



### **Managing Your Greatest Asset (part 3)**

In recent issues of Good Governance we have reviewed many of the considerations that both boards and their chief executives should be aware of in relation to the board's management of the performance chief executive. In this final article in this series we bring these considerations together and suggest a process that might be followed. This is by no means the only approach possible but it is proposed as a point of reference from which each organisation can determine its own needs and design its own process.

We recommend that each of the following formal, sequential steps be scheduled into a board's annual agenda.<sup>1</sup> In doing so we make an important starting assumption – *that the board has already done its job* of describing clearly:

1. the key results or outcomes the organisation is to achieve (along with any prioritisation necessary to accommodate resource constraints); and
2. the risks to the achievement of those results that it wishes to see avoided or mitigated.

Until the board has done this work – ideally in the form of up to date, explicit *board stated policies* - there is no effective basis for any delegation to the chief executive and certainly no basis for defining performance expectations. If the board has not done this work a more ad hoc and less effective approach is likely to be required.

#### **1. The Planning Phase**

The board and the chief executive should meet in advance of the start of a new financial year to discuss their respective perspectives and affirm the board's expectations of the chief executive's performance over the forthcoming year. It is also to discuss and confirm the evaluation criteria that will be used to assess that performance.

Thinking about its use in chief executive performance evaluation is a good test of the quality of the board's policy making. How well expressed are its expectations in policy terms? Are they realistically achievable by this organisation or do they really belong to others? Are they achievable in the time period over which the chief executive will be assessed? Are performance measures available and can relevant data be collected that will allow both the board and the chief executive to be clear whether or not the expected results have been achieved?

As has often been said – 'the ends do not justify the means'. The board must also, therefore,

be clear about what types of actions, activities, etc are not acceptable. We recommend strongly that these should be stated proscriptively in the form of 'limitation' policies – i.e. by the board stating what is unacceptable.<sup>2</sup> This will have required the board to be proactive in characterising the risks facing the organisation as it seeks the intended results.

A typical limitation policy to manage financial risk, for example, might prohibit the chief executive from committing more than a specified sum to any single capital investment without board approval. Limitation policies can also deal with matters of management style or process that the board considers important. An important consideration for most boards is that there are 'no surprises'. This risk would be addressed by requiring that the chief executive shall not allow the board to be uninformed about (for example) matters that could become the subject of public contention.

This planning phase is important because not only might the overall outcomes sought by the organisation, and priorities within those, change from year to year, but so might the board's assessment of allowable risk. To the extent that the board has confidence in the chief executive's ability and judgement it may feel less need over time to limit the chief executive's choice of means. Because of initiatives already taken, the probability and potential impact of risk factors may change. Risks beyond the organisation's control may also change their characteristics over time. The planning phase is thus to ensure that both the board and the chief executive are certain about *current* expectations and that these are realistically achievable within the organisation's resource constraints.

Even though this planning phase may be under the direction of a committee tasked with oversight of the chief executive's performance the chief executive works for the board *as a whole*. It is important, therefore, that the final statement of performance expectations be 'signed-off' by the full board. We have found that it is also useful to have an open-ended discussion with the full board *before* any specific expectations are considered. The purpose of such a discussion is to gain an understanding of the board's expectations generally and to increase all directors' commitment to the process. If the board typically undertakes an annual review of the organisation's strategic plan, or its contribution to this, before detailed business planning gets underway it may be possible to combine these two processes.

## **2. Regular Progress Reviews**

Provided the board has been effective in setting such expectations it has established a clear basis for monitoring organisational and, thereby, chief executive performance. Regular reporting against those expectations expressed in policy criteria represents an opportunity for the board to make an up-to-the-minute judgement about the chief executive's performance.

It provides the basis for a *continuous* year-round process of assessing chief executive performance rather than the traditional practice in many organisations of an annual end of year review. Feedback that is timely is most likely to keep the chief executive motivated and on the right track.

Another tradition in many organisations is delegation of the process of chief executive performance review to the chair or a board committee. While this may be a practical response to the mechanics of the review process, it can have the unintended consequence of denying to other directors the opportunity to have input into the performance review of their collective employee.

Thinking of chief executive performance review as a continuous process based on ‘normal’ reporting to the board allows the whole board to be involved and underlines their shared responsibility (and dependency) on the chief executive’s performance.

### **3. Formal Progress Reviews**

Continuous, informal, feedback from the board to the chief executive is the ideal. In practice many governing boards, particularly those that are required to hold their meetings in public, find it difficult to provide structured, criterion-referenced performance feedback to their chief executive. To help those boards an additional step that might be considered is a more formal and separate progress review meeting, undertaken at three or four monthly intervals. This forces a board to create a more structured opportunity to provide its chief executive effective performance review and feedback. It also creates an opportunity for the board and chief executive to discuss whether end of year expectations should be modified or even reset. (Adding this step may be essential if the board does not begin the process with clearly stated performance expectations.)

This step may also be useful for boards that for various reasons tend to find the evaluation of their chief executive’s performance difficult, even awkward.

The chief executive’s regular monthly reporting of *organisational* performance provides a backdrop but in this case it is recommended that the chief executive prepare a specific self-assessment to assist the board to concentrate on his or her performance. This could be simply a brief (say 3-4 page) report highlighting progress in the achievement of strategic results and examining compliance with the limitations set by the board.

Boards adopting this additional step should resist the temptation to try and rush these meetings. It is important for issues to be properly explored, for feedback to be thorough and well considered and for the chief executive to have the opportunity to assist the board to become thoroughly acquainted with the nature of the challenges that the chief executive is dealing with.

It is also important that these are recognised as performance *development* reviews. They look not only at what has been achieved in the preceding three or four month period but address the future. The discussion should define any additional support the chief executive requires to achieve the board’s expectations and any changes in expectations that may be considered necessary because, for example, of changes in the operating environment.

If a board committee conducts this step, the chief executive’s review report, along with whatever additional comment it is appropriate for the committee to add, should be tabled for the information of the full board.

### **4. End of Year Performance Review**

Whether the board relies on a continuous review process or adopts a formal progress review approach there should be a ‘wrap-up’ review at the end of the year.<sup>3</sup> While the chief executive’s performance review will be assessed against a range of non-financial as well as financial performance indicators, it may be worth delaying this review until the board can take advantage of the audited accounts for the year.

There are potentially several facets to this process which are based on the idea of '360 degree feedback'. For example:

- Supplementing monitoring reports that were provided to the board earlier in the year, the chief executive might prepare a written self-assessment covering the year as a whole. This should be focused on whether or not the board's expectations have been achieved and explaining any variances.
- If the performance review is to be undertaken by a committee of the board, it is worth holding a general discussion with the full board to give directors a chance to share preliminary views and information related to the achievement of the performance criteria. There is benefit in using an external facilitator to ensure that the discussion is criterion-related (to make sure the 'goal posts' have not shifted!), balanced and related to the year as a whole, not just to recent events or incidents. This discussion would enable all board members to have a direct input to the final evaluation and would assist the responsible sub-group to structure its approach to its review meeting with the chief executive. Board members would also be invited to complete a structured survey similar to that issued to staff (see next paragraph).
- There would be a survey of a sample of staff (the size of sample depends on the size of the staff – as staff numbers increase the sample size can come down). Survey respondents would be asked to evaluate the chief executive's performance in relation to any 'process' or 'management style' criteria stated in the 'limitation' policies. Some of the larger organisations we work with prefer to structure the sample so that, for example, only those who are in a position to observe the chief executive on a regular basis would be included in the population from which the sample is drawn. Staff should not be invited to assess the chief executive's performance against criteria not codified in these or other board-level policies.
- If the performance criteria stated expectations of the nature of the working relationship between the chief executive and external stakeholders a similar approach could be extended to a sample of those stakeholders.
- Each of these sources of feedback would be combined – perhaps again with outside assistance - for the committee or full board to use in conjunction with the chief executive's own self-assessment.
- The committee or full board would conduct a meeting with the chief executive to consider this information and to reach an overall conclusion on the year's performance. This discussion should not only review past performance but be a forward looking consideration of a future performance development plan for the chief executive including his or her professional development needs. This is also a good opportunity to discuss with the chief executive succession planning and the capabilities and suitability of other staff to take the chief executive's place if and when necessary.
- Once the review discussion was complete, if undertaken by a committee of the board it would report its conclusions back to the full board.

## **5. Remuneration Review**

Most boards will accept that there is a link between the chief executive's performance and his or her remuneration. Remuneration increases are one obvious way of rewarding outstanding performance. We do, however, caution against making the performance assessment the sole basis for determining changes to the chief executive's remuneration. When there is an expectation on the part of the chief executive that the board's satisfaction with his or her performance will automatically lead to an annual salary or benefit increase, the board can find itself caught in upward spiral. Sooner or later this will get out of hand resulting in some pain for both parties. If the pattern of pay increases is not maintained (for reasons that are unrelated to performance) it can lead to the chief executive feeling, at best, unrecognised and, at worst, cheated. It may prompt him or her to look for other employment options. An unmet remuneration expectation can undermine the relationship between the board and the chief executive and lead to an unwanted and disruptive outcome.

Where the remuneration of the chief executive has a specific a 'performance-related' component (e.g. a 'bonus') the remuneration consequences of the chief executive's performance must be clearly defined.<sup>4</sup> As far as possible *any* payment of this nature at all should be made subject to objective and measurable criteria which are tied to the achievement of the key strategic organisational results confirmed during the performance-planning phase.

Besides recognition of performance another key remuneration consideration is market relativity. The 'relativity' consideration is whether or not – over time – the remuneration of the chief executive is kept approximately similar to the remuneration received by those in similar positions. To the extent that the chief executive's remuneration is inconsistent with comparable and acceptable benchmarks the board will have either a dissatisfied chief executive (where it is below the market rate) or dissatisfied stakeholders (where it is known that it exceeds the market). The first step is to ensure that the board has relevant information available to it, analysed correctly, to allow it to make sound and consistent judgements about both the 'market rate', the organisation's preferred position relative to that rate (e.g. mid-point, upper quartile, etc), and its ability to pay.<sup>5</sup>

Remuneration advice is a specialised area and advice specific to each organisation should be obtained from an appropriately qualified source.

## Conclusion

This series of three articles has examined a wide range of issues relevant to the design and implementation of a chief executive performance management system. A suggested process has been described. This information is intended to assist readers to consider how their boards might approach this vital component of their stewardship. In our view an explicit and systematic approach to chief executive performance management is not an option - it is an imperative.

- 1 For an explanation of the concept of the 'annual agenda' see *Good Governance* #11 (September-October 1999, pp 4-7)
- 2 For an explanation of this powerful technique see *Good Governance* #3 (May - June 1998, pp1-3)
- 3 This assumes that the planning period for the chief executive's performance expectations relates to the organisation's financial year not, as in some organisations, linked to the anniversary of the chief executive's

appointment or the calendar year.

- 4 We are somewhat sceptical of the effectiveness of so-called 'performance pay'. See Q&A. Should the chief executive receive performance pay? *Good Governance* #20 (March –April 2001).
- 5 Information on salaries tends to be collected at a national level in NZ because of the size of the market. The situation is somewhat different in Australia where there are more regional differences even at the chief executive level. Given the trans-Tasman nature of the organisation this adds another layer of complexity to this process. The organisation must then exercise a judgement about where they should position their payments in relation to those markets in order to reward appropriately an effective chief executive.