



CEO Selection: The Costs of Getting It Wrong

Selecting a CEO is arguably one of the most vital decisions a board makes. The costs of selecting the wrong chief executive are immense, and the impact on the enterprise is far-reaching. Companies that choose the wrong leader can suffer hits to their stock price and market capitalization and lose in a variety of areas — momentum, opportunities, reputation, customer goodwill and, perhaps most importantly, trust within the organization, which can take years to re-establish.

The impact of the CEO — especially one who fails — is staggering:

- > The economic cost of appointing the wrong CEO at global companies is estimated at more than \$100 billion.¹
- > Nearly one-third of investment decisions are related to the reputation of the CEO; 39 percent of investors say they would likely sell a stock based solely on the CEO, while only 15 percent say they are likely to buy a stock based on the CEO's current reputation alone.²
- > A study conducted by Rakesh Khurana, dean of Harvard College, and Nitin Nohria, dean of Harvard Business School, found that CEOs appointed after 1985 were three times more likely to be fired than CEOs who were appointed before that year.
- > According to Harvard Business School, 40 percent of all executives who change jobs or get promoted fail in the first 18 months, a number that has remained steady for the past 15 years.

¹ "2014 study of CEOs, Governance, and Success," Strategy&, April 2015, <http://www.strategyand.pwc.com/global/home/what-we-think/reports-white-papers/article-display/2014-ceo-study>.

² "CEO Transition Study," FTI Consulting, October 2011, <http://www.prnewswire.com/news-releases/fti-consulting-study-shows-ceo-transitions-are-a-risky-business-when-it-comes-to-shareholder-value-132044798.html>.

Why is CEO succession and selection so hard to get right? Many boards still cling to a CEO selection process that sets organizations up for failure.

Unfortunately, cautionary tales abound. Juan Trippe, viewed by many as the greatest airline CEO in history, led Pan Am through tremendous growth, establishing it as a best-in-class airline. In 1980, William Seawell succeeded him, subsequently bought National Airlines and took on significant debt to purchase a fleet of 747s — debt that would force the airline to declare bankruptcy in 1991. Kodak was once an industry leader with peak revenues of \$16 billion in 1996.³ However, a series of CEOs failed to help the company adapt to digital disruption and, ultimately, ushered it into obsolescence. Under its former CEO, Tesco lost more than £6 billion and cut thousands of jobs.⁴ The grocer's expansion into the U.S. failed and the company overstated its profits, sparking a fraud investigation and reputational damage. The failed merger of AOL and Time Warner — which some attributed to lack of due diligence and leadership around aligning the two companies' distinct organizational cultures — was a costly one: The company posted a nearly \$99 billion loss two years after the merger was announced, and the total value of AOL Time Warner stock dropped from \$226 billion to approximately \$20 billion.⁵ The failures listed in these few examples alone cost hundreds of billions of dollars.

Despite understanding the high stakes of these decisions and witnessing high-profile failures, boards have not made wholesale improvement in CEO selection. Why is CEO succession and selection so hard to get right? Many boards still cling to a CEO selection process that sets organizations up for failure.

WHERE THE PROCESS BREAKS DOWN

The stakes of CEO selection require a process with commensurate rigor. However, boards can overlook important components of the process, especially if directors have never had to address succession previously. Here are some of the most common missteps:

The right people are not involved in the selection.

While the expertise of a previous CEO on the committee is valuable, some boards become too reliant on this perspective. Most airline passengers would not be comfortable on a flight where the pilot has never flown before. Similarly, the process runs more smoothly when at least one member of the CEO selection committee previously chaired one. However, this experience is rare given the episodic nature of CEO selection. Boards should prioritize CEO succession expertise when recruiting new members, even if there is no imminent transition. For the right balance of efficiency and diversity of perspectives, the optimal size of the committee is three to four directors, typically including the lead director or non-executive chair. Audit committee chairs should not be assigned to the selection team, as the time commitment is too great in the face of their existing responsibilities.

Some organizations have found it helpful for the current CEO to act in an “of counsel” capacity. However, depending on the level of emotion in the situation, the CEO's involvement may do more harm than good. Even when the CEO has proactively made the decision to leave, it can still be challenging for the executive to hand over the helm. For example, once one chief executive's retirement date approached and his departure was no longer a distant prospect, he waffled on his original decision to depart. Additionally, board members with aspirations for the CEO role can quickly undermine the integrity of the process and should recuse themselves well in advance of the formation of the selection committee.

³ “The last Kodak moment?” *The Economist*, January 14, 2012, <http://www.economist.com/node/21542796>.

⁴ “Tesco results: the five reasons behind Tesco's historic £6.4 billion loss,” *The Independent*, April 22, 2015, <http://www.independent.co.uk/news/business/news/tesco-results-the-five-reasons-behind-tescos-historic-64-billion-loss-10194620.html>

⁵ “15 years later, lessons from failed AOL-Time Warner merger,” *Fortune*, January 10, 2015, <http://fortune.com/2015/01/10/15-years-later-lessons-from-the-failed-aol-time-warner-merger/>.

The board may not be equipped to evaluate CEO candidates.

On average, boards tend to be extremely effective at understanding industry dynamics and financial and strategic planning. However, it is far more challenging to accurately assess a potential CEO successor's integrity, fit with the organizational culture, ability to inspire and energize the enterprise, and capacity to develop other leaders. Thus, many committees can fall into the trap of overlooking or discounting what they cannot tangibly measure. Drawing on experts with a history of CEO and executive assessment can help provide a fuller picture of the candidate's potential, as well as strengths and areas for development.

The CEO specification does not align with the organization's strategic goals.

At times, the articulated strategy is too rooted in the present and can include status quo assumptions, rather than reflecting a view of where the company needs to be in five to 10 years. If the specification is built upon an outdated strategy, the successor could be set up for failure. For example, if the strategic plan is to shift from stable growth to more innovation, it may be necessary to bring on a proven change agent versus a steady hand. The criteria for the new CEO should be tied to the strategic, organizational and operational levers that the next CEO will need to employ.

The length of the selection process also impacts the CEO specification. The process can easily take more than two years, during which the market can change dramatically. However, many committees can be reluctant to pause the process to reassess whether the expectations are still relevant out of fear of perceived failure.

There is lack of alignment on how the process should work.

A lack of agreement on the overall succession plan can undermine the selection process — and the successor's future success. A recent survey conducted by PwC revealed that nearly half of directors were divided on their companies' succession plans. Lack of alignment on the process may also indicate differing perceptions of the strategy and how to execute it, which can quickly derail a new CEO. Without unified board support, the successor can quickly fall into the trap of navigating conflicting mandates rather than delivering on the organization's strategic goals.

A BEST-IN-CLASS PROCESS

While many factors contribute to selecting the wrong CEO, a strong succession framework significantly increases the odds of a long-term successful outcome. Taking the following steps can help organizations create a more surefire process.

Opt for a committee that provides options.

Ensure the committee provides a slate of choices to the board — two to three candidates — after a transparent, inclusive process. Some committees tend to be more insular and hold more power in making the final decision; rather than presenting a few finalists, selection committees present a single candidate for the board to validate. Although the process is often shorter when the committee presents a single candidate for recommendation, a more time-consuming, consensus-driven approach often yields better long-term results.

It is worth noting that in many situations, the human resources (HR) function may not be deeply involved in CEO succession. In these cases, it may be time for organizations to revisit this approach, especially if the HR leader brings previous expertise that can contribute to the process.

Develop a forward-looking CEO specification.

To go beyond generalities, the board should identify the very specific effect it wants the next CEO to have on the business and define the skills that it will take to accomplish that. The board of a company delivering solid but unremarkable returns, for example, may want the next CEO to refocus on core businesses in untapped areas and lean toward a strong operator with a track record of success in new market development. For a poorly performing company where strategy is the primary contributor to lackluster returns, the board will have to consider whether to tap a turnaround specialist from outside the company. Even a company that has delivered consistently high returns versus industry peers must evaluate how it will continue to outperform, but also find ways to innovate, drive distinctiveness and avoid the complacency that can come with success. While expectations for the CEO must be appropriately high altitude, no more than five to six competencies should be included — beyond that, the assessment of prospective candidates can become too detailed and detract from the critical requirements.

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reports may not be the best candidates going forward if the organization needs to change direction. The committee will have to reflect carefully on the range and depth of the company's likely internal succession candidates — and consider whether changes in strategy, the nature of competition or customer behavior suggest the need to look at a wider

group of candidates both inside and outside the company. In addition, if there are internal prospects to be considered, it can be helpful to assign a board director to help them navigate the process while continuing to contribute at the highest levels in their current roles.

It can be beneficial for the board to work with a search firm that can develop a long list of prospects based on previous roles, industry experience and preliminary reference checks. It's important to note that candidates should not advance in the selection process until preliminary referencing is conducted. Once the slate is narrowed to four to six candidates, they should be assessed by the search committee and search consultant in order, resulting in the selection of two to three finalists.

Do not underestimate cultural fit.

Boards will want to consider whether the culture of the company needs to shift or change, and how aligned individual candidate profiles are with the desired company culture.

Prior to having the candidates evaluated by experts in executive assessment and organizational culture alignment, the committee members (as a group or individually) should spend additional time with the candidates in different settings in order to begin to gauge their cultural fit. Executives who are hired solely for their technical skills can fail if they do not align with the culture.

Understand the full picture.

A rigorous review of an individual's capabilities, including the observations of others who can validate their performance in current and past roles, can reveal whether candidates have the relevant experience as well as potential areas for development. Gaps may include a lack of specific knowledge or "hard skills," such as experience with regulators or financiers, or a deficiency in certain "soft skills," e.g., the ability to navigate complex interactions or to influence and motivate others. Gaining insight into external talent — through research, informal or formal introductions, or an executive search — can provide additional benchmarks when assessing the readiness of potential successors.

It is not enough to look at past accomplishments; boards should strive to gain an understanding of candidates' analytical capabilities, social intelligence and self-awareness — all skills that speak to an individual's Executive Intelligence and ability to succeed in more complex and demanding contexts. Years of data and experience have demonstrated the predictive power of these traits on executive performance — and their link to the performance of the business. Although some organizations evaluate candidates based on personality testing, there is no clear correlation between personality and performance.

KEY STEPS FOR THE SELECTION COMMITTEE IN THE INTERVIEW PROCESS

- ✓ Meet with the two finalist candidates and have the chair lead the meeting to maximize efficiency. Each candidate should receive 30 minutes to present his or her experience and plans for the organization, followed by 45 to 60 minutes of Q&A. The search consultant should be present only as an observer.
- ✓ Provide an interview guide to the board outlining the critical competencies from the position specification as well as the key organizational culture attributes and ask each member to rate the candidates in these areas. The primary purpose of this exercise is to eliminate subjectivity and focus on concrete skills and performance.
- ✓ Agree on a single candidate.
- ✓ Conduct formal references. The committee agrees on the list of questions, which focus on areas of concern.
- ✓ Note that references provided by the candidate should not be weighed as heavily as others: A search firm can seek feedback from former superiors, peers and subordinates. Ideally, these references should be done in person and members of the search committee should be present so that critical non-verbal communication is not lost.



At this point in the process, the committee can now compile and share the following multifaceted information with the entire board:

- > the results from a capabilities-based interview, reflecting past performance;
- > the results from a rigorous assessment of potential and aptitude, predicting future performance;
- > the results from preliminary reference checks and 360-degree conversations about the candidate's leadership style and its impact on the business, providing a current baseline; and
- > cultural assessments, highlighting the difference between the CEO prospect and the current culture of the enterprise, as well as the individual leader's interpersonal style.

Set up the new CEO for success.

Ideally, a 120-day plan is developed between the incoming CEO and the chairman. Once the new CEO is on the job, 360-reviews should be conducted on a periodic basis in order to ensure early and frequent feedback. Onboarding efforts are crucial and the process should be tailored for the role, developmental needs and the situation. Based on an assessment of the executive's capabilities and areas for development during the interview process, organizations can adjust onboarding to address specific areas. If the new CEO comes from outside the organization, it can be beneficial to help new leaders understand the intangibles — who the decision-makers are, how decisions are made and cultural nuances that may not be immediately obvious. It can also be valuable for HR to discuss employee engagement survey results to shed light on what is important to individuals throughout the organization, not just at the senior levels, especially when change usually must take place on the front lines. Clear, agreed-upon expectations for performance should also be covered in the onboarding process — a lack thereof can quickly derail even the smartest leaders.

CONCLUSION

With the high cost of failure — and the significant financial, reputational and talent impact of the right decision — boards need to reassess their CEO succession processes and ensure that they are supporting their strategic goals. There is no more important role for board members than selecting the organization's next leader. In addition to the potential damage to the organization, a poor decision in successor can also jeopardize a director's standing. Our experience has shown that processes that have the best outcomes are those in which the right people are brought to the table, the specification is designed with the future strategy in mind and candidates are assessed holistically. While there can be immense pressure to make a decision quickly, the board must resist that urge and take the time necessary to make a fully informed decision. In addition, it's important to remember that succession is rarely a neat process and the committee and chair need to have realistic expectations. Those who do not invest in developing strong selection processes well in advance of CEO succession risk paying heavily later.

ABOUT THE AUTHOR

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