Where Values Meet Value Creation: Foundations for Character-Driven Compensation

Using the intersection of short-term profits and long-term strategy.

BY STEPHEN CHARLEBOIS AND PHILLIP PENNELL

In an evolving governance environment, expressions of strong corporate character — exemplary corporate governance, responsible stewardship of the environment and positive contributions to society — are no longer nice-to-haves. They are increasingly becoming explicit expectations.

For compensation committees, this means finding ways to translate character concerns into practical and effective elements of their pay programs. It's not a straightforward task. Character is often intangible, which naturally leads to holistic assessments. Holistic considerations are common when assessing performance and pay for mid-level managers, but current thinking for senior executives heavily favors objective, transparent goals. Subjectivity is frowned upon. So how do you measure executive performance against something that can seem almost impossible to quantify?

Character and the value of a company

The success of a company is often defined in terms of shareholder value creation, which is influenced by quantitative financial performance, growth prospects and intangibles. Corporate character is becoming an increasingly prominent intangible, as shown in last year's resolution of the Business Roundtable and this year's outpouring of concern over pandemic-driven disparities and racial injustices. Just being profitable is no longer enough. Successful companies are increasingly being asked by the market and other stakeholders to have a broader positive impact.

It's worth noting that focus on transparent, objective performance goals remains. Objective goals often implicitly depend on character, with companies acting "outside of bounds" seeing the consequences play out in financial results. Even so, sometimes a board wants to commit explicitly to measuring more than just the bottom line, or to connect a program focused on short-term results with the company's long-term strategy.

> Value-delivery concerns aside, three years may not be enough time to capture the long-term impact of a corporate strategy or character-driven objectives.

The orthodoxy around quantitative goals for compensation, however, can at times discourage the use of character-driven metrics, such as environmental, social and governance goals (ESG), that may not pay short-term financial dividends but can drive long-term growth and value. When boards put ESG goals in place, shareholders expect expanded public disclosure to justify outcomes, which can yield uncomfortable publicity if the company fails to meet the goals. How can a committee wishing to expand beyond objective financial measures best address these challenges?

Based on our recent work with committees exploring character-driven metrics, here are three questions. The answers will support a strong character-driven pay program:

How do we make character-driven incentives compelling to our executives?

Go to the company's mission; clarity here can bridge the gap from the intangible to quantitative goals. For example, Southwest Airlines' mission focuses on customer service, warmth, friendliness, individual pride and company spirit. The board translates those attributes into objective goals in the annual incentive plan, which measures on-time performance, net promoter score and voluntary turnover. These attributes help drive intangibles that are tied to long-term growth and also provide stability in a year like 2020 that challenges the financial objectives.

Do our incentives capture the right timeframes?

The common practice today is to measure strategic execution on an annual basis for cash incentives, and to assess strategic success on a three-year basis for equity incentives. Value-delivery concerns aside, three years may not be enough time to capture the long-term impact of a corporate strategy or character-driven objectives. For example, how should a company focused on its environmental impact measure its operational success? A reasonable timeframe for incentives is likely very different for a software company than for an industrial manufacturer.

Can we promote character outside of our incentive programs?

Compensation for senior executives isn't the only way boards can encourage attention to ESG or other mission-driven goals. How a manager embodies the company's character can pay off in other ways, including promotion and pay decisions for rising stars. Boards are increasing attention to long-term succession. By explicitly considering the impact individuals might have on corporate character, they can help drive desired performance without explicit changes to compensation programs.

Regardless of actions taken in the short term, boards should be aware of evolving shareholder expectations for incentive programs. The broad social impact of the COVID-19 pandemic has accelerated this evolution. It's also worth recognizing the upside: Thoughtful engagement on this topic today can ensure tomorrow's incentive programs are more dynamic, well-rounded and responsive to the needs of both companies and their stakeholders. ■

Stephen Charlebois *is a principal and* ***Phillip Pennell*** *is a consultant at Semler Brossy*