Managing Your Greatest Asset (and Your Biggest Risk)

Part 2: Important factors in the design of an effective chief executive performance management process

The relationship between a board and a chief executive is sometimes less effective and productive than it should be. In the previous issue of Good Governance (#20) we explained how this situation might arise. To build an effective partnership between board and chief executive the solution is often the adoption of a more deliberate and transparent chief executive performance management process. In this second article, therefore, we outline a range of considerations that a board might take into account in the design of a suitable process.

1. How formal?

Some boards do not have a formal process for addressing the performance of their chief executive. They, therefore, have no regular schedule nor a reference point from which to subsequently judge how well he or she is doing the job. In such organisations board members commonly explain that:

- The chief executive knows what we expect of her and how we think she is doing already – we don't need to spell it out.
- What's the point? He knows what the organisation needs to do better than us.
- The organisation is doing well, why bother?

Most chief executives, however, welcome and need feedback on how well they are perceived to be doing the job. While many factors conspire against a chief executive getting honest and timely performance feedback he or she is as entitled as any other employee to have any performance problems pointed out constructively, and as soon as possible. A chief executive is also entitled to a 'due process' that gives him or her a reasonable chance to improve performance if that is needed.

Unless there is a suitable starting point – such as an explicit agreement between the board and chief executive on desired performance outcomes – logically there is no basis for assessing performance. That a board may have no basis for monitoring, recognising and agreeing on the extent of a chief executive performance problem, explains why many seem inordinately slow to deal with poor chief executive performance.

A formal process increases the chances that feedback will be timely and that performance expectations will be confirmed or reset when circumstances change. It encourages key process steps to be scheduled well in advance thus ensuring that vital aspects of the process are not neglected or overlooked.

Not only should the process be formal but the board's expectations should be written into a formal annual performance agreement with the chief executive.

2. How explicit?

It is inherently desirable for the parties to know where they stand in relation to each other's expectations. There are also pragmatic reasons for making performance expectations explicit. For example, if a chief executive's performance is perceived by some board members (or, as is often the case, by 'outsiders') to have declined, clearly defined and valid performance indicators will act as a check on the validity of such an assertion.

A board will quickly learn how well it is served by its performance management system should a termination of the chief executive's contract be on the cards. In the absence of a well-designed and systematically applied system a board has few options and they are mostly difficult ones.

One option is, belatedly, to 'manage' the chief executive more explicitly. Ironically, this requires the board to do what it should have done previously – to set clear and reasonable performance expectations and then monitor and hold the chief executive rigorously to account for their achievement. If the chief executive responds by improving his or her performance to the level required, everyone wins. If, however, the board's expectations are still not being met there is, at least belatedly, a transparent basis for termination.

Alternatively, there may be circumstances where the board may not wish to offer the chief executive the benefit of this type of 'second chance'. There is every possibility, however, that, without 'due process' (the opportunity to be advised that performance is less than required and to put that right) a termination will be contested. The lack of explicitly stated performance expectations and objective monitoring data to support its judgement leaves the board in a weak position. It is likely to be forced into 'compensating' the chief executive for agreeing to an early departure. There is a high risk that arrangements of this nature will be expensive both financially and in terms of reputational damage.

Regularly reviewed, an explicit statement of performance expectations is, therefore, a cornerstone risk management strategy for both the board and its chief executive. From the board's perspective it ensures that the chief executive is focused on those matters considered most critical to organisational performance. Having a good process in place to deal with performance review is also an important insurance policy should that performance fall below expectations. From the chief executive's perspective it creates a vehicle for communication with his or her employer about their performance expectations and to obtain performance feedback. It greatly improves the prospect that there will be no unpleasant surprises.

3. How often?

Things are never static. The external environment in which an organisation operates is subject to continual change. Internally, the composition of the board is likely to change over time and with it, the dynamics of its relationship with its chief executive. A board's expectations of the chief executive shift, sometimes quite slowly and subtly, other times abruptly and dramatically. Such changes may reflect outside influences that are not even visible to the chief executive. A chief executive's own performance can wax and wane as, for example, he or she outgrows the job or it puts demands on them they are unable to meet.

Chief executive performance expectations should not only be explicit but they should be up to date. If unusual circumstances should dictate a change in expectations, an immediate change to the performance agreement should be initiated with the chief executive. Otherwise this can be checked at appropriate intervals (we suggest every 3-4 months).

Bear in mind that a chief executive needs *timely* feedback (i.e. as immediate as possible) on his or her performance. Positive feedback should be offered promptly. Any concerns about the chief executive's performance should also be brought to his or her attention as soon as possible. It is pointless (and rather destructive of trust) if a board 'saves up' negative feedback until a scheduled performance review.

To the extent that the chief executive is able to control key organisational performance variables so should he or she be held accountable for organisational performance as a whole. That means that the regular (usually monthly) reports to the board on the organisation's performance can be viewed as substantive steps in the performance review process.

Although we recommend a process of performance review that is as continuous as possible, there is also a place for a formal review of the chief executive's performance to be held at least annually. The most appropriate time is after financial year-end. This should be a formal 'wrap-up' bringing everything together to gain a complete and balanced picture of the chief executive's performance over the full year. This is also a good time to discuss how the chief executive can develop his or her performance capability and what support the board can provide in facilitating that.

We also suggest supplementing this annual review with something explicit but less formal, perhaps every 3-4 months. Ideally the board or a suitable committee should sit down with the chief executive and discuss how progress is being made against stated expectations. An ideal trigger for this discussion is a brief self-assessment by the chief executive against the performance agreement. If there is any reason for change, possible alterations to the performance agreement can be explored.

A complete performance management process will be described in the next *Good Governance*.

4. What form should the expectations take?

It is often the case that the only documentation in which expectations are formally expressed is the chief executive's job description. Job descriptions are seldom an effective mechanism for chief executive performance management. Their focus is usually on a description of the scope of the job and the principal duties and activities to be carried out.

The ideal starting point should be documentation that sets out the expectations the board holds for the performance of the organisation as a whole. This should not only articulate desired outcomes and results but define situations and circumstances that are undesirable and that should be avoided or, at least, mitigated. We advocate bringing these together in the form of a comprehensive governance policy framework. In some organisations, however, these expectations might be found in strategic plans, risk management plans and similar documents.

For *any* document to be adequate for this purpose it is important that performance expectations are prescribed in terms of the outcomes or results to be achieved. The importance of expressing performance expectations in *outcome* terms cannot be over emphasised. This makes the assessment of the chief executive's performance a much more straightforward task. Attention can be addressed to whether or not a certain outcome has been achieved - 'yes or no?' When performance measures are defined in traditional *process* or *activity* terms (e.g. co-ordination, facilitation, etc.) monitoring is not only more difficult but less meaningful. Often such measures are simply an indication of the quantity of the activity (how *busy* he or she has been) rather than a measure of whether or not the activity has had the desired effect.

The board may expect the chief executive to achieve planned organisational results in their entirety, but this may not be realistic. Either the chief executive may be unable to influence certain outcomes or the resources needed many not be available. It might, therefore, be more appropriate for the board to determine priorities or weight key performance expectations. As far as possible the board should remove any uncertainty or ambiguity about what the chief executive should achieve.

It is not uncommon for boards to specify other performance expectations that are not directly related to overall organisational performance. Often such expectations relate to the completion of various types of 'personal' project. The board should be careful to ensure that *all* expectations are connected to desirable organisation-wide *results*.

5. Who should participate in the process?

In addressing this question we must start with the assumption that the board has already done its job of setting expectations for the performance of the organisation as a whole. Otherwise it is logically impossible for it to set expectations for the chief executive. The job of the chief executive is derived from the purpose and priorities of the organisation as a whole. Put simply the chief executive's job is to ensure that the organisation achieves what it should and that undesirable situations and circumstances that might otherwise arise are avoided. If this assumption is correct a suitable performance agreement can be progressively worked up, in discussion with the chief executive, to the point where it can be approved by the board as the basis for the subsequent evaluation of the chief executive's performance.

Because the board has ultimate responsibility for organisational performance and the chief executive works for the board as a whole, the entire board should participate, in some way, in the setting of performance expectations and the review of his or her performance. Involving the whole board in the subsequent performance monitoring process is easily achieved if the focus of the performance review is on the achievement of organisational performance measures. The normal (usually monthly) reporting to the board will evaluate progress against such measure forming, in effect, part of the chief executive performance review process.

In some organisations the chief executive performance review process is delegated to the board chair. We would argue, however, that he or she might not be the person best placed to conduct an objective review. Many chairpersons and chief executives have a necessarily close working relationship. To protect both parties from accusations of, for example, collusion, a wider participation in performance review is desirable. Initial data collection might be carried out by a sub-group of the board so long as the board as a whole is involved in reaching a final conclusion about the chief executive's performance effectiveness.

While boards are likely to rely primarily on the chief executive's own reporting for relevant information it may be desirable to commission, from time to time, independent reviews of specific areas of operation. Another increasingly common source of input to chief executive performance evaluation is the so-called '360-degree' survey. This is to complement the board's perception of the chief executive's performance with the wider perspectives of groups such as, for example, staff and external stakeholders who work closely with the chief executive. It is important that, if the board seeks such input, it is very careful to ensure that participants are asked to assess the chief executive only against the chief executive performance expectations previously set by the board.

An increasing number of boards are also using the assistance of an independent external facilitator to guide and assure the integrity of the process and to bring the whole picture together.

Conclusion

Although we are strong advocates of a formal process we urge that a chief executive performance management process should never be thought of as an end in itself. The process must be designed to produce worthwhile outcomes for the organisation, the board and the chief executive alike.

In the third and final article in this series which will appear in the next *Good Governance* we describe a process which brings all these considerations together.