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Executive Compensation

Reevaluating Executive Compensation to Meet Stakeholder Needs

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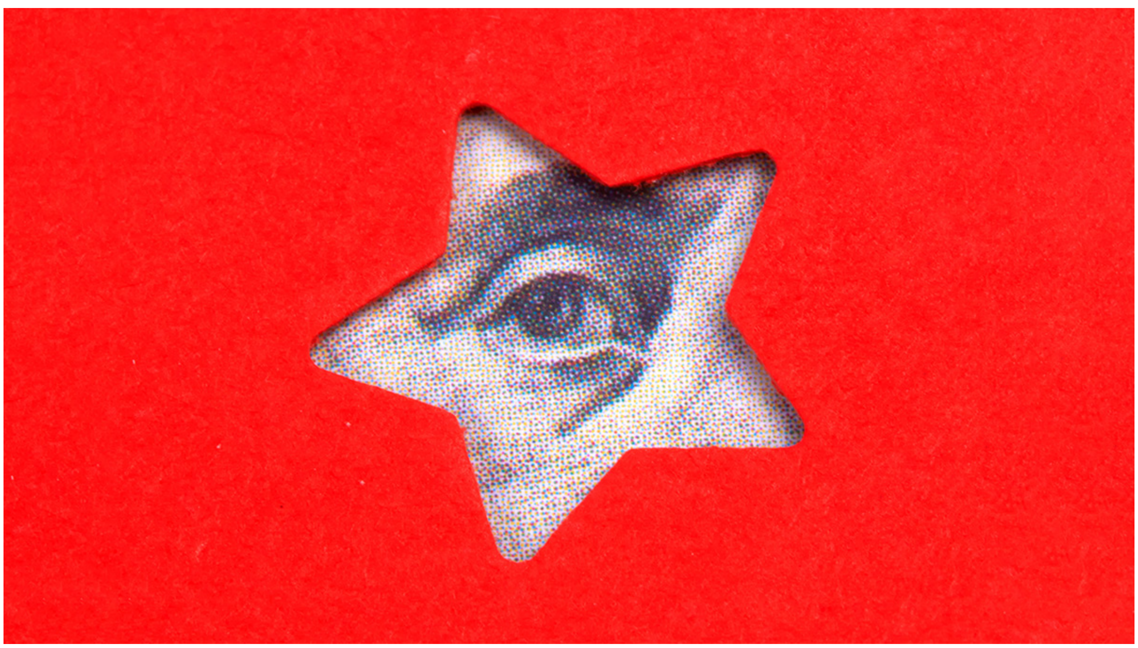

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Summary. The ground is shifting for executive compensation, from a focus on shareholder metrics to a more intentional longer-term approach that better supports key stakeholders: workers, suppliers, communities, and customers. To make the shift, companies need to... **more**

In 2018, a large manufacturer gave its top executives incentives focused on the usual investor-centric metrics, including revenue and profitability growth. Three years later, after several accidents that killed hundreds of customers, shut down factory lines, and triggered a shareholder lawsuit, the company fired its CEO and began the process of overhauling its culture. Giving inadequate priority to safety and quality contributed to lost sales and severe reputational damage, not to mention the lives lost.

Executive compensation was one of the many programs that was revamped in the cultural shift to emphasize safety. Modifications made to incentivize safety, in addition to financial performance, were a crucial signal of the company's new commitment.

This company's evolution demonstrates how the ground is shifting for executive compensation, from a focus on shareholder metrics to a more intentional longer-term approach that better supports key stakeholders: workers, suppliers, communities, and customers.

The good news is that this approach tends to yield more total company value. That's because, especially in our increasingly complex economy, corporate success depends on strong stakeholder relationships. Over the longer term, this approach benefits investors too.

To reflect this reality, pay packages at most companies must change. Here's how boards can shift executive compensation to meet today's business needs.

Start by Prioritizing Stakeholder Issues

Boards can start by picking the issues that matter the most for their company. They should stick to three to five company-wide objectives for their compensation programs: Given limits on resources and competencies, no company can satisfy every stakeholder. Focus is critical. A study by Mozaffar N. Khan, George Serafeim, and Aaron Yoon found that companies that focused on priority stakeholder issues outperformed rivals by more than four percentage points.

To narrow down their company's key issues, directors should first identify the priority stakeholders critical to the company's future success, such as: customers with the potential to generate substantial revenue or profits; employees in critical parts of the value chain; suppliers of essential parts or services; and communities suffering from externalities, such as pollution, that might limit the company's license to operate.

Boards should then ask the following questions:

- Is the proposed issue core to the company's mission, and does it address a significant business opportunity or risk? Does it build the brand or allow expansion into promising markets?
- Can the company address the issue with its specific capabilities or expertise?
- Would the proposed action have a material positive impact on desired stakeholder outcomes, while minimizing harm to other stakeholders?
- Can the company directly control its efforts, or must it partner with other organizations to meet its goals?
- Do the benefits to the company and society outweigh the costs to the company of taking action?

Determine Which Issues Actually Belong in Compensation

Boards have multiple reasons to include stakeholder metrics in incentives. Their inclusion signals, both internally and externally, the company's commitments and makes executives accountable for executing the strategy effectively.

However, only some stakeholder strategies are worth addressing in executive pay. Compensation incentives work only when few in number. Boards have plenty of other options for creating executive accountability, such as public reporting of progress, recognition systems, promotions, or reallocating budgets.

To identify which issues should be attached to compensation, boards should ask:

Is the issue such a priority that it beats out other operational concerns, such as improving innovation or supply chains? Companies need to consider priorities holistically instead of just comparing ESG and other stakeholder concerns.

Can the board efficiently collect the data necessary to determine success using existing or new systems? Pay incentives require reliable and timely sources of data, preferably from third parties, to boost credibility and benchmarking. Since many of the benefits of addressing stakeholder concerns involve intangibles, such as enhanced reputation, these likely shouldn't go into pay until they can be quantified or at least rendered concrete enough for a board's discretion.

Does management have a plausible plan for setting and achieving the goals? Any goal should have a top-down component showing what the company must accomplish based on stakeholder expectations, regulations, or competitor actions, and a bottom-up component that reflects what down-the-line managers believe is attainable. This should be coupled with a well-thought-out plan for achieving the goal, or it is likely not to be met.

Will including the metric lead to gaming or unintended consequences? For example, will reducing pollution and greenhouse gases lead to job losses through plant closures? Will investing in a single supplier reduce resiliency?

Is the board willing to disclose to investors and the public if it fails to meet a pay goal? Transparency is required by most executive-level compensation programs. If the board balks, that's reason enough to drop the incentive.

How Companies Are Adding Stakeholder Metrics to Compensation

Today, stakeholder metrics are used by more than half of S&P 500 companies, but their use in pay is generally in the early stages. The measures are often a secondary item in individual pay components or a discretionary company-wide adjustment (often in a scorecard). So far, most of these stakeholder metrics have gone into the annual bonus, not the three-year incentives.

Some companies in extractive industries, such as mining, oil and gas, have gone farther. Their license to operate depends on meeting stakeholder needs. One leader in this area is a large global company that relies on the goodwill of its host governments. The company must also attract skilled managers to remote locations. Its target stakeholders are therefore its field managers and the communities where it operates. The company incorporates a sustainability scorecard in its long-term incentive plan, with a 25%-weighted company-wide component based on worker safety, social and economic development, human rights, environment, and compliance indicators. Another 10% addresses human capital management.

For the annual bonus, the board uses discretion based on a separate scorecard assessing its implementation of its ESG strategy, including managing its environmental footprint and ensuring regular and transparent reporting. The company has sophisticated systems for monitoring metrics, and it shares them with its regulators. Each field manager is regularly evaluated against a plan for achieving compliance. The cost of developing a major site goes into the billions, so the downside of failure is enormous.

Those incentives have helped propel the company to a high level in published sustainability indices. It leads its own industry in the categories of environmental reporting, water-related risks, social reporting, and human rights.

Another example is a medical device company in the S&P 500. Its priority stakeholders are patients, the health care providers who use their devices, and the communities where these providers operate or where the company has its factories. The company's mission is to save and improve the quality of lives. To do this effectively, it needs to develop safe and cost-effective products, maximize access to their devices, ensure quality in supply and distribution chains, and comply with regulations. Accomplishing those goals requires an open culture where all employees contribute to innovation and elevate concerns that might otherwise go unidentified.

The enterprise-wide annual bonus for executives therefore has two parts. The first focuses on core financial metrics of growth and profitability, while the second addresses operational and product quality, compliance, patient outcomes, and access. If financial results are poor, no executive receives a bonus. But if those results reach a certain level, while hitting the more stakeholder-oriented goals, the bonus can go as high as double the base financial target.

With these two components of pay, the company has outperformed its industry peers consistently — both on returns to shareholders and patients' outcomes. Employees see the company's mission reinforced daily through the culture and incentive plans, making the company an employer of choice with top talent and low attrition.

The commitment to corporate purpose in serving stakeholders has opened up a valuable conversation about how companies measure success. Firms that align stakeholder priorities and business priorities can differentiate themselves in a way that captures the interest of employees and customers and benefits their communities. Boards and management teams who engage in this dialogue can transform their company's future viability and long-term growth.

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