ISSUE 100

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Face the Future with Confidence

Board Perspectives:
Risk Oversight

Board Oversight of Performance Management

No more pervasive issue falls within the board's purview than performance management — the process by which performance toward targeted goals is measured and monitored. Performance relates to virtually everything that is important to a company's progress — execution of its strategy, the customer experience, investor expectations, executive compensation and the board's oversight itself.

Performance management is so integral to a board's oversight, it's easy to forget that it too is a process and, like all processes, can be effective or ineffective in delivering value. Given the complexity of the global marketplace, the accelerating pace of disruptive change and ever-increasing stakeholder expectations, how should the board oversee the performance management process so that it is effective in driving execution of the strategy and incenting the desired behaviors across the organization? In spite of its importance to a company's success, there is very little literature on this topic.

Key Considerations

In August 2017, Protiviti met with 18 active directors during a dinner roundtable at a National Association of Corporate Directors (NACD) event to discuss the board's oversight of performance management. As the ultimate champion for effective corporate governance, the board engages management with an emphasis on four broad themes — strategy, policy, execution and transparency. Effective performance management touches each of these themes by focusing outwardly as well as inwardly and looking to the future as well as to the present and past. The message is that, in today's environment, the focus on performance must be anticipatory and proactive as well as reactive and interactive in focusing company resources on the pursuit of its goals.

Many organizations use some variation of a balanced scorecard that integrates financial and nonfinancial measures to communicate what's important, focus and align processes and people with strategic objectives, and monitor progress in executing the strategy. Our discussions with the 18 directors identified a number of priorities for boards to consider when overseeing performance management. These priorities are discussed below using six important themes that we are observing in the marketplace.

RETURN ON EXPECTATION — Performance management must embrace the appropriate metrics, given the strategy management seeks to implement and the organization's expected investments. Alignment with strategic priorities is a challenge. As one director noted, most organizations have yet to bridge the gap between efforts to attract and retain employees and efforts to engage and align them. The traditional strategic priorities relate to such matters as quality, cost, time, innovation, customer loyalty and talent strategy. More recently, sustainability objectives around environmental, social and governance (ESG) priorities are being integrated into the performance management process as asset managers incorporate the linkage of corporate sustainability performance and financial performance in their rationale for evaluating investment decisions.

The directors agreed that managing the balance between short-term and long-term performance presents particular challenges when determining executive compensation. Executives must be rewarded for performance, and long-term shareholder interests must be preserved. The prevailing view was that performance management should be linked to the storyline articulated in investor communications. In addition, proactive outreach to major shareholders is sometimes necessary, creating a dilemma about how to communicate long-term imperatives impacting areas such as culture, innovation and the customer experience when the stock price is down. However, directors should not allow stock price performance to dominate the spotlight so much that it detracts management from focusing on business fundamentals and strategic drivers.

STRUCTURE — In aligning organizational performance with the strategy, performance management must focus on operational excellence in the structure, or business model, in place to execute the strategy. Alignment starts with defining performance expectations, as set forth by the strategy, and communicating those expectations across the organization. For example, performance expectations should be incorporated into the roles, responsibilities and authorities defined for key personnel in job descriptions and reinforced through training and appropriate metrics, measures and monitoring. Performance measures should be used to track the execution of the strategy at the organizational, process and employee levels so that accountability for results cascades down into the organization. Tracking of these measures allows for necessary midcourse adjustments to be made on a timely basis to achieve performance targets.

Questions arise with respect to the reward system. Are people being incented in the right way, consistent with the strategy? How does the board know? How should the board assess incentive compensation and whether there are incentives that spur unacceptable behavior such as taking on excessive risks? In responding to these questions, several directors noted that the board needs to adopt an ownership mentality to function as effective advocates for shareholders (i.e., directors should discharge their responsibilities under the assumption that they "own the company" and provide guidance and direction to management accordingly).

CULTURE — A key concern for the directors, culture sparked much discussion during the roundtable. Several directors noted that while most boards assess and understand the tone at the top, they neither assess nor understand the tone in the middle. One director suggested the use of organizational health and effectiveness surveys to gauge how employees perceive the current leadership culture and compare that perception to the culture they desire. Gaps in perception, as revealed by such surveys, almost always provide informative insights into what's really happening in the business and what people below senior management really think. They also reveal opportunities for leadership development and improving the tone at the top and in the middle. The board should be privy to the results of such surveys.

There were several takeaways on culture:

- Performance management should drive the type of organization, inclusive of employee values and expectations, that management and the board would like stakeholders to experience when they interact with it. Conversely, it should not influence improper behavior and inculcate a dysfunctional culture.
- When the board sets goals, directors should consider how those goals will be achieved by management. For example, growth is always a worthwhile goal, but does the board really understand how management will make it happen?

- When attrition is unusually high, does the board ask why? Obtaining an understanding of the specifics as to why people are leaving could pinpoint problems embedded in the organization's culture.
- When performance levels are way above the industry norm, does the board inquire as to why? Dominant performance levels could result from undertaking unacceptable risks or engaging in unscrupulous activities.

The consensus of the group was that boards should encourage and, if necessary, push management to consider culture-related measures and come forward with an approach that makes sense. It's that important. As one director noted, "What gets measured matters." To that end, the board should insist that human resources be engaged proactively in the process so that the function is not an impediment and, when culture issues are identified, progress is made toward identifying the root cause.

One interesting question — often raised in the wake of high-profile examples of dysfunctional cultures — is this: "Does the company's culture emphasize treating people with respect and support individuals challenging something that is wrong or not safe?" Being risk-averse in such circumstances and supporting contrarian views, even in the face of significant organizational or peer pressure, should be encouraged and supported.

CUSTOMER EXPERIENCE — The customer base should be segmented and metrics should focus on the needs of each targeted segment. Customer experience metrics should address the distinctive attributes of the value proposition underlying why customers choose the company's product or service over other alternatives. For many organizations, success in sustaining customer loyalty can make or break their success in the marketplace; therefore, it is important that the focus on financial results does not detract from the need to serve and delight customers.

Customer-related metrics should provide insight as to what a company needs to do once issues are identified. To that end, they should reach beyond nonfinancial areas and address quality, responsiveness and other critical aspects of the brand promise, both expressed and implied. Interestingly, less than half of the directors in the roundtable indicated that their top executives reported on one or more customer experience metrics.

Data tells the story. The strategy drives the business model that creates the necessary alignment across the organization to deliver the desired customer experience. Data is collected at the appropriate customer touchpoints to monitor the effectiveness of customer-facing processes in delivering the desired experience. Based on mining, analyzing and synthesizing the data to derive predictive, focused insights, process adjustments are made to improve the customer experience. The cycle continues unabated, and is enhanced through advanced analytic capabilities.

When it comes to the customer experience (and even culture across the company), it is incumbent upon board members to also be observant and "do some homework." For example, directors should listen to the language and observe the behavior of their executives, read information about competitors, and seek information from other data available in the market. It also can be highly informative to talk directly with customer-facing personnel in the organization, as well as visit company locations and assess how people behave. As one director put it, "Try to do your own research and be a 'secret shopper.'"

INNOVATION AND RESILIENCE — Disruptive change and unwelcome surprises have become the norm rather than the exception. Accordingly, metrics should inform the organization's focus on innovation, changes in technology and the business environment, emerging disruption, and market opportunities. During a portion of the roundtable, the directors focused on innovation as a source of new revenue-generating opportunities and a driver of a positive, thriving culture. Several key points were made:

- The board should encourage consideration of innovation in the performance management process and expect management to report results to the board. In measuring innovation, management should consider business processes as well as products and services. An "innovation pipeline" should be established, and reporting should address progress through the pipeline.
- When appropriate, the board should establish innovation as a performance metric for the CEO and other C-suite executives. If innovation is not a performance goal, the board likely will not observe the desired engagement.

- With the wrong culture, innovation can create significant issues and possibly lead to a loss in market valuation.
- The board composition should include "innovation experience." Innovation oversight can be difficult for directors who haven't been part of an innovative, entrepreneurial culture. The key question is: Does the board require entrepreneurial experience among its directors to ensure diversity and the proper mindset to assess innovation, or is it enough to have the necessary knowledge and perspective to ask the right questions and frame the right requests? The former approach is vital if innovation is essential to survival.

The directors viewed innovation as more than just technology. Other innovation opportunities reside in financial re-engineering, portfolio management and launching new product ideas. The board should be mindful of the different ways organizations can be innovative and embrace them.

METRICS, MEASURES AND MONITORING — Some directors pointed out that when it comes to performance management, there is a risk of gaming the system. It is human nature for management to instinctively want measurements to reflect positive results. That is why there are several key attributes of effective performance metrics for the board to consider. Metrics should be realistic, understandable, objectively determinable, believable (meaning a "single version of the truth") and actionable. There should be a balance of forward-looking lead metrics to complement the traditional retrospective lag metrics.

As one director noted, "Flawed stories are better than perfect ones." It's a positive when the performance management process identifies one or more areas requiring attention and improvement. "Perfect narratives" tend to raise questions about the rigor under which performance is measured and monitored, as well as the authenticity of the results. As long as senior and operating managers are forthright in seeking the facts and telling the true story, with an eye toward improving products, services and processes continuously, the board can stand behind them with confidence when results are communicated to shareholders.

The above points get to the bottom of the essential question: Do the CEO and executive team really want to know the unvarnished truth? About the culture? The customer experience? Innovation? The effectiveness of the business model? When executive management commits to managing by fact and earnestly seeks genuine results, there is no holding back.

Questions for Boards

The board of directors may want to consider the following questions in the context of the nature of the entity's risks inherent in its operations:

- Is the board satisfied that the performance system is fully aligned with the strategy and effective in identifying issues and driving timely corrective action? Does performance management:
  - Focus on the customer experience?
  - Provide insights on culture (e.g., alignment of the tone at the top with the tone in the middle)?
  - Facilitate efforts to address the forces of disruptive change affecting the industry, and provide early warning of key issues affecting the viability of the business model through anticipatory, forward-looking metrics that track key factors and market drivers?
  - Assess the relevance and effectiveness of innovation practices by tracking the results and outcomes of investments made to innovate products, services and processes?
  - Benchmark performance against competitors?
  - Link to shareholder returns and the narrative to shareholders?
- Is the board satisfied with the quality of performance reporting, both for the full board and its standing committees? Is the performance system efficient, or does management have to engage in time-consuming "fire drill" issues to prepare the performance information that directors need in advance of board meetings?
- Do directors take the initiative to gather information and insights from a broad range of sources, and not rely solely on the company's internal metrics?
- Do incentive plans for the CEO and executive team incorporate appropriate long-term performance metrics linked to the strategy?
- Are there inherent conflicts within the metrics structure (e.g., aggressive sales metrics or cost and schedule versus safety issues), and is the board satisfied with how those conflicts are managed?

How Protiviti Can Help

With today's competitive global marketplace being all about quality, speed and continuous improvement, every organization's ability to transform, innovate and change is paramount. Protiviti's Business Performance Improvement solutions are supported by digital capabilities that provide a "digital lens" to help clients solve complex business challenges relating to the customer experience, digital transformation, robotics and artificial intelligence (AI), and process analytics. We provide pragmatic approaches to define, adopt and execute dynamic strategies to establish a cultural foundation that's accepting of the most complex transformations and partner with clients to help them improve:

- **Alignment** — focusing on culture, process and technology;
- **Collaboration** — through idea sharing, engagement and results;
- **Innovation** — to increase differentiation, transformation and business value; and
- **Delivery** — enhancing product life cycle, methodology and change management.

Clients working with us report lasting results in 90 days or less and that we are respectful of their time, talent and resource challenges; are effective in helping them bridge communication gaps between functional teams and the business; and bring to bear pragmatic approaches and tools that enable maximum stakeholder participation in achieving measurable results in a wide variety of areas. These results include increases in revenue, innovative idea sharing, global and cross-functional collaboration, and human capital retention, as well as reductions in elapsed process times (e.g., customer service center turnaround and speed-to-market of new innovations).

Protiviti is a global consulting firm that delivers deep expertise, objective insights, a tailored approach and unparalleled collaboration to help leaders confidently face the future. Protiviti and our independently owned Member Firms provide consulting solutions in finance, technology, operations, data, analytics, governance, risk and internal audit to our clients through our network of more than 70 offices in over 20 countries.

We have served more than 60 percent of *Fortune* 1000® and 35 percent of *Fortune* Global 500® companies. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies. Protiviti is a wholly owned subsidiary of Robert Half (NYSE: RHI). Founded in 1948, Robert Half is a member of the S&P 500 index.

Protiviti partners with the National Association of Corporate Directors (NACD) to publish articles of interest to boardroom executives related to effective or emerging practices on the many aspects of risk oversight. As of January 2013, NACD has been publishing online contributed articles from Protiviti, with the content featured on https://blog.nacdonline.org/author/jdeloach/. Twice per year, the six most recent issues of *Board Perspectives: Risk Oversight* are consolidated into a printed booklet that is co-branded with NACD. Protiviti also posts these articles at protiviti.com.