

EY Center for
Board Matters

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Let's talk: governance

Getting it right: succession planning
for the boardroom and C-Suite

The EY logo consists of the letters 'EY' in a bold, white, sans-serif font. The 'E' and 'Y' are connected at the top. The logo is positioned in the bottom left corner of the page, above the tagline. A decorative graphic of vertical white lines of varying heights is located to the left of the logo, extending from the bottom edge of the page towards the center.

EY

Building a better
working world

Getting it right: succession planning for the boardroom and C-Suite

Stakes are high when it comes to succession planning. Effective planning for the boardroom and C-suite creates opportunities to define and address a company's strategic goals and challenges, identify the qualifications and expertise needed to meet current and future leadership needs, and actively develop the teams needed to build long-term shareholder value.

Thoughtful planning for CEO transitions can avoid downward pressure on a company's stock price. By avoiding prolonged and expensive executive searches, a company can reduce uncertainty, strengthen investor confidence in the board and improve employee morale. In addition, a CEO successor who is in step with a company's culture and operational history can prevent significant business interruptions.

In the boardroom, attention to succession planning can help ensure the board includes directors with a balanced level of institutional knowledge and fresh perspectives. The right mix of directors will be better able to oversee ongoing and emerging risks and provide appropriate strategic insights and direction. Effective planning may also help defend against activist investors that attempt to exploit perceived weakness in board composition.

The key to getting succession planning right is maintaining an ongoing and dynamic process.

Seizing succession opportunities on the board

Market challenges and strategic goals drive the need for distinct skill sets and expertise at the board level. While some companies maintain term limits or retirement age policies to provide a forced mechanism for board turnover, such rules can result in the loss of high-performing, quality directors at times when their service may still be vital.

A more comprehensive and thoughtful approach involves proactive discussions around the skill sets that support corporate growth priorities and address chief areas of stakeholder concern - and supplements these discussions with rigorous director performance evaluations. This type of an approach is more sensitive to company specific needs.

- ▶ A skills matrix can help identify the attributes and experiences necessary at the board level to support a company's strategic plan over the short and long term, as well as provide an opportunity for thoughtful discussion and observation. It can also assist in identifying any gaps that need to be filled or areas that may not be appropriately balanced.
- ▶ At the same time, annual performance evaluations help to ensure that individual director competencies are fully understood, recognized, used and valued. This process can also serve as a mechanism for strategic turnover aligned with a company's goals and board-level needs. Having an independent third party help facilitate the assessments can depersonalize the process.

Refreshing the board

CEO succession has been a topic of investor interest for many years. Increasingly, this interest is focusing on processes around board succession and renewal. Lack of turnover and slow changes in gender diversity on boards are raising concern among investors that board independence may be compromised, group-think may be stifling boardroom debate, and fresh perspectives may be lacking from strategic discussions. Investors may be calling on nominating committee members to discuss board composition and how they are keeping their boards refreshed.

Leading practices for board succession planning include:

- ▶ Using a skills matrix to proactively shape board composition that incorporates strategic direction and opportunities, regulatory and industry developments, challenges, and transformation
- ▶ Conducting robust annual performance evaluations, including facilitation by an independent third party
- ▶ Establishing and enhancing written director qualification standards that align with the company's business and corporate strategy, and including these standards in corporate governance policies and bylaws as appropriate
- ▶ Reviewing evolving committee and board leadership needs, including the time commitments required
- ▶ Considering director election results and engagement by investors regarding board composition, independence, leadership and diversity
- ▶ Prioritizing an independent mindset on boards, including through board diversity, to foster debate, challenge norms and invigorate board oversight processes and strategy development
- ▶ Making sure mentoring and development opportunities are available for incoming directors

Skills matrix

Companies are increasingly disclosing in their proxy statements a skills matrix that clearly defines the areas of expertise and qualifications the company seeks to have on the board. Such a matrix also connects individual directors to their attributes, helping investors to better understand how board composition is tied to the company's specific circumstances, strategy and business characteristics.

C-suite planning for the future, building for the present

Developing long-term and emergency executive succession plans is a fundamental board responsibility. It should be addressed regularly, in advance of when it is actually needed and regardless of CEO health or tenure. An up-to-date plan lessens the risk of a company being harmed by an unplanned vacancy in leadership.

Leading boards approach succession planning as an integral part of long-term strategic planning and development of executive talent – with flexibility for change as corporate strategy shifts. They regularly re-evaluate their succession

plan both to mitigate the risks associated with transitions and to capitalize on strategic and developmental opportunities. While an appropriate level of CEO input is valuable, it is important that the process be led and managed by the board.

At its best, effective long-term succession planning at the executive level involves an organizational commitment to developing a robust leadership pipeline and reinforcing a company's strategic plan. These goals also should be integrated into the executive compensation program.

Leading practices for CEO and C-suite succession planning include:

- ▶ Reassess the succession plan as long-term corporate strategy shifts
- ▶ Identify upcoming leaders and engage them to directly assess the talent
- ▶ Develop internal candidates at least two ranks down
- ▶ Create custom leadership development goals that link to the long-term strategic plan
- ▶ Integrate succession planning with the compensation program by including pay incentives tied to leadership and development goals

Integrating executive succession planning and compensation

Executive succession planning creates a unique opportunity to strengthen a company's compensation program by tying pay directly to leadership development goals. Long-term compensation programs should support internal promotions and build a deep bench for the C-suite – while keeping in mind the relative levels of pay among executives. High pay differentials between the CEO and other named executives may create challenges in connection with internal promotion, retention and recruiting efforts – and it may even raise questions regarding CEO influence and company culture.

Investors are more closely evaluating the pay differential between CEO and other named executives to assess whether there may be broader governance concerns or potential issues in connection with the next transition. Significant pay increases for internal promotions or high pay to recruit an external candidate can draw the attention of investors and the proxy advisory firms. When these scenarios do occur, it is important to provide a clear explanation to investors – in the proxy statement and through engagement – to avoid having investors vote against say-on-pay proposals or the election of compensation committee members.

The average pay ratio between the CEO and other named executives is 2.8 times for S&P 1500 companies. These pay differentials vary by industry and other company circumstances.

10%

of S&P 1500 company boards have not added a new director in the last five years.

Leadership transitions in sight

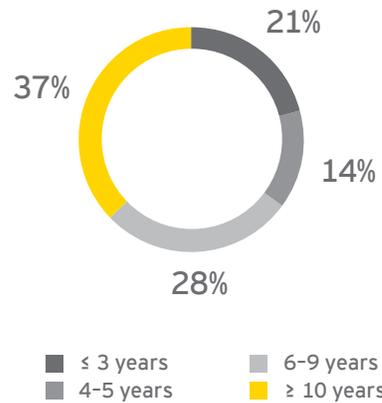
When thinking about succession, it is important to understand the landscape. EY's proprietary corporate governance database shows that 35% of S&P 1500 companies experienced a change in CEO in the last five years – and that most of these transitions were internal promotions. With nearly 40% of CEOs having held the top rank for 10 or more years, many boards may find the need to execute on succession plans in the coming years.

Most boards welcomed a new director in the last few years. However, there has been a decline in the number of new directors joining boards overall. About 10% of S&P 1500 companies have not brought on a new director in the last five years – 15% in the last four years. And a small handful of companies have not refreshed in the last 10 years.

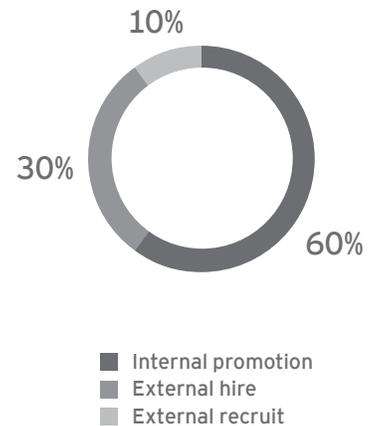
Understanding the timeline of a typical director's board service can help with succession planning. The most common retirement age for directors is 72, and average tenure is about 10 years.¹ The data shows that about 20% of all directors at S&P 1500 companies are 68 or older – soon approaching this common retirement age – and have served on the board for 10 years or more.

Succession planning is about more than leadership transition. It's about having the processes and procedures in place to ensure the best mix of directors and executive officers are lined up to meet a company's ongoing and changing goals and challenges.

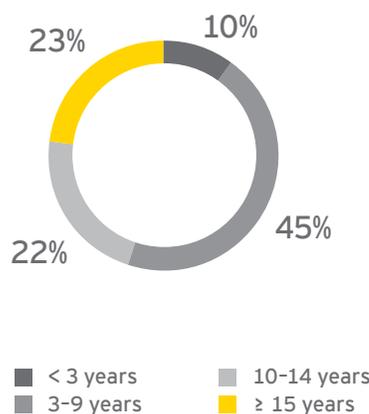
CEO tenure



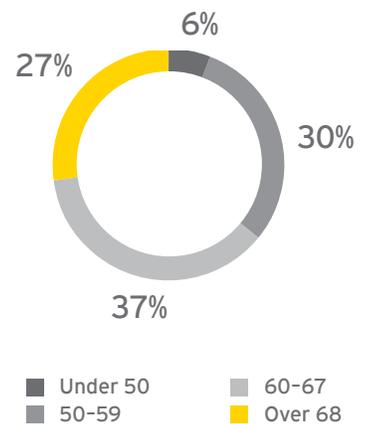
Background of appointed CEOs²



Director tenure



Age of S&P 1500 directors



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Effective corporate governance is an important element in building a better working world. The EY Center for Board Matters is committed to bringing together and engaging with boards, audit committee members and investors to exchange ideas and insights. Using our professional competencies, relationships and proprietary corporate governance database, we are able to identify trends and emerging governance issues. This allows us to deliver timely and balanced insights, data-rich content and practical tools and analysis to boards, audit committees, institutional investors and others interested in governance topics.

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Endnotes

- 1 More than 70% of S&P 500 companies have retirement age policies for their directors of 70 or higher; more than half of these have established 72 as the retirement age. For more information on the current composition of US boards, see *Diversity drives diversity: from the boardroom to the C-suite*, EY, 2013.
- 2 External hire includes those appointed as CEO upon joining the company; external recruit includes those appointed CEO within a three-year period after joining the company; internal promotion includes those who have been with the company for more than three years

Let's continue the conversation.

Find out more at ey.com/governance or contact one of the following professionals:



Allie Rutherford
Center for Board Matters
Ernst & Young LLP
+1 202 327 7026
allie.rutherford@ey.com



Ruby Sharma
Center for Board Matters
Ernst & Young LLP
+1 212 773 0078
ruby.sharma@ey.com



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