Business Horizons (2007) **50**, 277–290

KELLEY SCHOOL OF BUSINESS
INDIANA UNIVERSITY

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Ethical choices in the design and administration of executive compensation programs

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KEYWORDS
Executive compensation;
Business ethics;
Pay equity;
Compensation

Abstract Within the past few years, executives have come under increased scrutiny and criticism for the levels of compensation they receive. At the same time, corporate practices surrounding the design and review of executive compensation programs have received increased attention. While some recent executive misconduct has involved violations of the law, many academics and other corporate critics view the issues involving executive compensation more from an ethical than a legal perspective. Several dimensions of the executive compensation decision process offer significant opportunities for ethical choices. This article identifies the major components of executive compensation and highlights decision points in the design and administration of each component where ethical issues may arise. Proposals to reduce the potential for ethical misconduct are also offered.
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1. Executive compensation in the age of Enron

Over the past several years, the popular media has provided extensive coverage of irregular business actions and allegations of illegal and unethical behavior on the part of corporate executives. Many major corporations, including Enron, WorldCom, Tyco, Global Crossing Communications, Adelphia Communications, Imclone, HealthSouth, and others, have been profiled repeatedly in the press. While a number of the scandals involving these organizations involve misleading accounting practices and fraud, coincident with these irregularities are corresponding executive compensation issues that have significant ethical overtones.

At Enron, for example, employees were prohibited from selling company stock in their 401(k) programs during a blackout period, while executives were selling personally-held stock without restraint. For its part, Tyco received widespread attention because CEO Dennis Kozlowski purchased a $6000 shower curtain and a $15,000 umbrella stand, held a gala $2 million birthday party for his wife in Sardinia, Italy, and engaged in similar actions, all of which were paid for (all or in part) with company funds. These and related business practices (e.g., excessive perquisites, pay unrelated to performance, exceptionally large severance packages) at some of the country's largest companies have brought into question the fairness of executive compensation. Indeed, a survey of CEOs conducted by the Business Roundtable Institute for Corporate Ethics ranked fairness of executive compensation among the top five

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doi:10.1016/j.bushor.2006.12.001

ethical issues facing the business community (Verschoor, 2004).

A number of authors, including Hannafey (2003), Rodgers and Gago (2003), McCall (2004), and Moriarty (2005), have reviewed the moral and ethical value systems that affect executive pay and have proposed that U.S. executives are paid too much. Further, they conclude that neither considerations of aggregate welfare nor considerations of fairness support current levels of executive compensation. This article seeks to build upon this line of thought by identifying and examining various decision points in the design and administration of executive compensation where ethical issues may arise. Proposals are also made to ensure that decisions affecting executive pay reflect equity with regard to executive performance and fairness with respect to other stakeholders. Before these ethical issues can be addressed, however, it is necessary to outline the major components of executive compensation and provide a brief description of relevant ethical frameworks that can be used to examine executive behavior.

2. Components of executive compensation

Executive pay consists of a variety of components. Common components include salary, annual bonus, and one or more forms of long-term incentives (stock, stock options, etc.). Many executives, however, also qualify for additional forms of compensation and benefits, including Supplemental Executive Retirement Plans (SERPs), deferred compensation, severance arrangements through Change-in-Control agreements, and a variety of perquisites. Each of these components will now be summarized.

2.1. Base salary

Base salary, the most easily understood component of executive pay, is the foundation for all executive compensation programs. Many other components (e.g., bonuses, stock awards), however, may be directly linked to the executive's base salary. Hence, the influence of base salary on the executive's overall level of compensation may be multiplied significantly. Annual merit increases will also be considered as part of the discussion of salary.

2.2. Bonuses

Bonuses are cash awards that are paid to executives for the achievement of established goals during a set period of performance, typically a fiscal year. They are often referred to as short-term, or annual, incentives. Many organizations use targeted performance compensation plans that establish a range of potential bonus payouts for the attainment of various levels of company performance (expressed as a percentage of target achieved). For example, if actual company performance is 120% of target, the payout for an individual executive might be 200% of the executive's target bonus payout. Conversely, if company performance is 80% of target, the individual payout may be only 50% of the executive's target bonus payout. Usually, the executive's target bonus award is established as a percentage of the executive's salary based on organizational level, title, or related criterion. For example, the target bonus for a CEO might be 100% of base salary, while the target bonus for a vice president might be 70% of base (when the company achieves its targeted level of performance). Fig. 1 illustrates a typical performance target bonus plan.

2.3. Long-term incentives

Long-term incentives are awarded to encourage the achievement of goals that extend beyond a single fiscal year. Typically, LTI consists of restricted stock, stock options, or a combination of both. Some companies, however, use long-term, cash-based performance plans. Stock-based awards are advocated in LTI compensation plans to link shareholder and executive interests. The assumption is that if executives perform in a way that increases stock value in the long term, both shareholders and executives benefit.

Restricted stock is an outright grant of stock to executives that vests (i.e., becomes the unrestricted property of the executive) over a period of years, typically three to five. With a three year pro rata, or incremental, vesting period, the executive secures unrestricted ownership of 1/3 of his or her stock grant each year. With "cliff" vesting, ownership is restricted until the end of the full term. Infrequently, restricted stock may have a performance requirement other than tenure. In most instances, however, restrictions are time-based. As long as the executive remains with the company, the shares vest in accordance with the vesting schedule.

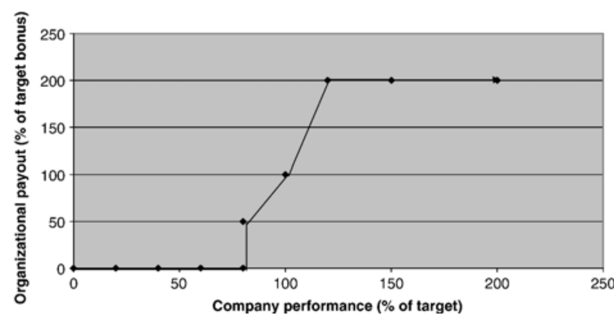

Figure 1 Performance target bonus plan.

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