (1 = not at all, 5 = to a very great extent) to evaluate their CEO appraisal process against the following criteria:

	Company A	Company B
1. Accurately evaluate the CEO's performance	4.8	3.9
2. Compare CEO's accomplishments against his or her 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

expect from a CEO evaluation process is greater accountability for performance. And indeed we found that with a system of formal, mutually agreed-on targets in place, it is 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 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 cascaded through the organization so that goals and accountabilities at multiple levels support the strategic direction. As o explained:

> The appraisal process has created a centerpiece of performance expectations...all board members have an opportunity to comment on the expectations and then cast them 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 12 months.

Just as important, the board now has an early warning system in place. The measurable targets become benchmarks for board members to determine whether the CEO is underperforming 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 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 bal-

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ance 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 the CEO's successor, helping to overcome his or her possible reluctance to share power with the board.

A final benefit of CEO evaluation surfaces in its contribution to the chief executive's ongoing development. For many boards, this is the main purpose of adopting a formal appraisal instead of just a pay-for-performance plan. One of the problems associated with the power and prestige of being the chief executive is that 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 360-degree appraisal as particularly useful.

Exhibit 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 their CEO evaluation process accomplished a number of objectives. Although the results are somewhat more favorable in Company A, the ratings are relatively similar across the two companies. In both cases, the board members felt that the appraisal did a good job of evaluating and focusing on the CEO's performance. They also indicated that it did a reasonably good job of promoting discussion on ways to improve that performance.

An additional question asked whether the appraisal *actually* improved the CEO's performance. While the answers were generally positive, there was some difference in the degree to which the appraisal was seen as supporting the implementation of business strategy. The first board clearly saw

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appraisal as accomplishing this, and the second board felt that it did so to a somewhat lesser degree.

Overall, the boards indicated that the appraisal was very much worth doing and that it should be continued. Our interviews with the CEOs themselves generally confirmed these reactions. The CEOs felt that the process went well and that it gave them valuable feedback.

DETERMINANTS OF BOARD EFFECTIVENESS

Research on knowledge workers suggest that in order to deal with complex issues such as CEO appraisal, these groups need the right mix of five elements: (1) knowledge, (2) information, (3) power, (4) motivation, and (5) time. Specific conditions in each of these areas support a board's ability to appraise performance.

Knowledge. The combined knowledge and experience of the board members must 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 group of individuals to understand all of the issues that come before a board. This argues for constructing a board around complementary 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 listing director capabilities and strategic tasks to assess the composition of both the board and the 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 explained the purpose of the matrix:

> 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, and what

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Finegold's work focuses on how workforce and management skills relate to economic performance in advanced industrial countries, with particular attention to innovative approaches to manager and worker development and to organizational designs that effectively use employees' capabilities. In addition, he is currently engaged in a major study of knowledge management and the new employment bargain for knowledge workers, as well as a series of studies analyzing the role that differences in skills play in the U.S. and Europe. His recently completed projects include a study for the White House, *The Decline of the U.S. Machine Tool Industry and Prospects for Its Sustained Recovery* (1994), and a report for the Australian Government, *International Models of Management Development* (1995).

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types of people we should be looking for to fill in.... 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 that gets played every year.

In the ideal case, a board also optimizes the mix of expertise from each individual director. 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 possibly undermining group effectiveness.

Information. The quality, quantity, and timeliness of data that a board receives on its business issues is crucial to all aspects of the CEO evaluation process. To be truly effective in its evaluation, boards also need information from multiple information: not just from the CEO, but also from outside stakeholders and from the directors themselves. Market research data are important, as are data from customers and employees. Since the appraisal needs to look at both strategic direction and leadership, it is important for the board to have information on more than just financial and operational results.

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, the most important being 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

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tends to increase when it has a leader who is not the CEO. This can be accomplished by appointing a lead director or having an outsider serve as chairman.

Motivation. Used correctly, incentives 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 board members' motivation. Issues of director compensation have achieved greater 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. It makes more sense to have a long-term orientation with options exercisable only after several years or on retirement to ensure that the board and CEO are not tempted to sacrifice the future health of the company in order to boost short-term stock price.

It also makes sense to evaluate individual directors so they will be held accountable for how they perform. If it is their money that is on the line, they are likely to behave more like investors and owners than pawns of the CEO.

Time. It takes time—more than many companies realize—for directors, as a group, to become well informed, to make effective decisions, 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 deal 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. Compaq, for example, never holds special strategy sessions. Instead, the company devotes a couple of hours at every session to some part of the business that is going to impact strategy.

In addition to time for strategy development and clarification, boards need time to review and discuss performance data 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 procedures. 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.

Assuming these conditions are 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, then set key short- and long-term objectives for the coming year. Once these objectives are defined, the CEO "translates" them into a set of personal performance targets and specifies how his or her progress will be measured against each. These objectives should include the usual financial and budget targets as well as strategic and personal development goals.

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.

This 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, they can undo whatever good intentions exist. When the CEO and the committee members reach final agreement on objectives, they present these to the full board for further discussion and final approval.

Consider one example of this in practice. William Steere, CEO of Pfizer, drafts initial sets of quantitative and qualitative objectives in December for the coming fiscal year. These are sent to his direct reports for their comments, providing one of several opportunities for his direct reports to influence and shape the firm's annual goals. In reality, this shaping 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 clarify responsibility down the chain of command for certain objectives. Senior managers 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 puts the objectives into a final draft and forwards this to the compensation committee. The committee, composed of three outsiders, meets in early or middle February to review the prior year's performance and to establish the coming year's goals. As part of their meeting, the committee reviews the CEO's sets of objectives (quantitative and qualitative) along with those of his seven direct reports. Afterwards, the group meets face-to-face with Steere 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, it gives rigor to the task of setting performance standards for the CEO and for the corporation.

The next step 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 board members to act before major problems develop and to 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 uses board meetings to highlight achievement of particular milestones for his objectives. 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 or held only an informal review. We feel that this is a mistake. Some form of mid-course check is essential if the company hopes to keep the process well integrated with its business objectives and avoid year-end "surprises."

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 in which the CEO assesses how he or she has performed over the year.

A number of companies combine this step with the goal-setting step. 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 pre-

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EXHIBIT 2

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.

sented to the board's executive committee 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, Bonsignore hands out a summary of his plan to the entire board and holds a general discussion. Although 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 focuses on the prior year's results and the board signs off on the upcoming year's plan.

Since objectives set at senior management levels tend to build on prior years, it makes some sense to combine the assessment of the prior year with objective setting for the coming year. It is also an efficient process. At the same time, however, it is important that boards see these activities as separate. If they are too closely 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 how the two activities can be effectively integrated 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 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 2 provides an example of the areas that should be covered.) Research shows that there is considerable variation in the appraisal forms being used: some have open-ended questions, others use rating scales, and others employ a combination of these. We recommend a combination. Rating scales make for easier comparisons over time and among board member evaluations and highlight where perceptions vary widely. Open-ended questions provide the flexibility to consider factors overlooked by fixed scales and targets.

To ensure confidentiality in the assessments, directors can hand off their evaluations to a trusted independent source such as a consultant or the board's legal counsel. This individual compiles and summarizes the comments to provide general feedback and preserve anonymity. The report is then made available to the compensation or governance committee for its 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 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 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 straightforward one.

For example, at Pfizer, the compensation

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committee makes a final decision on the CEO's overall performance by assigning rankings to his 10 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). For example, the committee 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, 70 percent of his performance being graded on his role as CEO and 30 percent on the chairman's role. The two scores are combined to produce a single number. This figure determines 50 percent of the CEO's final performance score. The remaining 50 percent results from a calculation of the company's performance, measured in earnings and return on investment, vis-a-vis a control group of retailing companies. The CEO's salary and bonus are then designed so that a score of "80" places the CEO's compensation at the 80th percentile of CEOs in 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. Setting the targets is critical because it determines what the board will focus on as well as the level of detail the board will be involved in.

Objectives that are too tightly focused on day-to-day managing can encourage inappropriate micro-managing by the board. For example, the question of how many managers are trained in the company's intranet is 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 economic downturn nor rewarded excessively by an exuberant market.

Evaluations should separate the performance targets for the CEO role and the chairman role. In over 80 percent 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 overall appraisal of the board.

It is important to set the right number of objectives. Too few, and performance is likely to be centered completely around financial indicators. Too many, and the CEO and the senior team risk losing a clear focus: The weight attached to each target is diluted, and the result may be the functional equivalent of having no objectives. Our best-practice companies kept their lists to between five and 10 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, these measures fail to capture important effectiveness issues that are not so easily measured. For example, issues like succession planning, involvement in lobbying efforts, trade association participation, communications within the company, board relations, union relations, and leadership are all critical qualitative areas of CEO responsibility. They need to be assessed in some manner. These are "big picture" qualitative issues that impact the company's long-term performance. Targets such as return on equity and company

profitability can only marginally and indirectly capture these important activities.

Texaco, for example, asks its senior executive to produce two sets of objectives. One set, related to financial indicators, tie to CEO pay. The other set, dealing with more subjective goals, are used for development and feedback purposes.

Once a board has an idea of the areas it wants to target, it needs to measure them in some concrete fashion. For example, leadership might be measured by internal employee surveys and 360-degree feedback questionnaires or by 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 in customer satisfaction surveys.

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

Scoring is always a difficult issue. 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 one 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 fails to deliver a clear message. Scoring can also help to avoid the upward creep in CEO ratings and salary. It's 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 in CEO performance assessments stems from the board's over-reliance on 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, biases easily 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 be "put down." We suspect that he is not alone in trying to game the ratings. Balance is critical. Ratings from customers and institutional investors, employee satisfaction surveys, and 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 toward 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 linchpins in any evaluation procedure—and that both are relatively easy to read. Directors quickly discern whether evaluations are a serious process or simply window-dressing for public relations. For example, a CEO's defensiveness toward critical but constructive feedback 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 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 encourages everyone to participate, it's going to work. If he is not, it won't."

A CEO's repeated defensiveness can stifle honesty and constructive challenges. The evaluation then simply becomes a yearly,

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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 we studied wanted the evaluation process to be done effectively. They felt it would make their job easier and that it was an important part of the corporate governance process. For these CEOs, 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 either resists the appraisal process or needs to be removed because of a poor performance appraisal. In these conditions, 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 ways to provide outside leadership. Probably the most effective is for the chairman to be an outsider and to lead the evaluation of the CEO. This approach has been used at Compaq since its inception. Ben Rosen, the chairman, is an outsider and takes the lead in the evaluation of the president and CEO.

The alternative is to have an outside director or perhaps the chair of the corporate governance committee take on the role of leading the evaluation. While this can provide an adequate substitute for an independent chair, one can rightly ask if a lead outside director or committee chair provides a sufficiently powerful position if the CEO resists the evaluation itself or actions that are suggested as a result of the evaluation.

The final issue concerns periodic review of the CEO evaluation procedure itself. Most boards we studied did such a review and found it improved the process. Typically, the review attempted to answer a number of questions: 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?

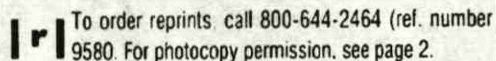
CONCLUSIONS AND FUTURE ISSUES FOR BOARD GOVERNANCE

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. Moreover, the separation of chairman and CEO, a common model among firms that began with venture capital, is unlikely to be adopted in the U.S.

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 with 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?"

In the absence of such a formal separation of power, careful evaluations can still accomplish much. They can create a new dynamic for the CEO-board relationship and provide 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, guidance on how to improve board operations, and clarification of the respective roles of the board and the CEO to ensure consistent 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.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