Compensation Impacts Culture

Time to take stock of executive pay and perks programs.

BY KATHRYN NEEL AND KATHERINE BARRALL

Leadership and tone at the top are obvious corporate culture influencers. What might be less obvious is how decisions on compensation structure shape, steer and promote corporate culture.

Compensation committees are increasingly discussing how the compensation program can be used as a tool to promote the desired corporate culture. These discussions are rarely simple since most program features can be assets or liabilities to the organizational culture.

It is possible, however, to analyze how pay program elements explicitly or implicitly affect culture. The following four aspects of compensation design shed light on how one impacts the other:

Individualized Payouts: Companies may incorporate individual performance in their annual incentive designs to provide the ability to differentiate payouts beyond corporate/business unit performance, thereby acknowledging stronger or weaker performance on an individual basis. While this approach may encourage a greater sense of individual accountability, it may also lessen the emphasis on teamwork and collective responsibility. On the other hand, having no individualized component may leave high performers feeling as though they were not rewarded appropriately for their efforts and even frustrated that lower performing employees can free-ride on the work of others.

Benefits and Perks: Although executive benefits and perquisites have decreased substantially over the last decade as public demand for disclosure, and proxy adviser and investor scrutiny has increased, companies continue to offer certain perks with the rationale that they support productivity, wellness and/or safety. These perks can play an important role in making employees feel appreciated and promoting a sense of fairness within the company when they are generally provided to all employees. However, providing generous perquisites can also foster an attitude of entitlement among employees and, in extreme cases, create distraction that detracts from work productivity. On the contrary, providing minimal or no perks may leave employees feeling undervalued and resentful, particularly if other companies commonly provide more generous offerings.

Transparency: Transparency in the compensation scheme, encompassing everything from how base salary levels are determined to what target incentive levels are and how actual payouts are calculated, can be crucial to creating a culture of fairness. Transparency establishes an even playing field and develops confidence that others are not receiving preferential treatment in a "black box" program. Nevertheless, extreme transparency (e.g., disclosing everyone's pay and performance on a granular level) can have undesirable effects, such as encouraging a competitive and even cutthroat mindset between team members. On the other hand, minimal or no

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transparency can result in confusion as well as skepticism about the fairness of the program.

Use of Discretion: Boards and committees may use discretion or make adjustments in the evaluation of performance against short- or long-term goals for a wide variety of factors, including goals that, in retrospect, were not set at appropriate levels, natural disasters and events outside of the company's control, and other notable items affecting the company that were not built into the original goals. While discretion allows flexibility to create "fairer" payouts than what would otherwise be paid formulaically, frequent or liberal use of discretion may cause employees to feel less motivated to hit established goals and even entitled to certain payouts when goals are not achieved. However, strict adherence to no discretion may create a culture that is entirely about "hitting the numbers," which may encourage gaming the system and other unwanted behaviors.

When combined, companies may be able to mitigate the risk of a heavy emphasis on transparency causing a cutthroat culture by using a balanced linkage to team performance in addition to individual performance to promote camaraderie.

While it is true that compensation can drive culture, it is important to remember that culture can also drive compensation.

For instance, at companies where there is an existing culture of employee entitlement, boards and committees may experience pressure to increase compensation even in the face of low performance or to use discretion to adjust for lower-than-usual payouts. Because compensation and culture exert a force on one another, committees should periodically take stock of both the cultural climate and compensation programs in place to ensure that both are aligned with intentions and consider changes as needed.

Whether program features, including the ones above, function as assets or liabilities to company culture depends on how they are used by the company and how they are balanced with other facets of the program. ■

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