

# **Ethics of Executive Compensation**

## **Abstract**

Executive compensation has been a target for criticism by stakeholders and academics over the past several years. Corporate executives have been receiving immense compensation packages specifically in the form of stock options. The purpose of the incentives is to align the goals of executives and stakeholders. Although theory encourages desirable behaviour, many a time executives take advantage of their governing position and engage in fraudulent activity to increase personal wealth at the expense of the corporations' shareholders.

This paper will analyze the ethics behind executive compensation. The first section provides an explanation as to why compensation has reached such high levels, followed by a discussion of possible prevailing ethical viewpoints embraced by corporate executives, and how these view points set the stage for unethical conduct with respect to compensation. The subsequent section provides an analysis of three empirical studies that attempted to find a correlation between executives' incentives and corporate social responsibility. Lastly, proposed solutions to these problems are presented along with concluding thoughts.

## **Current Compensation Levels**

Executive compensation has risen dramatically in past decade. In a survey conducted by Business Week, excluding stock options, executives received a 39% increase in compensation in 1996 while the salary of the average worker increased by only 3% (Nichols & Subramaniam, 2001). In another study of the compensation levels for S&P 500 firms, Bebchuk & Grinstein (2005) discovered that CEO compensation increased a dramatic 146% for the period of 1993-2003. In addition, the compensation levels of the top five executives of S&P 500 firms increased 125% in the same period. These increases are difficult to comprehend considering profits and stock prices of the S&P 500 only increased by 11% and 23% respectively (Nichols & Subramaniam, 2001). Although the increase in market value created an environment for increasing compensation without much criticism from outsiders, are these levels justifiable? Academics have studied compensation policies of numerous firms in search of an answer.

The economic principle of supply and demand offers an explanation of the compensation market equilibrium. A job has economic value to the employer that created the position. The price to fill the position is determined by the forces of supply and demand (Perel, 2003). As with all other commodities, when the demand for a particular service increases, the price rises. If the supply of the commodity increases, the value of the service declines due to the abundance and competitive pricing. The position of an executive is not one that can be easily filled as it requires a certain degree of skill, experience, and knowledge of the industry resulting in a low level of supply. The latter half of the 1990's brought with it the internet bubble, an era of internet based services which was deemed to be the new economy. During this period, executives of public companies were being drawn to new technologies and start up companies, creating an imbalance in supply and demand (Bebchuk & Grinstein, 2005). As demand for executives began to rise, firms increased their compensation packages in an attempt to keep talent within their firm. Although the internet bubble burst, the compensation

increases made the executive population financially secure. This increased wealth has escalated the reservation price of executives, specifically the older generation. As a result firms have to offer more in order to induce these individuals to work (Bebchuk & Grinstein, 2005).

In the last decade, long term compensation packages including stock options have accounted for the majority of compensation increases (Bebchuk & Grinstein, 2005). Equity based compensation packages of the early 1990's were low in comparison to other incentives. In theory, equity based compensation will align the goals of the executives and shareholders. Executives will receive the greatest payoff if the value of the firm increases over time. Therefore by rewarding executives based on future firm value, the goals of executives and shareholders would be placed on the same path.

Institutional investors have large ownerships in publicly traded companies and many a times act as advocates for shareholder interests by negotiating with management, publicly addressing corporations in the media, and by presenting shareholder proposals at the annual shareholder meetings (Matsumura & Shin, 2005). Institutional investor acceptance of the goal alignment theory resulted in equity based compensation to become widely accepted in the late 1990s, however the costs shareholders would bear as a result were not considered, nor were salary levels decreased.

In the perspective of board members these compensation plans involved no initial cash outflow, and the option value did not have to be expensed resulting in a greater reported income (Bebchuk & Grinstein, 2005). In an attempt to correct for this "costless" compensation illusion, the Financial Accounting Standards Board (FASB) proposed that the compensation expense recorded on the company's income statement include the market value of the stock option presented to executives. However due to the outcry received from the accounting profession, business community, and congress, the FASB withdrew their proposal (Nichols & Subramaniam, 2001).

Recently, the Securities Exchange Commission (SEC) made amendments to the disclosure requirements pertaining to executive compensation. The new rules require public companies to disclose the compensation packages of their top five executives in notes to financial statements (SEC, 2006). The expectation of this amendment was that the disclosure of such sensitive information would instill a compensation policy that was morally and ethically sound. The increased disclosure would benefit the firm by improving corporate governance, and by decreasing informational asymmetry between investors and executives, ultimately resulting in a lower cost of capital (Matsumura & Shin, 2005). On the other hand, disclosure of compensation may result in a "beauty contest" between firms (Matsumura & Shin, 2005). Companies might participate in the executive compensation version of an "arms race" as each firm strives to offer their executives top dollars. By developing a reputation for high level of pay, firms will attract the largest pool of talent to their organization.

The reputation of a CEO based on past performance directly correlates to compensation (Perel, 2003). For example, before his downfall, Al Dunlap, also known as "Chainsaw Al" had the reputation of bringing a company in financial distress back on its feet, by making drastic changes in the company including massive layoffs, discontinuation of operations, and corporate restructuring. History shows that when Chainsaw Al was announced the CEO of a firm on the road to bankruptcy, stock prices experience vast increases. His reputation gave investors the confidence that the firm

would become profitable once again. CEOs of this influence do not come cheap, and firms are willing to grant generous compensation packages because of the investor confidence they bring along with them (Perel, 2003). In addition, the limited number of such CEOs enables them to demand higher levels of compensation (demand/supply: low supply = high cost). Unfortunately, paying this inflated level of compensation does not come with a guarantee that the reputable CEOs' strategies/methodologies will be successful.

The concept of fairness has a significant influence on the determination of appropriate compensation policies. Bender & Moir (2006) suggested several aspects of fairness that should be considered in determining equitable pay. Compensation committees fear of losing top talent due to uncompetitive remuneration. However the SEC disclosure requirements and an analysis of the demand and supply of CEO skills provide an accurate benchmark.

First off, pay between the executive team in a corporation must be perceived as fair. In this setting, pay is usually determined based on the relationship between pay and performance. Executives must be able to understand their pay differences by comparing their inputs to the corporation. Second, executives must perceive their pay equitable in comparison to executive peers in comparable firms/industries. Executives will also expect to be paid better if their company performs better; else there will be a sense of inequity. Lastly, there should be an understanding amongst executives and employees compensation differences within the firm. It is understandable that the higher the position held in the corporate hierarchy the greater the compensation. Differences can be explained with regard to increased responsibility as well as greater skill, and education required to perform at that level. However, on average, executives are paid 209 times that of the average factory worker (Nichols & Subramaniam, 2001). Bender & Moir (2006) found that in practice this last category of fairness was considered least important in setting compensation policy.

Carr & Valinezhad (1994) developed a "Tournament Theory" that explains the difference in compensation on the executive level. According to the Tournament Model, "high CEO compensation relative to the next highly paid executive in the firm is designed to engender an extreme sense of diligence in management trainees" (Carr & Valinezhad, 1994, p.88). These trainees are well aware of the fact that they are candidates to replace to current CEO. The position of CEO will bring with it a large leap in remuneration, and therefore each will work hard in order to attain the title. The significant difference in compensation is the incentive to the work ethic. The theory states that trainees willingly accept a lower level of pay in the early years of their career for a chance to compete in this tournament. The compensation differences between the CEO and each trainee are "pooled" and awarded to the next CEO.

Up to this point I have provided various justifications as to why compensation has reached such high levels in recent years. However, there has been little explanation as to how these levels can result in unethical behaviour. The next section will outline ethical consequences behind compensation policies, and provide ethical perspectives to current executive cultures, giving examples of how management can take advantage of such situations.

## Ethical Dilemmas

Compensation packages of the last decade have been trying to address the Principal-Agent problem. The Principal Agent problem as explained by Bruhl (2003) exists when shareholders (the principals) have conflicting interests with the executives (the agents). Executives are responsible for managing the corporation on behalf of the shareholders. The problem with the arrangement occurs when executives focus their attention on attaining their own self-interests rather than working on increasing the value of the firm, the ultimate goal of the shareholder. Put in another light, "Agency theory views top management as self-centered opportunistic agents who would shirk and violate the rights of the shareholders if proper control mechanisms were not developed and enforced" (Carr & Valinezhad, 1994, p.87).

Long-term compensation packages make an effort to align the goals of executives with that of the shareholders. However, the effectiveness of such packages is strongly related to the culture of the board of directors and compensation committee. Shareholders want long-term returns on their investment, which potentially means sacrificing profits in the short-run in order to reap the benefits in the long-run. Corporate Social Responsibility which is the way a company balances economic, environmental and social obligations with that of stakeholder interests can have an adverse impact on short-run returns. However in the long-run, addressing such issues as environmental awareness, labour diversity, and safety precautions has positive impacts on corporate returns. While some compensation arrangements may achieve their goal of profit maximization, they fail to induce executives to behave in a socially responsible manner.

Rodgers & Gago (2003) used the concepts of liberty and equity to explain compensation policies from the perspective of six ethical viewpoints that can exist and prevail in executive culture. On the liberal side of the spectrum is egoism, a viewpoint in which individuals act in their own self-interest. Moving from liberty to equity we reach ethics of care, a viewpoint that takes into consideration outside perspectives. I will use these viewpoints to describe the effect each have on the agency problem and corporate social responsibility.

Under the egoist viewpoint, executive compensation policy is determined based on the perspective of the CEO, with little regard to the policy's effect on stakeholders (Rodgers & Gago, 2003). Egoists are motivated to act in order to achieve their own short-run interests. All related parties welfare is ignored in their pursuit unless their involvement will help attain the goals of the executives. Compensation packages are setup in a favorable light to executives giving an incentive to maximize profit at any expense (Rodgers & Gago, 2003).

An egoist corporate arrangement results when there is a lack of independence on the board of directors, giving the executives influential power over the corporation. The issue that is often omitted is that many directors also exhibit an agency problem, making it difficult for them to address the agency problem between shareholders and executives (Bebchuk & Fried, 2003). The title of a director is accompanied by a generous salary, prestige, and valuable business connections. Although boards of directors are established by the shareholders, CEOs play an important role in re-nominating directors back to the board, as well as determining directors' perks and salaries (Bebchuk & Fried, 2003). Therefore, directors have few reasons to oppose high executive pay if it falls within an

acceptable region, as it would hurt their chances of being invited back to the company's board (Matsumura & Shin, 2005). In addition, the fact that directors have minimal holdings in the subject corporation, gives them little incentive to oppose the CEO even if they viewed their director profile as unimportant (Bebchuk & Fried, 2003).

It is evident that offering executives lucrative compensation packages has little effect on the directors' reputation and financial status. However, if hiring negotiations were to fail because of inability to settle on a compensation amount, the reputation of directors would be damaged (Bebchuk & Fried, 2003). Further conflicts of interest arise as most directors hold an executive position in another company. As a result they are sympathetic to the executives' stance and ensure their satisfaction, a kind of "I scratch your back, you scratch mine" analogy (Nichols & Subramaniam, 2001). In the end, if the executives are pleased with the directors' decisions, they will re-nominate them to the board and pay them generously expecting the same in return (Nichols & Subramaniam, 2001). Being nominated to the board will make some directors feel thankful and therefore obligated to comply with executive requests. Lastly, directors make their compensation decisions based on information provided by the human resources department and compensation consultants, both of whom have an incentive to impress the executives (Bebchuk & Fried, 2003).

Lack of independence with respect to shareholders also contributes to a self-centered culture. The presence of outside shareholders, specifically institutional shareholders might establish an atmosphere for monitoring and scrutiny of the executives (Bebchuk & Fried, 2003). Rodgers & Gago (2003) found a positive correlation between corporate social performance and the number of institutional shareholdings. Whether it is via negotiations or public attacks, institutional shareholders have the ability to influence executive decisions to be in accordance with shareholder beliefs (Matsumura & Shin, 2005). "Investor activism has frequently targeted corporate governance, for example in promoting policies that facilitate shareholder input and openness in corporate governance and managerial accountability for firm actions" (McGuire, Dow, & Argheyd, 2003, p. 347). Pressure from shareholders might cause executives to consider a wider scope of stakeholders in their decisions.

Further contributing to the egoist culture are compensation consultants tied to the organization. Compensation consultants analyze the market and the industry, and provide a report along with suggestions to the board of directors. The directors base their compensation offering to executives based on the information and suggestions given by the consultants. From a narrow perspective it seems like compensation consultants provide a credible independent opinion. The problem with compensation consultants is that they are mainly used to justify compensation rather than suggest its value (Bebchuck & Fried, 2003). The human resource department (which is tied to the CEO) hires these consultants. It is in the consultants' best interest to provide favourable results to the executives, as if they suggest amounts that will decrease executive pay, they hurt their chances of being rehired. In addition, these consultants usually have large and more profitable engagements with the hiring firm, providing further reason to please executives (Bebchuck & Fried, 2003).

Placing the executives on top of this "untouchable" pedestal gives them the power to manipulate the corporation for their interests, jeopardizing a sound principal-agent relationship and corporate social responsibility. The excessive compensation packages

granted to executives in the late 1990s along with the lack of internal controls as explained above, tempted executives to use whatever means to keep stock price high (Perel, 2003).

The theory behind stock options (which constitute most of executive compensation) was sound. By making operational decisions that would increase the value of the firm (shareholders goal), executives would earn the greatest payoff. In addition, Mahoney and Thorne (2005) stated that “longer-term performance based compensation can be used to align executives’ self-interests with that of society because socially responsible actions are generally those with a longer term time horizon, which is captured by a market valuation of a firm” (p.243). However many a times illegal activity is adopted to artificially boost stock prices (Perel, 2003). Aside from fixing the books, executives use their influence to gain third party help. For example, US firm stock price rises if the profitability of the firm outperforms analytical forecasts. Executives have motivation to engage in what is called “management of earnings” and conspire with the analysts to reduce their forecasts in exchange for future underwriting work (Matsumura & Shin, 2005).

In an egoistic culture the executive influence over corporate governance can result in financial gains even in times of poor performance. Directors may feel obligated to help the executives in times of financial distress, and there is growing evidence that firms use stock option re-pricing to shield executives from share price risk (Matsumura & Shin, 2005). An explanation of this concept is required. Stock options allow their owner to purchase the underlying asset at a predetermined price (strike price) in a predetermined period. The strike price is usually set equal to the value of the equity at the time of issuance. Profits are recognized when the strike price is below the market price. This is called “in the money”. The owner can buy the underlying asset at the lower price (strike price) and immediately sell it in the market at the market price, resulting in a gain of the difference in prices. If the market price should fall below that of the strike price, the option is said to be “out of the money”. In this situation the option is valueless. What firms have been known to do is lower the strike price of the option when it is out of the money, reviving the owner’s profit potential.

Stock option compensation, especially in an egoist culture, may encourage executives to adopt riskier strategies as they focus their attention on potential gains rather than further losses (McGuire et al., 2003) In addition, McGuire et al. (2003) argued that stock options are not actually a form of ownership until exercised. Therefore, executives are not as concerned of their reputation as there is no direct link between themselves and the weak corporate social performance.

To avoid outcry, executives instill performance measures into their compensation policies to justify the amounts. However most of these measures are simply set to comply with industry standards (Bender & Moir, 2006). Therefore in an egoist culture, performance measures for executives and directors may be set simply to comply with the legislature and avoid disclosure of sensitive information. It has been found that many companies have similar if not the same performance measures. Similarities of this sort are inappropriate as different companies experience different growth rates and market expectations. Therefore even if the measure is met, value may not have been added (Bender & Moir, 2006).

In addition, another means by which executives can avoid complaint from outsiders is to camouflage their compensation in the notes to financial statements rather than provide a direct disclosure. “The current method of reporting the details of executive pay by scattering the information throughout the proxy, and camouflaging it with technical, legalistic and accounting jargon conflicts with the shareholders' rights to effectively judge the appropriateness of the compensation package” (Carr & Valinezhad, 2003, p.83). This means of disclosure paints a foggy picture of the actual compensation packages. Executives use their technical expertise to show shareholders only what they wish for them to see (Carr & Valinezhad, 2003). The failed corporation WorldCom, an entity driven by greed and self interest, went to the extreme in skewing shareholder beliefs as they failed to disclose \$400 million of loans granted to the CEO (Bebchuk & Fried, 2003).

Lastly, a corporation with an egoistic tone at the top and overcompensated executives may find its employees supporting the theory of social inequity. “According to the social inequity theory, whenever one perceives the ratio of his output to his input to be unequal to another person's ratio of output to input, inequity exists” (Carr & Valinezhad, 2003, p.87). Feelings of inequity amongst employees on the front lines reduce their motivation and cause harm to important success factors like teamwork, commitment, and implementation of strategic goals. An atmosphere of this type causes reduction in productivity and loss of any competitive advantage. Executive abuse of power demoralizes employees, eventually leading to loss of profits and reduced firm value (Carr & Valinezhad, 2003).

The recent demise of energy giant Enron is a prime example of an executive culture run by an egoistic ethical viewpoint. There was a lack of independence between the executives and board which gave the executives a clear path to do as they please. The executives and board viewed themselves as they key stakeholders of Enron. Other stakeholders were not given the rights and treatment of equality they deserved (Perel, 2003). Perel (2003) noted that “News stories and analyses around the time of Enron’s collapse told tales of executive hubris, and an arrogant belief in their own invincibility and infallibility. These people managed the firm in a wholly egotistical manner with greed and self-aggrandizement as their primary motivation” (p. 387).

Investigators of Enron’s board of directors discovered that their compensation committee was keeping up with competitor pay rather than monitoring the existing compensations (Perel, 2003). The executives of Enron participated in fraudulent business practice to increase the value of the stock and in turn their options (Perel, 2003). In addition, it is well known in the business world that Enron had a golden code of conduct. If ethical business practice was based on the contents of the code of conduct, Enron would be at the top. However, the executives waived clauses of the code in order to pursue investments that would give them personal benefit (Perel, 2003). The case of Enron is proof of how long-term stock option compensation has the potential to derail shareholder and executive aligned goals.

The left wing liberal perspective of egoist ethics is the negative extreme of the ethical viewpoints spectrum. I provided the ethical behaviours that can sprout from this type of corporate culture in order to provide a base from which to draw comparisons. The ethical viewpoints discussed next move from the concept of liberty to equality. I will not again analyze the types of behaviors that result. The egoist examples provide the



fundamentals to gain an understanding of how compensation policy decisions more effectively address the principal-agent problem and corporate social responsibility as ethical viewpoints become more equality based.

The deontological viewpoint imposes a more moderate emphasis on liberty. This viewpoint “insists on adherence to principles of individuals and the judgments associated with a particular decision process rather than on its choices” (Rodgers & Gago, 2003, p.191). Under this approach, the decision makers take the stance that the ethical decision depends on duties rights and justice considerations. It aims to address to duties owed and the rights expected by the stakeholders involved in the decision. Individuals are seen to act under “enlightened self-interest” rather than “pure self-interest” as in egoism (Brooks, 2006). The interests of the individuals are considered but by no means are the primary concern.

The utilitarian viewpoint is “concerned with consequences, as well as the greatest good for the greatest number of people” (Rodgers & Gago, 2003, p.191). This approach studies decisions in terms of benefits and harms it provides to stakeholders. The ethical decision is the one that results in the greatest benefit for the greatest number of stakeholders (Brooks, 2006). Under these circumstances excessive pay may be viewed as just if the receivers generate additional returns to the related stakeholders (Rodgers & Gago, 2003). This viewpoint makes an attempt to address the needs of all stakeholders, making investment more attractive.

Relativism is the viewpoint that places moderate weight on liberty and equality. “Relativism is a meta-theory, which assumes that companies’ management uses themselves or the people around them as their basis for defining ethical standards” (Rodgers & Gago, 2003, p.191). Building on the independence issues discussed earlier, this approach would better align shareholder and executive self-interests thanks to the importance placed on outside stakeholder opinions. Under this approach, the same organization would have a different compensation policy in different geographical areas as the surrounding issues, rules, and laws between cities and countries differ. The compensation policy would reflect the majority stakeholders’ view of the importance of economic or social performances (Rodgers & Gago, 2003).

The virtue ethics viewpoint places moderate weight on equality and less emphasis on liberty. “Virtue ethics views the cultivation of virtuous traits of management’s character as its morality’s primary function” (Rodgers & Gago, 2003, p.191). The viewpoint focuses on the virtues of the decision makers with guidance from moral and professional communities to address the ethical issues (Brooks, 2006). The compensation decisions take into consideration the economic and social consequences, as well as reputation of executives, and relationships with close parties (employees, clients, suppliers). When considering the acceptance of investments that will results in personal benefits, executives consider the impact on their reputation and business relationships. (Rodgers & Gago, 2003)

Finally, the ethics of care viewpoint is based heavily on equality. “Ethics of care viewpoint focuses on a willingness to listen to distinct and previously unacknowledged perspectives” (Rodgers & Gago, 2003, p.191). The corporation builds a sense of unity with stakeholders. In making compensation decisions, directors act on the input received from this rich pool of stakeholders. The corporation strives to minister to social and economic goals beyond that of profit maximization. The need to be accepting of

community and cooperation explains why this viewpoint is most commonly found in community based cultures of the Middle East and Japan.

Now that the ethical consequences of executive compensation have been considered, I would like to bring the attention to the empirical studies. In the next section I will compare the results of three studies. Each study has similar variables and measures used, and all try to find a correlation between executive compensation and corporate social responsibility (CSR).

## **Empirical Studies**

A study conducted by McGuire et al. (2003) examined the relationship between executive incentives and corporate social responsibility of 374 US firms using data from 1999. McGuire et al. (2003) sought to determine how salary, bonus, and long term incentives as well as the governance aspects of ownership, and institutional ownership impact CSR dimensions of community, employee relations, environment and product, and business practices. The ratings for firm CSR were derived from the Kinder, Lindenberg, and Domini, and Company (KLD) which is a multidimensional Corporate Social Performance database. For each firm, strengths and weaknesses were evaluated for each CSR dimension and aggregated to attain total strength and weakness values.

The results of the study found the salary and long term incentives were positively related to weak social performance, and that bonus payments were unrelated. McGuire et al. (2003) dictate that these results support the arguments that state that high salaries promote excessive pride and arrogance in executives. In addition, the long term incentives results in managerial pressures to ensure positive stock performance. Stock options, rather than concrete ownerships do not focus executives' attention on the down side risks of projects. Executives instead take more risks in an attempt to profit because of the lower ownership levels and in effect less impact on reputation. A surprising result of the study indicated that there is a stronger positive relationship between high salary and long term incentives, and poor social performance in firms with a high level of institutional investors. Bonus payments also become more significantly related to weak social performance in these firms.

The next study was conducted by Mahoney and Thorne (2006). The study was similar to that of McGuire et al. (2003) except it used data of the largest Canadian firms based on the TSX. Data of 69 companies was collected from 1995, and 77 from 1996. Mahoney and Thorne (2006) used two years of data in order to incorporate a lagged examination. This technique captures the correlation between 1995 executive compensation and the effect it had on 1996 CSR data. The CSR ratings were obtained from the Canadian Social Investment Database (CSID) which is a multidimensional database of CSR for Canadian firms. To allow for direct comparison to McGuire et al. (2003) study, Mahoney and Thorne (2006) used both a four item configuration of CSR that includes the aspects of community, employee relations, environment and product, and business practices. In addition, Mahoney and Thorne (2006) conducted an examination of three additional CSR measures which included diversity, international, and other. Like McGuire et al. (2003), this study aggregated the strengths and weaknesses of each incentive on CSR to arrive at total CSR strengths and weakness values. They also used a total CSR amount which is the summation of total CSR strengths and weaknesses.

Consistent with the findings from McGuire et al. (2003), Mahoney and Thorne (2006), found that salary is positively related to CSR weaknesses. On the contrary, this study revealed that bonus payments and long-term incentives (stock options) were positively related to total CSR and CSR strengths. This suggests that executives, who received stock options and bonuses in one year, took actions to enhance their firms CSR in the next.

Another study conducted by Mahoney and Thorne (2005) examined the association between executive compensation and CSR for 90 publicly traded Canadian firms from 1992 to 1996. The study used the seven item configuration of CSR (community, diversity, employee relations, environment and product, international, business practices and other) the rating of which were gathered from the CSID. Data for the CSR was gathered from 1995 to 1999 in order to capture the lag between incentives and their consequences. As with the previous study, Mahoney and Thorne (2005) examined the effect of incentives on total CSR, CSR strengths, and CSR weaknesses. In addition, this study measures the subsets of total CSR: total CSR product and total CSR people. CSR product strives to measure the firms' commitment to quality products and the extent to which the firm instills sound environmental policies. CSR people attempts to measure actions firms take to help communities by hiring women and minorities, as well as how the firm treats their employees.

The results of the study found long-term compensation was positively related to the total CSR weakness and total CSR product weakness; however, it was not found to be related to total CSR people or total CSR people weakness dimensions. The results showed no correlation between long-term compensation and any aspect of CSR strengths.

Although some similarities in the results do exist, the studies prove that there is no consistent relationship between executive compensation and ethical behavior. In the following section I will provide some suggested solutions to the ethical problems of executive compensation and conclude with my own beliefs.

## **Proposed Solutions**

The issuance of stock options as a form of compensation was one solution to the ethical dilemmas. Academics have offered various other means of compensation that they believe would better align executive self-interests with shareholders, and in turn encourage ethical behaviour. It has been suggested that compensation committees should ensure that executives build and maintain significant equity ownership in their respected corporation. "The market favourably views the mandatory increase in executive ownership" (Matsumura & Shin, 2005, p.106). Executives might be more risk averse as their wealth and reputation are on the line. "Long-term incentive compensation is less likely to bring the same reputational ties or feelings of "ownership" as actual equity ownership" (McGuire et al., 2003, p.346).

On the contrary, it can also be argued that an executive who holds a large share of stock in their company may resort to alternative or unethical practices as their wealth is on the line, an example being Bernie Ebbers at Worldcom (Bender & Moir, 2006). Bruhl (2003) pointed out an interesting dilemma with such a solution. He believes that by compensating the executives with shares, the agent-principle problem compounds as the executives are now both principles and agents. The reason for this is that the executives

can use their position as principles to enhance their position as agents. Executives are exposed to the most sensitive information, and they can use this information for self benefit. Bruhl (2003) makes the point that although insiders are required to report any trades, the damage is already done long before the disclosure.

Bruhl (2003) does offer a solution. He suggests that companies should offer their executives a pre-set amount of non-voting stocks that are available for withdrawal after predetermined amount of time after the CEO leaves the company. The fixed number of shares eliminates the executives' purchasing advantage over other shareholders. The non-voting aspect eliminates the executives' influence in determining their compensation as an agent. Lastly, keeping the stock unavailable for a significant period of time after their tenure forces the executives to be concerned about the long term, as any poor behaviours/decisions will likely surface when their options become available.

Bebchuck and Fried (2003) offered yet another proposition. Current stock options are given at the money, meaning strike price is equal to market price. Bebchuck and Fried (2003) suggested that firms should offer out of the money options (strike price is greater than stock price). Such options have a lower expected value because they are less likely to payoff as the stock price has to rise before the option is exercisable, and if they do payoff the owner will make less of a profit. This lower expected value will allow companies to issue more of such options, and it is more sensitive to pay-for-performance compensation.

Finally, once options become vested, the owner is entitled to the options and has the opportunity to use them. Bebchuck and Fried (2003) suggested that compensation contracts should include a clause restricting executives from exercising the option for a specified period of time after the vesting date. This way the incentive to perform remains without the firm having to grant new compensation packages. It is natural for executives to become more relaxed after they have profited from their options, as further effort will likely go unrecognized. Introducing such a clause would require effort after the vesting date.

## **Conclusion**

Executive compensation is an ethical dilemma in today's business world. The new generation of executives is continually awarded growing compensation packages, often at the expense of the shareholders. The recent attempts to align executive interests with that of the shareholders have been important stepping stones in the ultimate goal of assuring ethical behaviour. I believe that the proposed solutions to the agent-principle problem and poor corporate social responsibility each have merit, but also bring light to additional unethical behaviour. Although such compensation packages and governance of the executives make it more difficult to engage in unethical conduct, the potential will always exist. Many corporations are strictly focused on the bottom line, engaging in whatever acts necessary to attain the goals. In the words of Harvard Business School Professor, Thomas Piper, "Maximizing shareholder wealth has become the overarching corporate goal, and whatever it takes to accomplish that seems to be deemed OK. Ethics – that is, notions about honesty, transparency, and a concern for a wide range of constituencies – has been pushed aside and has been replaced by a technical definition of what is acceptable" (Perel, 2003, p.386).

In my opinion the true solution to these problems are the executives themselves. As the common phrase states “where there is a will, there is a way”, if executives want to act unethically they will do so, regardless of the internal controls in place. The values of the individual will determine whether or not unethical behaviour will surface. Many executives would not act unethically even if there was no chance of exposure. On the other hand, there are those that take every shortcut to reap personal benefits. Therefore, the root of this problem lies with individuals’ virtues and morals. Our surroundings have an impact on the things we value and the virtues we cultivate. It may be that in order to address these issues our society as a whole will need to change. It may be that our society needs to place more value on community, cooperation, and teamwork rather than the immense emphasis given to individualism.

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