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Connecting CEO Performance Evaluation to Compensation Decisions

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Most boards have a process for evaluating CEO performance, and most compensation committees have a process for determining CEO pay. Too often, however, those processes operate more independently than they should.

In our experience, the CEO evaluation should not be treated like another compensation formula. It should give the board a broader perspective on performance to consider alongside the company's incentive plan results.

Incentive plans typically focus on a defined set of financial, operational, and strategic objectives. Those measures are important, but they rarely capture the full scope of the CEO's responsibilities. The board also needs to consider how effectively the CEO is executing the company's strategy, building the leadership team, developing the succession pipeline, allocating capital, managing risk, and positioning the organization for longer-term success.

Those considerations are particularly important when incentive plan results do not tell the whole story.

For example, a company may exceed its financial goals while experiencing meaningful regrettable turnover within the senior leadership team or falling behind on important strategic priorities. Conversely, a CEO may deliver strong leadership through a difficult

operating environment even when financial results fall short of the original plan.

A well-structured CEO evaluation gives the board a way to consider those factors without continually adding more metrics to incentive plans.

Keep the Processes Distinct, but Connected

The CEO evaluation and compensation decisions are related, but they serve different purposes. The evaluation is intended to provide the board with a broader assessment of the CEO's overall performance as well as provide the CEO important developmental feedback, while the compensation process determines how that performance should be reflected in pay. Keeping those two objectives distinct helps preserve the integrity of each.

One useful practice is to complete the CEO performance evaluation before reaching conclusions on compensation. Doing so helps the board develop a view of performance on its own merits rather than working backward from a particular pay outcome.

The compensation committee can then consider what, if any, implications the evaluation should have for compensation.

In some cases, the evaluation may support the outcome already produced by the incentive plans. In others, it may provide context for the use of discretion, influence an individual performance component, or affect decisions regarding future compensation opportunities.

Any judgment should be deliberate and grounded in factors the board has identified as important to the CEO's role.

Establish Expectations at the Beginning of the Year

The process should begin at the start of the performance cycle, when the board and CEO agree on the CEO's priorities and expectations. Objectives should reflect the company's strategy and include both quantitative and qualitative measures. Relevant considerations might include:

- Execution against long-term strategy and allocation of capital
- Development, retention, and succession of senior leadership
- Organizational culture and leadership effectiveness
- Board and stakeholder relationships
- Risk management and preparedness for emerging challenges
- Progress against major strategic initiatives that are not captured in incentive plans

Documenting those expectations helps avoid a common problem: introducing new performance considerations at year-end that were never clearly communicated to the CEO.

It also makes the evaluation more useful throughout the year as a management, development, and governance tool, rather than simply a year-end scoring exercise.

Use Compensation Judgment Carefully

There is nothing inherently wrong with using judgment in CEO compensation decisions. In fact, some degree of judgment is often necessary given the breadth of the CEO role. The concern arises when discretion appears arbitrary or is used simply to produce a preferred outcome.

In our experience, the CEO performance evaluation may help contextualize where the compensation committee feels the CEO should be positioned within the range of market data. From there, the compensation committee may consider several ways to reflect that assessment in pay:

- Annual incentive outcomes, particularly where the plan incorporates individual or strategic performance.
- Salary adjustments, although these are generally a relatively small component of CEO compensation.
- Future long-term incentive opportunities, where sustained leadership performance or strategic progress may inform grant sizing.
- Special recognition or retention decisions, particularly during periods of significant transformation or unusual leadership demands.

The evaluation may also lead the board to conclude that no compensation adjustment is appropriate. Not every aspect of CEO performance needs to result in an incremental pay action.

Boards should therefore be clear about the circumstances when the CEO evaluation may affect compensation and be able to explain the basis for any meaningful adjustment. In many years, the appropriate conclusion may be that the evaluation provides useful feedback but does not warrant a modification to the proposed compensation actions. The objective is not to make every element of CEO performance directly compensable. It is to make sure the board is considering the full picture when determining whether compensation outcomes appropriately reflect performance.

A Better Connection Between Performance and Pay

An effective CEO evaluation process should ultimately reinforce the board’s expectations of the CEO and improve the quality of the compensation decision.

At its best, the process is fairly straightforward: set expectations, evaluate performance against those expectations, determine any implications for compensation, and provide

clear feedback to the CEO.

The result is a stronger link between CEO performance and pay without adding another layer of unnecessary complexity to the compensation program.

About the Authors

Terry leads the Life Sciences practice and advises companies from venture-backed to multinational on executive compensation strategy, incentive design, governance/disclosure, and transaction-related arrangements.

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About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.