

ARE CEOs EXPECTED TO BE MAGICIANS?

PERFORMANCE EXPECTATIONS OF A CEO

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01

THE MESSAGE FOR THE MODERN CEO – PERFORM OR PERISH

The expectations placed on the shoulders of the modern chief executive officer (CEO) have never been greater.





Company boards, shareholders and customers all look to the CEO to perform exceptional feats. Whether it's turning around a sick company, revitalising the share price, undertaking a merger or acquisition (M&A), or redefining the business strategy, the CEO is under immense and sustained pressure to perform.

Often, where the focus is an ailing organisation, the timeframe allowed for a turnaround is relatively small - perhaps only a year or two before the support of the board, and shareholders evaporates.

CEOs are required to perform these achievements while dealing with all of the routine tasks involved in the day-to-day running of a business. They are increasingly the target of shareholder activism, as well as the brunt of accusations that they are overpaid and underperforming.

It raises the question as to whether the pressures being placed on CEOs to deliver these results are realistic, or even humanly possible in certain situations.

What impact is this pressure having on CEO tenure? How is the tight timeframe impacting key decisions on capital investment and long-term shareholder value?

And is the modern CEO becoming a type of scapegoat for structural faults that go beyond the capacity of any one individual?

This paper explores the array of demands confronting contemporary CEOs and looks at how well they are handling them, while also examining the way in which important business decisions are being impacted by sustained pressure for rapid results.

IT RAISES THE QUESTION AS TO WHETHER THE PRESSURES BEING PLACED ON CEOs TO DELIVER THESE RESULTS ARE REALISTIC, OR EVEN HUMANLY POSSIBLE IN CERTAIN SITUATIONS.

02

GREAT EXPECTATIONS

The Business leaders are under pressure across the globe. As the economy gradually emerges from the deepest global recession in a generation, the role of the CEO is coming under renewed focus.





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Business leaders are under pressure across the globe. As the economy gradually emerges from the deepest global recession in a generation, the role of the CEO is coming under renewed focus. There is the hope that many incumbent CEOs can perform the sort of miracle work that, during the 1980s, transformed the corporate landscape.

CEOs with vision, courage and foresight have always been elevated to cult status. Names such as Jack Welch, Katharine Graham, Sam Walton, David Packard and Lee Iacocca once cut a swathe through the business, media and political landscape.

And while the CEO success stories become legendary, so do the failures. The global financial crisis of 2008-09 added a legion of scalps to a shame list of CEOs whose records are etched in corporate folklore.

In between these two extremes lay a less public and less spectacular gallery of men and women who serve as CEOs – the appointed agents of the owners of businesses, large and small, across the globe.

The responsibilities on these individuals span the entire spectrum of company operations and they either prosper or perish on the outcome of a range of performance measures, interpreted by directors, customers, shareholders, analysts and the business media.

At the same time, standards of corporate governance are being ratcheted up in many jurisdictions as regulators and boards heed the calls for improved accountability and transparency flowing from past corporate failures.

But with the increased pressure from all these quarters, are CEOs getting less time to develop and build organisations? Are boards making it harder for CEOs to prove themselves in a shorter timeframe?

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It is a pressure that most CEOs will feel at some point, but which few actually put into the public domain. One exception was the CEO of Yahoo, Carol Bartz, who in early 2010 probably encapsulated the frustration of many CEO's when she called for patience in her efforts to turn around the struggling Internet company.

Bartz pointedly reminded investors and the board how long it took Apple founder Steve Jobs to revive that company after his return as CEO in 1997. Jobs, she said "knew the DNA (at Apple) better than anyone and it took him four years," she exclaimed.

Bartz's comments reflect the weight of expectation that falls on CEOs, particularly those who assume leadership for businesses that have fallen on hard times. CEOs who have been able to perform spectacularly in one business setting are presumed to be able to do the same in another setting.

The "turnaround CEO" as they have become known as, must be able to perform almost super human feats. But is it reasonable?

One spectacular example centres on the role of C. Michael Armstrong, the former CEO and Chairman of AT&T who was brought in to revitalize the business in the era of digital communications but ended up overseeing the break-up of its divisions, followed by his own departure.

There was no doubting Armstrong's stellar record of achievement as CEO of Hughes Electronics and Comcast. Surely the same results would follow for the telephone giant, as it entered the dawn of new era of converged telephony and entertainment services.

It is clear that many things went wrong. There were a series of execution problems, strategic misjudgements about the pace of decline in fixed line services, the colossal task of transforming the culture of a former monopoly, and ultimately the dot.com crash that savaged the telecoms sector.

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The lesson abound: many were caught short by the speed at which wireless and cable services expanded at the expense of legacy services; no matter how vibrant or dynamic the individual, monopolies have entrenched cultures which can take years (perhaps decades) to shift; and occasional seismic shifts in market sentiment as occurred in the dot.com crash can overwhelm even the best strategy.

On the other hand, the case of Steve Jobs who took over as CEO of Apple in 1997 shows the scale of turnaround that is possible through an individual able to capture the emotion of a generation of consumers and transform that into products that embody the mood and fill the need. Items such as iPod, iPhone and iPad completely repositioned Apple within the industry and transformed its fortunes.

The example of the charismatic individual able to conduct a game-changing assault is relatively rare. It is arguable that in some instances no individual has the knowledge, expertise, time or resources to navigate the multiple challenges that confront contemporary businesses, particularly at times of profound change.

It is generally accepted in management literature that there are two fundamental streams to business success – strategy and execution, or as it is sometimes put: “doing the right things”, and “doing things right”.

Strategy is the culmination of a process of assessing the present business situation and the broader market environment, and then determining the appropriate product and market segment to be targeted. The execution involves all of the tactical and operational decisions required to ensure the appropriate logistics, personnel, and other business resources are working in harmony to deliver the outcome.

In many ways, they can be viewed as two distinct tasks, each requiring their own knowledge, expertise and competencies. It is a rare individual with the capacity to formulate both the high-level strategy with all of its nuanced judgments about direction and the competitive environment, and the ability to bring it all together on a day-to-day basis.

IT IS ARGUABLE THAT IN SOME INSTANCES NO INDIVIDUAL HAS THE KNOWLEDGE, EXPERTISE, TIME OR RESOURCES TO NAVIGATE THE MULTIPLE CHALLENGES THAT CONFRONT CONTEMPORARY BUSINESSES, PARTICULARLY AT TIMES OF PROFOUND CHANGE.



Yet this is what many boards and stakeholders are expecting of CEOs, particularly those who are hired to institute the dramatic corporate turnaround. The scale of the challenge is captured in a series of responses from almost 4,000 CEOs in a report by consulting firm, Booz & Company which looked at the way the CEO role has evolved in the last decade.¹

“The tenure of the CEO is becoming shorter and more intense, the margin for error or underperformance is narrow....,” the report says.

Global CEO turnover has also plateaued at quite a high level historically, with 14 percent of CEOs being churned.

“It’s not the amount of work, but the sheer intensity of it,” says one CEO in the study.

And from another, “There aren’t many things I don’t feel both accountable and responsible for...I don’t think there’s any abdication of anything by the CEO on any subject.”

Being appointed CEO is a privileged and honoured position in the business landscape, but one which is getting tougher, more unforgiving, with higher expectations, and less time to succeed.

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¹ Favaro, Ken; et al, CEO Succession 2000-2009: A Decade of Convergence and Compression, Booz & Company, 2010.

03

DOES THE MODERN CEO NEED TO BE SUPER-HUMAN?

It is sometimes said that the times will dictate the person.
So it is with CEOs.





In the military, it is often asserted that there are generals for peace and generals for war. In the corporate landscape, it seems that a similar notion applies; there are CEOs who thrive in a crisis, and others who are ideal in less turbulent situations. It's all a question of what CEOs actually do.

The issue of what CEOs actually do, and what they expect to do, was the subject of a 2009 study that examined how leaders deal with the many burdens of the job.² It says that one of the most difficult aspects of the job is determining exactly the best way to spend their time.

Interestingly, the one area of work that eats up most CEO time is that of talent management; taking up to 90 per cent of time, but rarely less than 40 per cent. And most of the time – whether on talent management or other operations – is involved in *making decisions*, rather than *doing*.

It goes without saying that they must like working with people, and they must excel at making decisions. But it lists several key competencies essential to the CEO role:

- Operational capability – they must have the hands-on capabilities and understanding to drive the business and instil a culture of operational excellence.
- Talent-management expertise – they must be able to create, motivate, and retain talent across all the senior-executive positions.
- Flexibility – they must be able to deal with rapid change across all areas of business and have the intellectual agility and creativity to arrive at new solutions.
- Financial acumen and risk management – the need to understand and manage budgets and deal with tight credit markets, and have acute contingency planning and risk management skills.

THE ONE AREA OF
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² Citrin, James M., Still want to be a CEO?, The Conference Board Review, May/June 2009.



The complete role of the CEO is put more succinctly by executive coach and company director, Bill Warner who says that a CEO has three roles: as a leader who establishes and directs the vision and mission of the team; as a project manager who deploys all the firm's resources to achieve operational outcomes; and as a coach who improves the performance of people through ongoing counselling.³

What is also illuminating is the profile of those who have made it to the position of CEO, because it provides a clue as to the make-up and the traits common to those who have scaled the ladder. According to a survey of S&P 500 CEOs, these are the common traits:

- The most common degree was Engineering (21 percent), followed by Business Administration (15 percent). Only 5 percent had an Accounting degree.
- Most have an advanced degree, either an MBA (38 percent) or in fields other than an MBA (29 percent).
- There is no additional benefit in degrees obtained from "Ivy League" universities than those from lesser institutions.
- The median tenure in the CEO's job was four years.
- Experience in the military (15 percent) or in the international sphere (33 percent) is relatively common.

It is clear by the profile of the competencies as well as the actual profile of those who are in the CEO chair that the nature of the job is one that imposes unique demands, different from normal day-to-day executive roles and on a scale and intensity that is rare in civilian life.

It is also evident that CEO's must approach the job with a different timeframe to that of other executives. With a median tenure of just four years, there is not a moment to waste. They do not have the luxury of an open-ended horizon or a strategic vision that will take 10-15 years to implement. They know that, no matter what the innate merit of their long term goals, if they do not produce results within the first few years, boards and shareholders will lose patience.

**THE MEDIAN
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³ Warner, Bill, What does a CEO do?
Evan Carmichael, 2009.



A 2003 study by McKinsey & Co of 20 CEOs revealed just how much a new CEO's fate rested on the company's stock performance during the first year in the job. The study showed that 75 per cent of CEOs whose company's stock price rose during the first 12 months were still in their jobs two years later, while 83 per cent of those whose stock price fell had departed.

This is the source of considerable tension in the way the CEO's undertakes his or her job. Directors and shareholders all pay lip service to the need for long term strategic vision, but there is an unquenchable desire amongst virtually all stakeholders for immediate results.

For firms that have experienced lagging share price or difficult operating environment, this often entails significant and far-reaching reforms to culture, management, business lines, and may entail redundancies and divestitures. None of these are ever accomplished quickly and even modest corporate restructurings take months, even years to implement and to settle down.

At best, most CEO's might be given 12-18 months to demonstrate that the turnaround is beginning to gain traction, even if it has not yet produced measureable outcomes. All parties want some assurance that the goals being enunciated have some prospect of delivering a return in a relatively short timeframe.

So even if the ingrained problems of an enterprise are ones that the CEO believes will entail a long term strategic re-direction, there is an imperative for some near-term "fix" that will produce sufficient dividend to keep investors at bay.

This raises the question of the relationship with the board and how it is best managed so that expectations are kept in perspective, and ultimately met. The evidence suggests that the first year on the job for many CEOs is one where they are overwhelmed by the sheer magnitude of the demands on their time and the juggling of multiple tasks.

DIRECTORS AND SHAREHOLDERS ALL PAY LIP SERVICE TO THE NEED FOR LONG TERM STRATEGIC VISION, BUT THERE IS AN UNQUENCHABLE DESIRE AMONGST VIRTUALLY ALL STAKEHOLDERS FOR IMMEDIATE RESULTS.



Added to this is the need to develop an immediate and strong relationship with the board, something that has been highlighted as one of the most critical, yet often overlooked aspects of the job.

A 2009 report by Forbes cites the CEO-board relationship as absolutely pivotal to the long-term success of the corporate partnership but one characterised by pitfalls.⁴

Among the main things that go wrong are the following:

- Failing to establish the parameters of CEO authority – the board is a diverse group who meet a few times a year. While they have tremendous influence, they often have only moderate knowledge of the organisation. They are typically busy people who balance numerous competing commitments. It is important to understand the parameters of the playing field, delineating the CEO role and the board's role including how they like to interact with the CEO, preferred styles of communication and how much exposure they want to the senior management team. It is critical not to assume anything.
- Failing to understand the board's spoken (and unspoken) power dynamics – the boardroom is a highly nuanced environment where people often make subtle points in ways that require the CEO to truly listen. It is important to get to know each board member personally, understand what makes them tick, and what specific talents and value each brings. Also important is the power relationship of the board – if there is an informal leader or a "board-within-a-board".
- Avoiding hasty change – new CEOs often work in ways very different to their predecessors. They may reject entirely the way their predecessors did things. Irrespective of whether the past CEO performance was popular, board members and other stakeholders are likely to be very used to it. By taking an abrupt change of course, it can create a sense of paralysis, or worse, a questioning of the CEO appointment.

A 2009 REPORT
BY FORBES CITES
THE CEO-BOARD
RELATIONSHIP AS
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TO THE LONG-
TERM SUCCESS OF
THE CORPORATE
PARTNERSHIP...

⁴ Wajnert T. and Miles S.A., Advice to a new CEO:
How to handle your board, Forbes, December 2009.



- Acting as an autocrat – many new CEOs struggle with leading the board. They try to lead it the same way that they lead the company – laying it on the line and moving on. That does not work in the boardroom. In fact, it can be perceived as arrogance and autocracy; eroding trust and breaking down the relationship. It is often better to let the board reach consensus on its own.
- Being transparent – the corporate world has become very open, with governments, regulators and the public demanding transparency. The days of the CEO who could rely on being trusted are over. Embracing the board and creating a transparent and open environment from day one is critical. The board must be told of all key happenings so there are no surprises.

One of the most common reasons that CEOs are let go results from a breakdown in the relationship with the board. Boards have changed and the role of directors has changed also. The boards of high-performing firms are no longer gentlemen's clubs where the directors duties are a perfunctory obligation. Standards of governance and oversight have dramatically altered in the wake of financial scandals such as those at Enron, WorldCom, Lehman Brothers, Bear Stearns, and Merrill Lynch.

Once taken for granted, the task of maintaining a relationship with the board is now paramount. The old guard of CEOs who fail to embrace this element of the job, or who see it as a distraction, or delegate it to others, do so at their peril.

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04

SETTING THE RIGHT TARGETS

When highly paid CEOs fail to perform to the satisfaction of shareholders and boards, there are not only howls of protest from the shareholder meetings but often community outrage at excessive CEO salaries.





This fury is amplified when CEOs walk away from failed companies with multi-million dollar payouts. The issue of CEO remuneration has become intertwined with that of CEO performance. CEOs are increasingly bound by a prescribed set of benchmarks that are directly linked to the fortunes of the organisation they are leading. But what are the right measures? How can shareholders be certain the CEO is going to deliver? And what are appropriate rewards?

It is worth considering what the CEO is actually engaged to do and why the remuneration issue is so important.

The modern business is the product of a process of corporate evolution that has arisen in order to allow the ultimate owners of the business (the shareholders) and their representatives (the board) to delegate day-to-day running of the operation to their agent (the CEO and the management team).

The problem faced by the shareholders and the board is how to ensure that their delegated agent is working in the best interests of the ultimate owners – something that is commonly known as the principal-agent problem. This theory holds that a conflict of interest arises because the goals of the owners and the CEO can diverge. While the board's interest is in maximising the long-term profitability of the business and ultimately the returns to shareholders, the CEO's interests are met by maximising personal wealth through remuneration on non-financial benefits.

The major issue facing shareholders, boards and remuneration committees is how to structure the incentive arrangements so that the CEO is acting in the shareholders' interests. This means an arrangement that will encourage and reward the CEO for those decisions that promote the long-term success of the business.

The size of the remuneration package has itself become a particularly thorny issue among the wider community, with the prevailing view that CEOs are overpaid, are not paid for performance, and that boards are doing a poor job in compensating and monitoring CEOs.

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In fact, data suggests that while CEO governance and pay are not perfect, the situation has not been as dire as some might imagine. In the US, average CEO pay declined in real terms from 2000 to 2006 according to a 2008 study.⁵ There is also a strong link to performance, and CEO turnover was shown to be strongly tied to share market performance.

The CEO of McDonald's, Jim Skinner is on a US\$17 million pay package that is directly tied to the fast-food company's delivery of revenue and returns for shareholders during an economic downturn. The bulk of his take-home pay in 2009 came from a performance-based cash bonus that saw him earn US\$1.4 million in salary and US\$11.5 million in performance bonuses. The remainder came from stock options. His 2009 pay package was 29 per cent higher than in 2008 and more than double his 2007 pay.

Such a large pay packet arouses strong emotion, but its link to performance targets that need to be met, makes it effective in the eyes of remuneration analysts. In the two years to the end of 2009, McDonald's market capitalisation had increased some US\$8 billion to US\$67 billion.

But exactly what those performance measures should be is quite another question. Some of the earliest theories on this agency concept suggested that it was better to have a relatively larger number of performance criteria because this provides a clearer assessment of the CEO's contribution to organisational performance.⁶ This still holds true and most organisations settle on a mix of measures that go to make up the total performance measure applied to the CEO.

Typically, these performance measures will include some combination of elements including the change in share price, the achievement of corporate earnings targets, and perhaps some specified accounting measures.

THERE IS ALSO A STRONG LINK TO PERFORMANCE, AND CEO TURNOVER WAS SHOWN TO BE STRONGLY TIED TO SHARE MARKET PERFORMANCE.

⁵ Kaplan, Stephen N., Are US CEOs overpaid?, Academy of Management Perspectives, May 2008.

⁶ Holmstrom, Bengt, Moral hazard and observability, Bell Journal of Economics, 10: 74-91, 1979



Each of these has its pros and cons. For instance, a reliance on share price may push the CEO to invest in schemes that boost short term share price at the expense of longer-run investments. In the case of earnings targets, it is important to arrive at a target that excludes outside factors such as economy-wide effects that have nothing to do with the CEO.

Whatever set of performance measures are used, they serve a compelling benchmark for all the parties. For the CEO, they represent the hurdle that has to be beaten in order to attain rewards over and above salary. For the board, the performance measures are aimed at establishing a guide to their “expectations” about what should be achieved; it is only by beating expectations that the CEO gets the rewards.

For the beleaguered CEO under pressure to transform the firm, the mere utterance of the word “expectations” can send shivers down the spine. What these expectations are, and the basis on which they are formed will substantially impact the CEO’s immediate career prospects.

What has become clear from recent research is that there is a definite correlation between board expectations and CEO turnover. There is also evidence that the time horizon in which expectations are being framed is getting shorter.

But how is a CEO to know exactly what expectations are required in terms of performance targets? Surely it relates directly to the benchmarks that are set out in the performance agreement. Well, it may not be that simple. What directors dictate in a formal agreement and what they intuitively “expect” may be quite different.

WHAT HAS BECOME CLEAR FROM RECENT RESEARCH IS THAT THERE IS A DEFINITE CORRELATION BETWEEN BOARD EXPECTATIONS AND CEO TURNOVER.



One group of researchers attempted to drill down into exactly what constitutes the expectations of the board, on which their judgement of the CEO will be based.⁷

They say that rather than rely on the performance metrics laid out in the contractual agreement, the more accurate way of assessing the real thinking of the board is to go to the analysts' reports on the corporation. These are deemed to be a relatively accurate assessment of likely business outcomes, based as they often are, on informal briefings from informed sources. The extent to which these expectations are met provides a remarkably accurate guide to the tenure of the CEO.

So, one message for the CEO would seem to be: "Don't necessarily rely on what is stated in written agreements regarding performance benchmarks – directors will have a gut feeling about what should be achieved, and they will rely on this in assessing CEO performance."

The lesson from this for CEOs is probably to get to know the board well, and try and dig down for a real understanding of how they expect the business to perform.

For any CEO, let alone a new CEO, this is a formidable task. Understanding the chemistry that drives a board of directors is not easy.

In weighing up their assessment of a CEO, a board will take into account a range of opinions. As most board members are occupied on multiple boards, they should have a good understanding of underlying economic conditions and the state of the industry concerned. They will have an appreciation of how competitors are faring and how their own firm is performing by comparison.

Many board members are in contact with other executives in the firm. They would have formed a view about how well the CEO is performing as a leader, and how they are doing in developing a high-performing organisation. Many with extensive experience will bring a wealth of business knowledge to the decision-making.

FOR ANY CEO, LET ALONE A NEW CEO, THIS IS A FORMIDABLE TASK. UNDERSTANDING THE CHEMISTRY THAT DRIVES A BOARD OF DIRECTORS IS NOT EASY.

⁷ Puffer, Sheila M. and Weintrop, Joseph B, Corporate performance and CEO turnover: The role of performance expectations, Administrative Science Quarterly, 1991.



Adding further pressure to the CEO is the fact that boards themselves are far from perfect. Even their choice of CEOs is open to question. Harvard academic, Rakesh Khurana says many boards get the hiring decision wrong. He says that when a CEO position becomes suddenly vacant, directors feel tremendous pressure to fill it speedily, knowing that a company can pay both financially and in terms of image if leaderless for too long. Analysts and business media all exert pressure to come to a decision and boards can rush to identify candidates before pausing to re-evaluate goals.⁸

With shareholder activism at fever pitch in some companies, boards are under enormous pressure to get the CEO decision right. They come under the attention of shareholders, analysts and the media. In a discipline as complex as talent management, they have to choose the candidate that will bring to fruition all their hopes and desires for the organisation.

In turn, all of the aspirations of the board rest on the shoulders of the CEO. The new leader is expected to sometimes perform a minor miracle in turning a company around. They will have to undo any mistakes of the previous incumbent and set a new direction promptly.

If they are an outsider, they will need to rapidly learn all they can about the industry and quickly come up to speed and perform at a higher level than the CEO they replaced. If they are an insider, there is at least the advantage of having watched and learned from a predecessor.

They will need to be not only accomplished at the core competencies underpinning the business, but judicious in interpreting the signals that emanate from the board. While meeting the defined targets is a necessity for the CEO, it is not sufficient. There are very likely a range of unstated criteria that are equally important, and which will determine their fate.

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⁸ Khurana, Rakesh, Finding the right CEO: Why boards often make poor choices, MIT Sloan Management Review, 2001.

05

THE REAL COST OF SUSTAINED PRESSURE ON THE CEO

The question arises as to whether the sorts of pressures being placed on CEOs by boards and shareholders are reasonable and, more importantly, whether they are leading to positive outcomes.





If CEOs feel under such great pressure that they make the wrong choices for the long-term good of the business, then there may be a perverse outcome arising from the collective pressures on CEOs.

At a basic level, it is entirely plausible that a CEO, acting in his/her own self interest, would be inclined to make short-term decisions that favour their own interests rather than optimal decisions for the long-term good of the business. There is considerable empirical evidence to demonstrate that managers' decision horizons are shorter than shareholders' investment horizons.

As one researcher puts it, "Managers' claim on the firm is limited to their tenure, while a firm's lifespan is much longer. Since managerial decision horizons are limited to their expected tenure, managers approaching retirement age or about to be replaced become more "myopic", in the sense that they tend to place less weight on cash flows occurring after their employment time horizon."⁹

The consequence of this is that CEOs are under intense pressure to make decisions that will deliver quick results. A choice between a project that will deliver modest short returns and one that will provide large long-term returns will tend to lean to the former. There is no benefit to a CEO in investing in projects that will benefit a successor.

Former Procter & Gamble CEO, Alan Lafley sums it up thus: "First-time chief executives rarely have much experience with weighting the balance toward a long-term future. Typically, they have been accountable for results only a few months out. Their careers have not depended on bets placed a decade or more into the future. Their instincts for investing for long-term growth have not been honed."¹⁰

Lafley says that in times of financial crisis and global recession, CEOs feel under even more pressure to focus on "this week, this month, and this quarter".

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⁹ Antia, Murad; Pantzalis, Christos; and Park, Jung Chul; CEO decision horizon and firm performance: An empirical investigation, Department of Finance, College of Business Administration, University of South Florida, 2010.

¹⁰ A G Lafley, What only the CEO can do, Harvard Business Review, May 2009



One outcome of this managerial mindset is that some good projects may be avoided. Those with faster paybacks will be favoured over those with longer paybacks. From an investor perspective, it means that long-term shareholder value may be unwittingly diminished as a result of these lop-sided investment choices.

Faced with what many consider as unreasonable pressure to deliver quick results, CEOs may be inclined to respond in an entirely rational way and opt for the projects that capture “low hanging fruit” but do not significantly enhance long-term shareholder value.

One area where this “horizon” problem is most acute is in spending on R&D. This involves a significant capital expenditure with long payback periods. In a climate where cost-cutting is paramount, R&D represents a relatively easy path to cost containment, but one with long term implications for shareholder value.

This short-term mindset may also help to explain the preoccupation with acquisitions and the periodic upsurge in M&A activity that is associated with efforts to boost revenue and increase firm value.

CEOs who are specifically hired to undertake turnarounds are particularly vulnerable to “short-termism”. Their entire focus is on delivering quick, near-term results. Their reputation has probably been established on the basis of rapid results and they will have little interest in decisions that go beyond their tenure.

It raises the question as to who actually wins out of the turnaround situation, if it results in a quick fix at the expense of diluted share value over the longer term. Directors and shareholders who impose a herculean burden on CEOs to perform miracle cures may actually end up with poorer outcomes.

This is especially true of younger CEOs who can expect to have many years of work ahead of them and for whom their managerial reputation is vital. They will not want to risk the ire of a board by missing short-term targets. A CEO who is nearing retirement may not be so concerned about their reputation beyond the current position.

CEOS MAY BE INCLINED TO RESPOND IN AN ENTIRELY RATIONAL WAY AND OPT FOR THE PROJECTS THAT CAPTURE “LOW HANGING FRUIT” BUT DO NOT SIGNIFICANTLY ENHANCE LONG-TERM SHAREHOLDER VALUE.



Similarly, a CEO who is nearing the end of his/her tenure (but not retiring) may be inclined to manage to achieve short-term earnings or share price outcomes in a bid to win favour with directors. The make-up of remuneration packages can try to alleviate this short term bias by building in lucrative separation packages that seek to reduce risk-aversion.

Yet most CEOs know instinctively that there is a great deal riding on their performance in the early years in the job. CEO turnover is directly related to the performance of the firm in the CEO's first four years in the position.¹¹ In fact the rate of forced departure peaks in the fourth year.

What is more irksome for CEOs is that often the cause of the poor company performance is beyond their control. Extraneous forces such as a sour economy or weak industry demand can overwhelm the best-run firms and make a good CEO look mediocre.

But surely boards recognise when outside forces beyond the power of the CEO are to blame for a poor company result? Evidently not. Research shows that CEOs are much more likely to be dismissed after bad industry and bad market performance – factors which are typically beyond their control.¹² It appears that boards are not good at filtering out exogenous shocks when they are contemplating CEO dismissal decisions.

This is the challenging set of hurdles that confronts the modern CEO. Yes they are paid handsomely and the rewards can be immense, but so too are the difficulties. They will be expected to deliver results, virtually from day one. They will be given very little tolerance in meeting their targets. They are very likely to be dismissed if they cannot deliver to the expectations of the board, and they should not think about laying the blame elsewhere.

Any shortcomings, whether their own or the result of events on the other side of the globe, will be good enough to see them out the door.

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¹¹ Coates, John C and Kraakman, Reinier, CEO tenure, performance and turnover in S&P 500 companies, Harvard Law School, May 2010.

¹² Jenter, Dirk and Kannan, Fadi, CEO turnover and relative performance evaluation, Stanford Graduate School of Business, National Bureau of Economic Research, March 2006.

06

WHAT DO CEOs THINK?

The dilemma facing CEOs becomes a delicate walk of the tightrope. Do they bend to the multiple pressures of stakeholders and go for a quick fix, possibly at the expense of longer term gains?





Or do they stand up to boards, shareholders and analysts and argue the case for sustainable longer-term approaches that will enhance shareholder value over years to come?

In the course of this study, we canvassed the views of a number of CEOs across a range of industry sectors in the Asia Pacific region in order to obtain their first-hand accounts of the sort of pressures they face, and the way they reconcile these.

We wanted to understand what they feel is a reasonable time to have an impact on an organisation, where the greatest pressure is coming from, how the structure of remuneration affects strategic decision-making, and how it could be better adjusted to achieve optimal outcomes.

When asked about the time it takes to have an impact on an organisation, there is a brutal reality. Most proffer the view that it takes a minimum of one, and up to two, years to be able to make a significant impression on operational performance.

As one CEO says, "You are probably kidding yourself if you think you are making substantial headway in less than a year. It might be a change in the culture but it won't be having any impact on the bottom line".

And another: "It depends entirely on the company type and the situation it faces. If it's a start-up it should take about one to two years. If it's a profitable company then it should not take much time. If it's a loss-making company, it should again take about one to two years."

One CEO observed that while a one to two year timeframe is reasonable time to initiate substantial change, the real fruits of reform only eventuate in the final year or so of a CEO's tenure.

"That's why it's important to be able to have a five to six year horizon so that there is some hope of achieving a result."

**"YOU ARE PROBABLY
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It is interesting that scarcely any of the CEOs think that they can accomplish genuine change in much less than the “one-to-two-year” timeframe that is commonly stated. Most understand that entrenched problems take time to diagnose and remedy. Unless the prior management was particularly inept, it is likely that best efforts have already been directed to the problems.

One CEO noted that even where he might have a reasonable idea of what needs to be done, it can take a considerable time in building the understanding and consensus necessary to get everyone headed in the same direction. “Senior managers need to be firmly on board or they can cause havoc among their teams.”

As another remarked: “For a new CEO in a large organisation, it can take months simply to get to the bottom of where the problem lies, who has the data, and why things haven’t been done.”

There is widespread agreement that the pressure on CEOs is coming from all quarters, led by shareholders, boards, business analysts and the media.

“Shareholders have become a lot more aggressive. There are a lot more people who own shares and they have a huge range of outlets pushing the cause.”

One CEO said that he received a daily diet of comment from shareholder activist reports and media about his firm. These also went to boards and analysts. Boards, of course know a lot more about what is actually going on in a business, but they too are influenced by what they hear and read in analyst reports.

“I have worked with boards that are very fair and reasonable, and others that jump every time they pick up an analyst’s report. You really start to value people with an even temperament.”

Most do not consider that boards are necessarily unfair or greedy in their expectations, but that CEOs are being placed under intense pressure to get results.

“You can see it in the mood at shareholders meetings where some board members are placed under tremendous pressure.”

**MOST UNDERSTAND
THAT ENTRENCHED
PROBLEMS TAKE
TIME TO DIAGNOSE
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Another CEO noted that there was also pressure from company staff as they were often concerned about possible lay-offs flowing from corporate changes.

CEOs were also asked how the structure of remuneration might be altered in order to change management behavior and instill a longer term focus.

One suggested that remuneration might be shifted to long term variables such as stock options, equity stakes in the firm, or employee stock ownership plans (ESOPs).

It was also pointed out that even where longer term incentive structures are in place, there is still an unremitting routine pressure that emanates from analyst briefings and media reporting that tends to shorten the management horizon.

One CEO says performance measurement should be kept in alignment with budget plans over a three to four year period.

Another says boards need to be more supportive of the senior management team in allowing a reasonable timeframe to execute changes: "It's no good having long term incentives if the board overrides the remuneration arrangements and insists on impossible timeframes."

It has also been suggested that much greater use should be made of variable pay, with greater focus on quarterly, half-yearly and annual bonuses to help entrench a more long-term focus.

There is always some element of risk that a longer term outlook could entrench poor management practices, resulting in weak-performing CEOs staying in place beyond their useful tenure.

One CEO remarked that it was often hard for a genuine reforming CEO to demonstrate results that would satisfy analysts and business commentators: "If you are trying to turnaround a company with deep problems, the metrics might not show up for quite a long time."

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As another said: "There are some situations where you have to rely upon a board that understands the issues and will back you. A chairman who has been through it before is a great asset because a lot of people don't really understand how long it can take."

It was remarked that while the board will itself know exactly what rate of progress was being made in a company turnaround, it may not have the inclination or the capacity to stand by a "slow and steady" CEO.

"They (the board) love a good news scenario so it takes a lot of courage to stand up and say this is not going to happen overnight – it's going to take time."

Among the CEOs who contributed, there is little argument – the pressures are diverse, intense and unrelenting. Almost all parties they interact with want things done, and done quickly. Many acknowledge that these time horizons represent the "new order", even if they know intrinsically that they are not right for them or the organisations they lead.

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CONCLUSION

The legendary business theorist and management scholar, Peter Drucker made some telling observations about the role of the CEO in an unfinished draft shortly before his death in 2005. In it he posed the simple question: "What is the work of the CEO?"

His ensuing thoughts condensed a lifetime's observation into a tidy insight.

He observed that the CEO is the link between the *inside*, represented by the organisation and the *outside*, made up of the society, the economy, technology, markets, and customers. Inside, he said, there are only costs. Results can only occur on the outside.

As Alan Lafley, formerly of Procter & Gamble puts it, "without an outside, there's no inside."

To Drucker, the work of the CEO is unique. The CEO is the *only* person in the organisation who can see the outside from an enterprise level.


What many CEOs are now seeing on the outside is a world that is shrinking; time horizons are compressed and what would once take months to complete now takes weeks.

CEO tenure has also shrunk. Boards, shareholders, analysts and the media all demand results – and scalps!

Perhaps what is most disturbing is that this new modus operandi is pushing enterprises into judgements that may not be in their best long term interests. Changing CEO remuneration may help but CEOs are still being judged by outside parties whose near-term horizons are entrenched.

There has also been an explosion in share ownership. Almost every worker has a stake through pension funds, superannuation or direct investment in shares. There is a thirst for investment results that mirrors a sporting league table. The CEO who defies this, does so at their peril.

It will take a brave CEO, fund manager, analyst or investor to call a halt. No-one wants a pampered, closeted CEO, but a CEO who is coerced into meeting impossible deadlines may not be a good outcome for anyone.



It's not the amount of work, but the sheer intensity of it.

It's why it's important to be able to have a five to six year horizon so that there is some hope of achieving a result.

You can see it in the mood at shareholders meetings where some board members are placed under tremendous pressure.

The Board in some countries in Asia don't even deserve to members of the Board as they do not know the business and therefore serve as a hindrance and distraction.

For a new CEO in a large organisation, it can take months simply to get to the bottom of where the problem lies, who has the data, and why things haven't been done.


CEO turnover is directly related to the performance of the firm in the CEO's first four years in the position. In fact the rate of forced departure peaks in the fourth year.

Don't necessarily rely on what is stated in written agreements regarding performance benchmarks – directors will have a gut feeling about what should be achieved, and they will rely on this in assessing CEO performance.

CEOs are much more likely to be dismissed after bad industry and bad market performance – factors which are typically beyond their control.

There aren't many things I don't feel both accountable and responsible for...I don't think there's any abdication of anything by the CEO on any subject.

If you are trying to turnaround a company with deep problems, the metrics might not show up for quite a long time.



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