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How a Board Should "Talk Talent" with Its CEO

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A lot has changed since corporate governance matters have been more responsibly practiced. The board's focus on talent management matters is one of the most significant changes. Historically, a board's concern ranked low. As recently as 2008, directors ranked these matters 12th or 13th in importance. Fast forward to 2013, and talent management has jumped to one of the top governance concerns.

Investors historically have operated from hunches to make the connection between adept leadership and shareholder value creation. Yet in a 2013 study of equity analysts, strength of management was ranked as the most important factor influencing investment decision making. Arguably, analysts have awakened to focus on leadership as a key differentiator between good bets vs. bad ones.

A 2013 study of over 1,000 corporate directors conducted by Women Corporate Directors and Heidrick and Struggles, talent management was rated the board's most strategic challenge—above risk management, technology, competitive threats, innovation, debt, and even regulatory compliance.

It seems clear that corporate boards have elevated their attention toward talent management as a significant strategic concern.

Does Excellence in Talent Management Translate into Financial Returns?

Yes, and dramatically so. Major studies of the impact of leadership and human resource practices on financial business results were first published in the 1990s. From the University of Minnesota's Industrial Relations Center, a 1995 study of the quality of leadership and human resources practices of a large sample of public companies were compared with their company's financial performance. Those companies with top quartile leadership and human resource practices were compared with bottom quartile companies. The results were significant:

- Market to book value of top companies was 35% higher
- Employee productivity of top companies was 31% higher, and
- Market value of the top companies was 4X their laggard competitors.

McKinsey’s Organizational Performance Profile study, reported in 2007, examined the link between organization leadership and talent practices with financial performance. McKinsey researchers were asking: What’s a great organization really worth? McKinsey found that companies with top quartile talent practices, compared to bottom quartile companies were:

2.2 times more likely to deliver above median EBITDA

2.0 times more likely to deliver above median book value growth, and

1.5 times more likely to deliver above median net income.

A 2010 *Business Week* article suggested that the best performing organizations pursue something that is “different but powerful” compared to other organizations. The authors cited organizations—Baxter, P&G, PepsiCo, FedEx—in which their “greatest achievement was in developing leadership—more than products. While some rivals are mired in management challenges, these companies have developed deep leadership benches with the payoff being solid sales and consistent double-digit earnings.”

A New Strategic Question?

Directors are typically prepared with a short list of crucial questions which can be posed in pursuit of their governance responsibilities. Talent-related questions have traditionally not made their short list. However, the growing body of research and expert opinion regarding the importance of a board’s attention to leadership and talent management spawns a new contender for a board’s *most* strategic question: Does our operating organization have the leadership to set a winning strategic agenda and talent throughout the organization to implement it?

Beyond CEO succession most other leadership and talent management discussions have been “back burner” topic in the board room—perhaps due to the uncharted connection between talent and financial performance; or perhaps due to concerns about a board becoming too involved in a company’s operational matters.

Boards are now looking for a useful framework to fulfill their oversight role in the area of leadership and talent management. This article presents such a framework.

Five Frames for Board Oversight of Talent

The balance point between "nose in and fingers off" is a persistent concern as Boards and CEOs navigate lines of demarcation separating them and giving their roles independence and identity. Directors are understandably cautious about becoming too hands on in the wide range of talent matters where they have limited interaction and visibility. The CEO expects to be the "captain of his/her ship."

So, the aim of this article is to provide directors with a comprehensive framework for their oversight responsibilities. The factors in the framework are:

Leadership at the Top

Talent throughout the Organization

Bench Strength Depth and Readiness

Compensation Alignment

Effectiveness of the Organization's Leadership Renewal Programs and Processes

This framework sets up a comprehensive assessment of an organization's leadership strength and talent depth by the CEO. The process relies upon candid discussion by the CEO in reviewing leadership and talent matters with his or her board.

1. Leadership at the Top

This frame is the fundamental element separating top quartile companies from market performers and bottom quartile laggards. Not much matters, if the organization's leadership is weak or simply out of gas. This frame puts focus on individual competency and team capability of the organization's senior leadership, usually the top one or two organizational levels.

Assessment of each senior leader may include their credentials, experiences plus important competency variables such as ethics, strategy skills and instincts, operational leadership, talent development, and increasingly important, external skills.

Key areas for discussion and evaluation include:

Individual performance and effective teamwork. Candid assessment of the contribution of each senior leader—short term and long term—is information a board should have. Discussion by the CEO should focus on areas where senior executives demonstrate role model behavior and where remedial learning is necessary, and preparatory experiences are planned.

Educational, age, and experience qualifications. Demographics can paint a picture of the capability, seasoning, and diverse thinking. These data can indicate areas of likely strength versus deficiency, or immaturity.

Impact of recent upgrades and change outs. Leadership ranks are rarely stable. Losses and additions tell a story of shifting demands or standards in competency, business focus, team dynamics and the ability of the leaders to assess and manage its leadership talent. Discussion spotlights leaders the company must heavily rely and in contrast, leaders who place the company at undue risk.

Adequacy of the structural design of the organization. Organizational design reveals how an organization chooses to coordinate its business processes. It is valuable for a Board to consider the suitability of the structure as a means of resource allocation and strategy execution.

External influence and impact. The influence senior leaders have with stakeholders is increasingly important. Discussion reveals how the behavior of senior leaders strengthens, or impedes the company's external impact and influence.

2. Talent throughout the Organization

This frame focuses on those leaders below senior leadership—from upper management to mid-management, perhaps to supervision. Some companies choose to include discussion about front line workforce.

This "slice" is where the majority of decisions involving your customers are made, where resources are prudently committed or squandered and where leadership affects the culture on a daily basis. This "slice" is where change management initiatives produce new direction and impact or where initiatives languish as the flavor of the month and die. Simple questions might be:

Does our organization outperform our competitors?

Does our organization handle challenges and change well?

Key areas for discussion and evaluation include:

Capability of leaders in pivotal positions. Discussion should focus on those leaders in "make or break" positions and also the talent depth in their unit. What is the maturity and capability of those leaders *and* that unit to perform? Assessment may lead to identification of potential performance risks, or gaps. Retention matters should be discussed for high performance leaders in pivotal positions.

Functional Capability. A Board should understand the technical strength in areas crucial for fundamental market differentiation, i.e., core competency areas. Core competency areas may be unique technical know-how, distinctive processes, R&D excellence or close customer relations. Anticipation of likely disruptive technologies enables a board to assess the level of risk.

Workforce Optimization. Size, deployment, and cost of the workforce are important matters. Board members gain valuable insights on a range of workforce issues internally and in comparison to the competition.

Employee Engagement. Employee engagement directly links to performance and resiliency. Boards should have a sense for the overall vitality of the workforce. Boards also should be aware of troublesome, high risk areas including third party intrusion such as unions or regulatory agencies and litigation.

Performance of Business Units and Staff Functions. A Board benefits from discussion about the performance of each of these units against expectations or against competitive benchmarks and 'best in class' models. Which are the exemplary units? Which units and functions represent risk?

3. Bench Strength Depth and Readiness

This frame is used to assess readiness and adequacy of emerging leadership talent needed to meet replacement, growth and promotability demands.

The intent of management should be to fund the organization's needs with "on time, ready now, superbly qualified talent"—talent that excites and reassures versus talent deemed high risk and ill-fitted.

Demand forecasting is challenging. The time frame for anticipating demand varies from "now" to well out into the future—ranging from an immediate need due to an emergency or opportunity to a well thought-out succession plan which materializes over the course of months or perhaps years. Long term development initiatives compete with the demands of day to day work.

Repeated errors in talent judgment must be noticed by senior management, if not the board. When the organization has too little “take your breath away” talent; or when high potential-rated talent is not promoted and “left on the shelf too long,” corrective action must be taken with those who have failed their talent management responsibilities. The themes presented here should guide board discussion of bench-strength:

Adequacy of decision support information**.** Boards need to feel certain they are presented with an accurate and candid picture of the company’s talent and its bench. Many organizations use a quantitative talent dashboard to monitor talent events and trends. Trust between the CEO and board is reinforced when candid discussion is foundation of discussion.

General Management Bench. For an organization to deliver sustainable performance over time, its leadership pipeline must be filled with a cadre of talented general managers—P&L leadership whose promotional readiness is intentionally staggered from “ready now” to “ready in five years.”

Functional Bench. Some staff functions are simply more vital than others as contributors to the overall performance of a company. Boards are wise to understand these critical functions—their thought leadership and ability to influence the broader operational organization. These units are also places where high potential leaders can be deployed to gain technical insight as well as important lessons of leadership, a 'corporate perspective’ for a future GM role.

“Rising Stars.” There is a handful of very high potential talent in the depths of most any organization. Talent which is years away from senior leadership, yet crucial for its future. These assets should be on an early watch list. A board should understand the plans for developing, testing, and retaining these emerging leaders—and the risks. Diversity candidates can be spotlighted in these deliberations. Those “stars” that have left the organization and those whose potential has “faded” should be discussed also.

4. Compensation alignment

Compensation alignment is simply a determination of fairness in the manner that compensation programs deliver rewards—base, short term incentives, and long term incentives. These days, fairness is judged through the optics of many stakeholders. Alignment, i.e., fairness is achieved when goal targets and projected payouts are understood in terms of the risk profile—risk to the performer and risk to the shareholder; when payouts are affordable to the company, when payouts are reasonable within the relevant, competitive markets; and when compensation decisions are sensitive to company performance over time.

Discussion about compensation alignment clearly overlaps with an annual executive compensation review but the discussion in this frame may range more broadly throughout the organization and highlight program and process matters.

<u>Effectiveness of the Performance Management System.</u> An effective performance management system differentiates individuals, teams and even business units and functions whose behavior and achievement meets [or, fails to meet] expectations. Discussion may spotlight over-performing and under-performing functions and business units; company philosophy and practices for addressing poor performers; and circumstances with negative or positive discretion is applied by the CEO and senior management.

<u>Compensation cost.</u> Discussing compensation affordability and payroll spend on core vs. non-core competency resources elevates these matters to strategic importance to a Board.

<u>Compensation "optics" that may trigger negative attention.</u> There are compensation-related issues which potentially can diminish the company's reputation and require senior management time and attention to explain or diffuse controversy. Deliberation about the merit of these "red flag" items and their potential to disrupt are perspectives a Boards should have.

<u>Vendor Performance.</u> With many companies operating extensive supply chain relationships with outside vendors or business partners, a board is well served to understand the performance and relationship dynamics with major vendors, business partners and advisors.

5. Renewal Processes

The final frame addresses the adequacy of the company's leadership and talent management *policies, programs, and processes* — i.e., the "machine" that keeps the pipeline filled with talent for "ready now" deployment actions and future needs.

Renewal begins with a company's ability to see the future accurately and translate this perspective into tactics which will prepare leaders and organizational talent to outperform the competition in the future.

The scope of this frame is broad. It covers all the systems and processes developed to recruit, on-board, develop, deploy and retain talent. Discussion may occur around the themes which follow:

Investment focus and trends...where are we spending our resources? Discussing return on investment takes the issue to a strategic level. Like other areas of the business, it is instructive for a Board to understand the investment necessary for equipping a high performance organization, and the time horizons and uncertainties involved in managing the talent pipeline.

Alignment with Strategy. The board should be convinced that people programs, processes and information systems are clearly linked to business strategy.

Alignment of “people” programs, processes and systems requires communication and collaboration between planning units and Human Resource function. The evidence of this should be convincing.

Program Evaluation. Does evidence show that talent management “machine”—policies, programs, processes works effectively and efficiently to deliver world class talent?

Hands on Mentoring by Senior Leaders. Leadership is often about delegation. Effective talent management is not; most importantly the signals sent by senior leaders are of paramount importance. Organizations that “win” expectthat the senior leaders are truly 'hands on', involved daily in the pursuit of building a bench and coaching others. This behavior sends a strong signal to the organization about the values of “what is truly important around here.”

The Board’s Annual Talent Review Process

A straightforward process is presented below. It is always important to note that robust dialogue between the board and the CEO is far more valuable that forms and rating scales. Key to the Talent Review process is the dynamic of the CEO self-report to the board on status of the organization’s leadership and talent. The steps:

1. Talent review begins by setting a date on the Board’s annual calendar—probably not at the same time as end of the year activities;

2. The nominating committee should lead a brief discussion with the Board around concerns and expectations for the upcoming Talent Review by the CEO;

3. The nominating committee should brief the CEO about particular issues of Board interest or concern and set the tone for the upcoming Talent Review meeting;

4. The CEO prepares for board review with a self-assessment of current status of talent plus a narrative discussion. The rating scale below is typically ample structure for the assessment process and aids in year over year tracking;

Leadership & Talent Management Risk Assessment

	1. Significant Risks Have Emerged	2.	3. Risks are Being Addressed	4.	5. Risks are Continually Well-Managed
Leadership at the Top	○	○	○	○	○
Talent Throughout	○	○	○	○	○
Bench Strength	○	○	○	○	○
Compensation Alignment	○	○	○	○	○
Renewal Processes	○	○	○	○	○
Narrative Description	**Needs Action Plan**		**Need to Regularly Monitor Progress**		**Monitor Results & Energy Risks**

5. During the talent review meeting, the CEO talks the board through the five frames and his/her assessment of the specific area. Particular importance should be placed on future moves, investments in talent, risk and risk mitigation.

6. Executive session time is devoted to consider the CEO's assessment and plans. This session should conclude with written comments to be taken back to the CEO plus acceptance or adjustment of the CEO's rating.

The board should decide how to reflect leadership and talent management matters into the CEO's short and long term compensation. We believe there is a very personal obligation required by the CEO to the organization's talent which just cannot be delegated.

Looking Forward

Boards increasingly appreciate that leadership and talent management are decidedly not back-burner matters. More than ever, they appreciate that these matters significantly impact the sustainable performance of the enterprise and should not solely be the charge of the HR executive or even of the CEO and top management. There is clear recognition that that the board and senior leadership must align talent management with the long-term strategic goals of the organization in order to earn competitive advantage. There is clear recognition that boards have a contribution to make in this area.

With this heightened attention on leadership and organizational talent, there are issues every board should consider:

What ongoing role should our board have to help the organization build better talent management?

What should our leadership competency model look like over time?

What diagnostic processes should be in place to focus the Board's attention on critical or emerging leadership and talent matters? Where should our Board focus its attention?

How can we improve the review process with the CEO?

What works best for us over the long haul?

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1. A study under the direction of Dr. Cheri Ostroff, Associate Professor at the University of Minnesota's Industrial Relations Center sets forth the financial impact of HR practices that resulted in a number of both general and specific findings about the impact related to four financial measures; Reported in the Human Resources Management Journal, Fall 1997, Vol.36, Pg. 305-306; David Ulrich; editor: Measuring Human Resources: An Overview of Practice and a Prescription for Results.

The Missing Link: Connecting Organizational and Financial Performance; Working paper by McKinsey & Company; Aaron DeSmet, Rodgers Palmer and William Schanger; February, 2007. In the citation, which is a result of McKinsey's Organization Performance Profile (OPP) they found that the degree to which particular management practices were in place, one of which is the quality of talent, directly and substantially affected financial results and earnings.

Business Week article; circa mid-year 2010, reported on the comprehensive study conducted by the American Productivity and Quality Center (APQC), the Center for Creative Leadership, and Duke Corporate Education. The study was headed by Robert Fulmer, PhD. and Jared L. Bleak, PhD. Drs. Fulmer and Bleak later collaborated on **The Leadership Advantage**, in which they review the primary findings of the study. In the study they found a direct relationship of the organizational commitment to building a pipeline of talent, producing a strong 'bench' and the financial performance of an organization.

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