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Corporate Governance Reform and CEO Compensation: Intended and Unintended Consequences

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ABSTRACT. Recent scandals allegedly linked to CEO compensation have brought executive compensation and perquisites to the forefront of debate about constraining executive compensation and reforming the associated corporate governance structure. We briefly describe the structure of executive compensation, and the agency theory framework that has commonly been used to conceptualize executives acting on behalf of shareholders. We detail some criticisms of executive compensation and associated ethical issues, and then discuss what previous research suggests are likely intended and unintended consequences of some widely proposed executive compensation reforms. We explicitly discuss the following recommendations for reform: require greater independence of compensation committees, require executives to hold equity in the corporation, require greater disclosure of executive compensation, increase institutional investor involvement in corporate governance (including executive compensation), and require firms to expense stock options on their income statements. We provide a brief summary discussion of ethical issues related to executive compensation, and describe possible future research.

KEY WORDS: corporate governance, executive compensation, independent compensation committee, institutional investor, stock-based compensation.

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Recent scandals allegedly linked to CEO compensation have brought executive compensation and perquisites to the forefront of debate about constraining executive compensation and reforming the associated corporate governance structure. This paper discusses intended and possible unintended consequences of recent calls for reform of executive compensation and related corporate governance structures. We focus on U.S. publicly traded companies, which are subject to rules of the relevant stock exchange and the Securities and Exchange Commission (SEC). We begin by briefly describing the structure of executive compensation, and then describe the agency theory framework that has commonly been used to conceptualize situations where an agent acts on behalf of a principal, such as an executive acting on behalf of shareholders. We detail some criticisms of executive compensation and associated ethical issues, and then discuss what previous research suggests are likely intended and unintended consequences of some widely proposed executive compensation reforms.

We explicitly discuss reforms related to three of Business Roundtable's[1] widely supported principles

of desirable attributes of executive compensation in "Principles of Executive Compensation". These six principles (listed in the Appendix) are intended "to serve as best practices for the design, implementation, and oversight of executive compensation programs at publicly held corporations" (Business Roundtable, 2003). The three Business Roundtable recommendations we examine pertain to independent compensation committees, requiring executives to hold equity in the corporation, and greater disclosure of executive compensation practices. We then examine two recommendations from other sources: (1) increase institutional investor involvement in corporate governance, and specifically, executive compensation, and (2) require firms to expense stock options on their income statements. Our discussion of recommendations also pertains, directly or indirectly, to the Business Roundtable's first principle: "Executive compensation should be closely aligned with the long-term interests of stockholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term stockholder value and should reflect upside potential and downside risk." We conclude the paper with a brief discussion of ethical issues related to executive compensation, and possible future research.

The structure of executive compensation

Although differences may occur across firms or industries, most executive compensation packages consist of four major components: base fixed salary, annual bonus, stock options and restricted stock grants, and long-term incentive plan (Murphy, 1999). Furthermore, there is an "other" category of broad compensation such as severance payments, tax reimbursements, and signing bonuses. Base salaries for executives are often determined by benchmarking salaries of peers in the same industry. An annual bonus is usually paid based on a specific year's accounting performance, such as earnings per share or return on equity (Murphy, 1999). Stock options, through which a company gives the executives the right to buy the firm's shares at a pre-specified exercise price for a pre-specified term, are also widely used. Firms sometimes grant "restricted" shares that are forfeited under specific conditions. Finally, unlike the annual bonus that rewards a single year's performance, many companies offer a long-term incentive plan based on rolling-average three- or five-year cumulative performance.

Agency theory framework

Agency theory has been the dominant economics-based framework offered for understanding executive compensation issues (see, for example, Lambert and Larcker, 1991). According to this theory, managers (executives) who are not also owners are shareholders' agents and will not necessarily act in shareholders' best interests. Rather, managers are assumed to choose actions to maximize their own expected utility. Moreover, shareholders are unable to directly observe managers' actions and decisions. Shareholders must therefore rely on reported results, and because of uncertainty in the economic environment, are unable to perfectly infer whether managers' actions and decisions were optimal from the shareholders' perspective.

The potential conflicts of interest between shareholders and managers fall into three broad categories (Lambert and Larcker, 1991). First, executives may enjoy "perquisites" ("perks"), that is, nonpecuniary benefits such as exorbitantly expensive shower curtains or lavish parties. Of particular note, L. Dennis Kozlowski, Tyco's former chief executive, reportedly used tens of millions of dollars of company funds for personal spending. Sorkin (2002) states:

> The report [from Tyco] itemized tens of millions of dollars in personal spending that Mr. Kozlowski made with company money. They include his $16.8 million apartment on Fifth Avenue—along with $3 million in renovations and $11 million in furnishings—and a $7 million apartment on Park Avenue for his former wife.

> According to the report, he also had the company secretly pay for personal items like an $80,000 American Express bill; a $72,000 fee to German Frers, a yacht maker; a $17,100 traveling toilet box; a $15,000 dog umbrella stand; a $6,300 sewing basket; a $6,000 shower curtain; $5,960 for two sets of

sheets; a $2,900 set of coat hangers; a $2,200 gilt metal wastebasket; a $1,650 notebook; and a $445 pincushion.

Second, executives may be more risk averse than shareholders, who can better diversify their risk. Executive risk aversion implies that they require a higher expected value of compensation as a tradeoff for increased compensation risk, as occurs with stock-based compensation. Third, executives may base decisions on a shorter time horizon than shareholders wish. For example, in order to boost short-term accounting performance, and in turn, increase their compensation, shortsighted CEOs may reduce long-term investment, such as research and development spending that sustains firm growth, and thereby harm long-run firm value. Note that even if managers own shares in the firm, their interests will not necessarily be fully aligned with shareholders' interests because, for example, other shareholders will bear some of the cost of managers' excessive consumption of perquisites.

A company's board of directors has responsibility to represent shareholders' interests and mitigate the conflicts of interest between managers and shareholders. Typically, the compensation committee (a subcommittee of the company's board of directors) approves executive compensation. In each annual proxy statement, the compensation committee must report on the company's previous fiscal year compensation policies for the chief executive officer and the next four most highly paid executives. The company must describe the compensation paid and the relationship of compensation to corporate performance, such as earnings or stock returns. Furthermore, the company must show how its stock price performance compares to an appropriate peer group and market index (SEC, 2003). The New York Stock Exchange (NYSE) and NASDAQ Stock Market recently adopted new rules requiring shareholder approval of stock option plans and other forms of equity compensation.

Ideally, then, the board of directors designs optimal contracts for executives to align their interests with shareholders' interests. However, Bebchuk and Fried (2003, 2004) highlight the role of managerial power in the executive pay-setting process. They argue that the CEO exercises significant "power" over the Board through influencing the director nomination process and director compensation. Bebchuk and Fried (2004) state, "Directors have relatively few reasons to oppose higher CEO pay as long as it falls within the range of what is considered conventional and acceptable." Coupled with shareholders' lack of direct power to curb executive pay, "captive" boards of directors may approve executive compensation that is not in shareholders' best interests, so that the directors appear to be more like employees than watchdogs of the CEO. Similar to Bebchuk and Fried, Jensen and Murphy (2004) recommend that companies "[c]hange the structural, social and psychological environment of the board so that the directors (even those who fulfill the requirements of independence) no longer see themselves as effectively the employees of the CEO". CEO power over the board violates the ethical standard of procedural fairness, or "fairness of the processes used to set and administer compensation" (Bloom, 2004). Not only the process, but also the resulting CEO compensation contract may be unethical, in the sense of violating shareholders' rights or granting grossly inequitable compensation.

Criticisms of U.S. executive compensation

Criticisms of U.S. executive compensation and related governance structures abound. Critics assert that compared to other countries, compensation is much too high[2] and is not tied closely enough to performance. Specifically, CEOs may earn large bonuses simply because the economy is strong and growing, and CEOs may be shielded from downside risk when they fail to achieve the previously designated thresholds for bonuses. Moreover, the ratio of executive to worker pay has climbed dramatically, even in the face of worker layoffs and outsourcing of jobs overseas. After declining for two years, the ratio was 301:1 in 2003, compared to 42:1 in 1982 (Anderson et al., 2004). William J. McDonough, chairman of the Public Company Accounting Oversight Board (PCAOB),[3] has described the dramatic increase in relative CEO compensation levels as "grotesquely immoral" (Anderson et al., 2004) and warned that if executives and boards of directors do not curb excessive compensation, then Congress will address the issue with legislation in

order to respond to the "fury at the level of the average American" (Countryman, 2004). Recent scandals concerning excessive perquisite consumption, such as the report on L. Dennis Kozlowski mentioned earlier, have further inflamed the public. Frequent complaints have raised ethical issues of equity, fairness, and justice of the absolute and relative levels of executive compensation, as well as the practice of shielding executives from downside risk.

Putting aside the deserved criticism of fraud and excessive perquisite consumption, arguments exist to support current levels of executive compensation in order to attract and retain needed executive talent. For example, Murphy (1995) argues that the *effectiveness*, rather than the *level*, of executive compensation is the core issue. That is, compensation committees, on behalf of shareholders, should design contracts that provide incentives for executives to fulfill their ethical responsibility to shareholders by increasing the value of the firm. Effective contracts would motivate executives to take actions to increase the value of the firm a great deal more than the executive's compensation.[4] In a related vein, Core et al. (2005) argue that what matters is not the level of executive pay, but rather the magnitude of executive incentives that links managerial wealth to firm performance. They point out that U.S. CEOs who hold much more of their firm's shares than their European and Japanese counterparts naturally require a higher pay level because they bear more risk due to their large equity portfolio, consistent with the economic theory of optimal contracting.

CEOs' holdings in their firms' stocks provide a strong link between stock price and CEO wealth. Because the U.S. capital market rewards firms' meeting or beating analysts' forecasted earnings, CEOs have incentives to engage in unethical "management of earnings" and to collude with the analyst community to reduce earnings forecasts in exchange for potential underwriting business.

The stakeholders include those not commonly included in traditional agency theory models of executive compensation. These models include shareholders and executives (managers), and sometimes debt holders. Clearly, however, a firm's employees may be greatly affected by executives' decisions that are motivated by self-interest. For example, the fallout from the Enron scandals affected not only shareholders, but also employees with pension funds depending heavily on the value of Enron stock, and the broader community. Jayne (2003) aptly sums up the tensions among various stakeholders as follows[5]:

> Chief executive officers' multimillion-dollar pay packets are attracting shareholder anger, compounding employee disaffection and attracting the attention of restrictive regulators. Are these packages really justified and necessary to attract top talent? Or are they the outcome of a self-inflating cycle of competition being pumped by global compensation consultants? Before long, executives start believing their own hype and that of the compensation consultants who work on ratcheting up the individual's value to the company. Surveys suggest management risks undermining its leadership role by alienating itself from those it is trying to manage. A top-performing CEO is a valuable asset to any enterprise. The question is how best to put a monetary value on that worth in a way that both reflects actual performance and does not create an impression that top management is being disproportionately rewarded for its efforts.

Recent calls for executive compensation reform seek to balance the tensions among the various stakeholders. In the next section, we describe frequently suggested executive compensation and related corporate governance reforms, and draw on research to suggest likely consequences.

Intended and unintended consequences of CEO compensation reform

This section discusses research addressing whether the following three Business Roundtable recommendations will likely result in the intended consequence of close alignment of stockholders' and executives' interests: (1) require executive compensation to be determined by an independent compensation committee, (2) require executives to hold equity in the corporation, and (3) require greater disclosure of executive compensation practices. We then examine two other recommendations: (1) increase institutional investor involvement in corporate governance, and specifically, executive compensation, and (2) require firms to expense stock options on their income statements. Our dis-

cussion also pertains to the Business Roundtable's first and overarching goal: "Executive compensation should be closely aligned with the long-term interests of stockholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term stockholder value and should reflect upside potential and downside risk."

Business Roundtable principle 2: independent compensation committees

We begin with Business Roundtable principle 2, which addresses corporate governance regarding the compensation committee:

> Compensation of the CEO and other top executives should be determined by a compensation committee composed entirely of independent directors, either as a committee or together with the other independent directors based on the committee's recommendations.

A firm's compensation committee has responsibility for assessing executives' performance and determining appropriate compensation packages. Therefore, establishing truly "independent" compensation committees has the potential to play a significant role in curbing excessive CEO compensation. The recently adopted New York Stock Exchange (NYSE) governance rules[6] requiring firms to have compensation committees composed entirely of independent directors reflect this belief. The NYSE's further requirement that firms remove the CEO from the nominating committee deserves mention. Extant research suggests that firms whose CEO serves on the nominating committee tend to appoint fewer independent outside directors and more gray outsiders[7] (Shivdasani and Yermack, 1999) and that the level of CEO pay is positively associated with the fraction of outside directors appointed by the CEO (Core et al., 1999). These findings suggest that the key issue is not the fraction of independent directors on the compensation committee, but rather, whether the CEO appointed the compensation committee directors. Therefore, requiring firms to remove the CEO from the nominating committee will help establish a more independent compensation committee and board of directors.

Prior research on the impact of board composition on executive compensation provides evidence that after the 1992 SEC compensation disclosure rules, the number of committees with management participation steadily declined over time, partly motivated by public concerns over board independence (Vafeas and Afxentiou, 1998). More recent studies on the composition of firms' compensation committees show that on average, insider committee membership declined from 6.05% of the total in 1991 to 1.42% of the total in 1997 (Vafeas, 2003).

Using a sample of U.K. firms, Conyon and Peck (1998) find that the fraction of independent directors in a compensation committee is positively related to the sensitivity of pay to performance. Furthermore, Vafeas (2003) and Perry and Zenner (2001) show that for firms with committee insiders, the pay for performance relation is lower and the mix of cash-based to stock-based pay is higher than that for firms without committee insiders. Bryad and Li (2004) find that the opportunistic timing of granting options – the board's tendency to grant options on the days when stock price are low – is mitigated when compensation committees are more independent.

On the other hand, Daily et al. (1998) examine the effect of compensation committee composition on CEO compensation in a sample of 200 firms from the 1992 Fortune 500 and find no evidence that "affiliated" directors[8] lead to greater levels of CEO compensation. Anderson and Bizjak (2003) also do not find a relation between the CEO sitting on the compensation committee and CEO pay. In summary, although some evidence points to the importance of independent directors on compensation committees, much of the benefit has already been captured because of previous movement toward independent compensation committees.

Business Roundtable principle 4: executive equity holdings

We next turn to Business Roundtable principle 4, regarding required executive equity holdings:

> Compensation committees should require executives to build and maintain significant continuing equity investment in the corporation.

This policy builds on the agency theory view that agency problems result from the separation of

ownership from control. Managers with little or no ownership of the firm may fail to maximize shareholder value because they have an incentive to consume perquisites. If this is true, we expect the degree of agency problems to be inversely related to managerial ownership, i.e., the fraction of a firm's shares a CEO holds, and granting stock options or restricted stock to executives will reduce the firm's incentive problem. Consistent with this view, Core and Larcker (2002) examine a sample of firms that adopt target ownership plans[9] and find that increased managerial ownership in these firms is associated with excess (intuitively, greater than expected) accounting and stock returns, suggesting that the market favorably views the mandatory increase in executive ownership.

A slightly different perspective on the benefit of stock-based compensation is that compared to cash compensation tied to short-term accounting performance, stock-based compensation aligns executives' incentives more directly with shareholders' interest in firm value, an inherently long-term measure. Furthermore, stock-based compensation encompasses upside potential and downside risk as the stock price varies. A renewed emphasis on shareholder value, changes in executive compensation disclosure[10] and tax rules[11], and the 1990s bull market collectively resulted in a huge escalation of stock option grants over the past decade, supported by many academics and practitioners (Hall and Murphy, 2003).

Nevertheless, a growing body of research provides evidence that questions the net benefit of using stock-based pay. Stock options are not efficient because of the discrepancy between the economic value of the options and the value of options to executives (Hall and Murphy, 2003)[12]. Moreover, self-serving CEOs opportunistically time good or bad news to maximize the value of stock options (Aboody and Kasznik, 2000). Furthermore, there exists evidence suggesting that some CEOs attempt to maximize their wealth with stock prices boosted by accounting earnings, sometimes fraudulently (Cheng and Warfield, 2004; Erickson et al., 2003). Another problem arises when firms' stock price drops below the exercise price. The option is then ''out of money'', reducing the options' intended incentive effects. Repricing stock options involves lowering the exercise price on stock options previously granted, either by altering the terms of existing options or by canceling and reissuing options (Carter and Lynch, 2003). There is a substantial body of evidence that firms use stock option repricing to compensate managers for poor performance, shielding CEOs from downside risk (e.g., Carter and Lynch, 2001), probably to prevent CEOs from leaving the firm due to out-of-money options (Carter and Lynch, 2001, 2004).[13] Option repricing does, however, help to reinstate the incentive effect of the options.

Whether a low level of managerial ownership is necessarily evidence of sub-optimal compensation remains an open question. Demsetz and Lehn (1985) and Himmelberg et al. (1999) argue that the level of managerial ownership is endogenously determined by factors such as the severity of moral hazard problems and firm-specific contracting environments[14], suggesting that the optimal level of managerial ownership will differ significantly across firms.

Furthermore, whether granting stock options or restricted stock to executives will increase managerial ownership to a desirable level is also questionable. Ofek and Yermack (2000) find that when high-ownership managers receive new options, they sell the shares that they previously owned to diversify the risks. The board also seems to consider the level of managerial ownership when it makes a decision to grant equity-based compensation. Several studies find that executive ownership is negatively related to the granting of stock options, supporting the perception that when executives hold a large fraction of their firm's equity, the demand for further stock-based compensation is likely to be reduced (Bryan et al., 2000; Yermack, 1995).

Business Roundtable principle 6: ''complete'' disclosure of compensation practices

The last Business Roundtable principle we address is Principle 6, regarding ''complete'' disclosure of executive compensation practices:

> Corporations should provide complete, accurate, understandable, and timely disclosure to stockholders concerning all significant elements of executive compensation and executive compensation practices.

It has been more than a decade since the SEC adopted regulations aimed at increasing the quality

and quantity of executive compensation disclosures. The SEC's intended goal was to improve corporate governance by encouraging more transparent disclosure concerning the level and the ways in which executives are compensated (Lo, 2003a). However, it is unclear whether the SEC attained its goal. On the one hand, increased disclosure can benefit a firm through improved governance and eventually decrease information asymmetry between managers and investors, leading to a lower cost of capital. On the other hand, the voluntary disclosure literature suggests that disclosure regulation may impose additional costs on firms. For example, unwanted public scrutiny of executive pay may be detrimental to firms through high political costs. That is, media and activist attention to executive pay may translate into political pressure and public anger, to which legislators may respond with new regulations. Furthermore, executive pay disclosure may turn executive pay into a "beauty contest", leading to increased levels of compensation as firms seek to ensure that their executives are among the higher paid (Lo, 2003b). Given these two conflicting theoretical predictions, it is difficult to conclude whether firms will enjoy a net benefit from fully disclosing executive compensation.

Vafeas and Afxentiou (1998) provide descriptive evidence on the effect of the 1992 SEC compensation disclosure rules in terms of improving firms' governance. They document that the number of committees with insider participation steadily declined after the 1992 reform, partly motivated by public concerns over board independence. Vafeas (2003) also finds a steady decline in the number of compensation committees with insider participation during 1991–1997. Lo (2003a) directly tests the economic consequences of expanded compensation disclosure. His findings suggest that consistent with the governance improvement hypothesis, shareholders have actually benefited from the compensation disclosures mandated by the SEC.

Recommendation: increase institutional investor involvement in corporate governance (executive compensation)

As institutional investors have increased their equity holdings in the U.S. financial market, they have become active in monitoring corporate governance (Johnson and Shackell, 1997; Gillan and Starks 2000). It is well documented that public pension funds and union pension funds have become more active participants in the governance of their portfolio firms by negotiating with corporate management, publicly targeting corporations through the media, and presenting shareholder proposals at corporate annual shareholders' meetings. The SEC is considering allowing institutional investors to nominate at least one director for election. Institutional shareholder activists include California Public Employees Retirement System (CalPERS) and College Retirement Equities Fund (TIAA-CREF) (Carleton et al., 1998; Nesbitt, 1994).

Institutional investors can actively monitor the process of evaluating and rewarding CEO performance. Recent empirical research documents that institutional investors play an important role in monitoring their portfolio firms' management (David et al., 1998; Hartzell and Starks, 2003). Johnson and Shackell (1997) find that shareholder proposals on executive compensation and corporate governance sponsored by institutions received greater voting support than proposals sponsored by individuals. The findings suggest that institutional investors influence executive compensation practice in accordance with shareholder preferences, i.e., institutional ownership concentration is positively related to pay-for-performance sensitivities. However, the literature provides mixed findings on whether institutional investors play a role in decreasing the level of executive compensation.[15] Alternatively, institutional investors can also influence firms' compensation policy indirectly through their preferences and trading if firms adopt specific compensation plan to attract institutional investors (Hartzell and Starks, 2003).

However, one should note that there are heterogeneous monitoring incentives among institutional investors. Although prior research documents the monitoring role of large blockholders and activist institutions, it is unclear whether mutual fund advisors have strong incentives to monitor firms' governance. If institutions generally consider liquidity to be more important than monitoring and trading costs are low enough, mutual fund companies will simply sell shares of firms that have 'bad' governance. Furthermore, it is an open question

whether mutual fund companies are concerned about portfolio firm's governance. In fact, recent research by Bushee et al. (2004) finds that only 15% of mutual fund advisors exhibit preferences for better governance. Possible business relationships between mutual fund companies and portfolio firms may also cloud active monitoring by mutual funds. Recent analysis of proxy votes on CEO pay from the 10 largest mutual fund companies during 2004 lends support to the conjecture that mutual fund advisors may not serve as active monitors of executive compensation (AFL-CIO, 2004). Nevertheless, the recent requirement that mutual fund companies disclose how they cast proxy votes is likely to stimulate their incentives to monitor the governance of firms they invest in.[16]

Recommendation: require firms to expense stock options on their income statements

Current accounting rules effectively do not require firms to record an income statement expense for stock options either at the time of grant or exercise. The relevant accounting standard, APB No. 25, states that there is no income statement options-related expense if companies grant stock options with a fixed exercise price that is set equal to the share price on the grant date (fixed option grant). Most companies grant fixed option grants. In 1995, a new standard, SFAS 123, required firms to expense stock options based on a fair market value of options granted, but it permits firms to continue reporting under APB No. 25 as long as they disclose *pro forma* net income as if option grants are expensed.

This favorable stock option accounting is often cited as one of the main drivers of the dramatic escalation of stock options as a compensation vehicle during the past decade[17] (Hall and Murphy, 2003). The consequence of SFAS 123's allowing firms to continue reporting under APB No. 25 is that only a small number of firms chose to voluntarily recognize stock-based compensation as an expense. Although a number of firms, such as Microsoft and Amazon, stated that they will begin expensing options in response to recent accounting scandals, Aboody et al. (2004b) report that they could only identify 155 firms that voluntarily recognized stock-based compensation as an expense in 2002.[18]

Putting aside whether expensing option is a ''superior'' accounting treatment, a growing number of business practitioners and academics argue that expensing of options will lead to better compensation decisions (e.g., Hall and Murphy, 2003). For instance, current accounting rules on stock options discourage use of all forms of stock options whose exercise price is not set equal to the grant-date stock price (e.g., indexed options or performance-based options). Current accounting rules on stock options also contribute to worsening the gap between perceived costs of options and economic costs of options.

However, the FASB's recent proposal to require all publicly traded companies to expense all forms of employee stock options has faced immense opposition by some politicians and start-up companies concerned about possible consequences of discouraging companies from granting options to employees.[19]

Conclusion

Reform proposals and ethical implications

We have discussed likely intended and unintended consequences of recent proposals to reform CEO compensation. Although these proposals provide some potentially useful remedies for US executive pay practice, we believe that without a renewed emphasis on the ethics of CEOs and ethics within companies, these reforms will not necessarily resolve the problems and issues as intended. For example, as we discussed, CEOs who hold substantial amounts of their firms' stock have incentives to manage accounting earnings and to collude with analysts to reduce analysts' forecasts of corporate earnings.

In addition, to the extent that powerful CEOs can award benefits to directors through re-nomination, higher director pay, and other non-pecuniary forms of incentive, regulatory action to increase director independence in terms of the fraction of independent directors on the Board will not achieve the intended goal of a more ethical environment surrounding executive compensation. Moreover, independence is inherently virtually impossible to observe, and its surrogate definition is a rules-based list of conditions that cannot hold if a director is to be deemed independent. Consequently, firms may focus on satisfying the rules for independent direc-

tors rather than the broader concept of independence, similar to situations where people focus on rules to specify ethical behavior instead of evaluating whether particular behavior is ethical.

Future research

Great public interest in reforming executive compensation and related corporate governance structures will undoubtedly persist. The focus on increasing the independence of boards of directors, including the compensation subcommittee, has led to stricter stock exchange governance rules for boards Klein (2003). As these changes take effect, research can attempt to discern how effective the new rules on independent directors are, perhaps by examining what effect the more stringent independence criteria have on disciplining CEO compensation.

Other forces to discipline executive compensation can be examined. One potentially fruitful path for future research could examine institutional investors' willingness and ability to influence executive pay practice. Institutions have traditionally paid more attention to improving general corporate governance rather than executive compensation itself. Whether recent reform will shift the institutional investors' focus from generic governance, such as board independence, to more direct involvement in executive compensation is an open question. However, an ethical dimension arises if potential business relationships between firms and institutional investors such as banks, insurance companies, and mutual funds preclude institutional investors from realizing their full potential to become actively involved in aligning firms' governance and executive pay practice with shareholder preferences.

Another path for future research involves broadening the economic framework of analysis beyond agency theory's principal/shareholder-agent/manager model, for example by incorporating the welfare of a broader group of stakeholders or explicitly modeling an ethical component. A step forward appears in Stevens and Thevaranjan (2003), who incorporate an explicit ethical dimension for the agent.

Complementing economic theory with other theories should provide useful insights, particularly on ethical issues arising in the continuing debates on executive compensation. For example, Carr and Valinezhad (1994) describe social comparison theory and equity theory in relation to executive compensation, and Bloom (2004) discusses various aspects of fairness in relation to general compensation.

Jensen (2001) proposes a corporate objective of maximizing "the long-run total value of the firm", in contrast to maximizing short-run stock price, the apparent objective that has led to accounting scandals. He argues that in the long run, firms cannot maximize firm value if they mistreat or ignore the interests of stakeholders such as customers, employees, and communities. Therefore, companies should adopt a combination of enlightened value maximization and enlightened stakeholder theory in which "the objective function – the overriding goal – of the firm is to maximize total long-term firm market value." Although Jensen asserts that "value creation gives management a way to assess the tradeoffs that must be made among competing constituencies", ethical issues will still arise in making the tradeoffs. Moreover, disagreements about how to measure value creation or whether particular decisions will create value present opportunities for self-interested behavior.

We agree that undesirable consequences related to current executive compensation are attributable at least in part to current pay practices that encourage executives to take actions to increase short-term shareholder value at the expense of other stakeholders. Given the intrinsic limitations of regulatory actions intended to discipline executive pay, we believe that redefining the corporate objective and designing executive compensation to take account of the interests of a broader group of stakeholders will help address the current ethical problems with executive compensation.

Appendix

Business Roundtable (2003) Principles of Executive Compensation

1. Executive compensation should be closely aligned with the long-term interests of stockholders and with corporate goals and strate-

gies. It should include significant performance-based criteria related to long-term stockholder value and should reflect upside potential and downside risk.
2. Compensation of the CEO and other top executives should be determined by a compensation committee composed entirely of independent directors, either as a committee or together with the other independent directors based on the committee's recommendations.
3. The compensation committee should understand all aspects of the compensation package and should review the maximum pay-out under that package, including all benefits. The compensation committee should understand the maximum pay-out under multiple scenarios, including retirement, termination with or without cause, and severance in connection with business combinations or sale of the business.
4. Compensation committees should require executives to build and maintain significant continuing equity investment in the corporation.
5. The compensation committee should have independent, experienced expertise available to provide advice on new executive compensation packages or significant changes in existing packages.
6. Corporations should provide complete, accurate, understandable, and timely disclosure to stockholders concerning all significant elements of executive compensation and executive compensation practices.

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Notes

[1] Business Roundtable is an association of approximately 150 CEOs of leading corporations. "The Roundtable is committed to advocating public policies that ensure vigorous economic growth, a dynamic global economy, and the well-trained and productive U.S. workforce essential for future competitiveness. Business Roundtable ... presents government with reasoned alternatives and positive suggestions" (http://www.businessroundtable.org/aboutUs/index.html).

[2] Jayne (2003) cites a Hay Group study reporting that U.S. CEOs are paid up to 500 times more than average workers, while the comparable ratios in Australia and New Zealand are 36 and 12, respectively. Murphy (1999) reports a 1997 Towers Perrin compensation study showing that across 23 countries, the highest average executive compensation occurs in the US, at $901,000 per year. The next highest were Brazil ($698,000 per year) and Hong Kong ($673,000). Average executive compensation was $477,000 in Australia, $398,000 in Japan, and $183,000 in New Zealand. The compensation study included industrial companies with approximately $250 million (U.S.) in annual revenues. It must be pointed out, however, that averages can be somewhat misleading. For example, the average CEO compensation among S&P 1500 firms in 1997 was $3.83 million, but the median was $1.9 million and the 75th percentile was $3.9 million. This suggests that average CEO compensation is heavily affected by some CEOs with very large salaries.

[3] The Sarbanes-Oxley Act of 2002 established the PCAOB as a private-sector, non-profit corporation "to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports" (http://www.pcaobus.org/). The Act states that its purpose is "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."

[4] Murphy (1995) argues that stock prices provide better measures of wealth creation than do accounting profits. He therefore asserts, "effective pay-for-performance contracts combine below-market base salaries with high potential payouts based on stock-price appreciation and including dividends" (p. 722).

[5] A firm's customers and suppliers are also stakeholders, as are institutional investors such as pension funds and mutual funds.

[6] Newly adopted NYSE governance rules (http://www.nyse.com/Frameset.html?displayPage=/listed/1022221393251.html) require that each listed company have a nominating/corporate governance committee and a compensation committee composed entirely of independent directors, in addition to requiring a majority of directors on the board to be independent. The Listed

Company Manual states, "No director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)." The Manual specifies situations in which a director is deemed not independent. The NASDAQ has similar requirements for compensation committees, though slightly less stringent than the NYSE's.

[7] "Gray" outside directors include retired employees, relatives of the CEO, persons having a business relationship with the firm, and persons with an interlocked directorship. At least some of these directors would not be independent directors under current NYSE rules.

[8] Affiliated directors are defined as non-executive directors who maintained some form of personal and professional relationship with a firm.

[9] In target ownership plans, the board of directors mandates that executives own at least a target amount of stock.

[10] The 1992 rules, for example, stipulated new requirements that firms provide (1) a graphical five-year comparison of the firm's stock price performance to a market index and to an index composed of peer companies and (2) a three-year summary compensation table for the CEO and four other highest paid executives.

[11] The Omnibus Budget Reconciliation Act of 1993 effectively prohibits publicly traded companies from deducting executive cash compensation exceeding one million dollars. Because companies were not required to expense stock-based compensation on the income statement, some people viewed stock-based compensation as "free". Critics hypothesized that the value of total executive compensation would actually increase with the shift to a greater proportion of stock-based compensation, because risk-averse executives must receive a larger expected value in compensation when the compensation carries risk.

[12] Standard option valuation methodologies, such as Black and Scholes pricing, value the cost of options as the amount an outside investor would pay for the option with the same conditions. However, risk-averse managers will not value the nontradeable option as much as outsider investors will. For a more complete discussion, see Hall and Murphy (2002).

[13] Unlike a "fixed" option that is not required to be recorded as an expense under SFAS 123, the FASB requires companies to expense the difference between the new exercise price of repriced options and the market value of the stock.

[14] For example, prior research documents that compensation of firms in regulated industries includes a lower portion of incentive compensation including stock-based pay than firms in other industries because regulation limits managers' investment discretion. Accordingly, the incremental impact of managerial actions on firm value is relatively small.

[15] Johnson and Shackell (1997) examine 169 shareholder proposals on executive compensation filed against 106 firms by 74 sponsors during 1992–1995 and identify 83 proposals targeting executive pay level and 20 proposals targeting compensation committee independence. Interestingly, individuals sponsored most of the proposals on executive pay level and institutions' proposals targeted compensation committee independence.

[16] The SEC recently adopted a rule requiring mutual funds and other management investment companies to disclose proxy votes cast, as well as their proxy voting policies and procedures. The reporting deadline was August 31, 2004 for the year ending June 30, 2004.

[17] Another related source of inducement to issue stock options arose from the Omnibus Budget Reconciliation Act of 1993 (see footnote 11).

[18] Accounting academics generally agree that stock option grants constitute a real economic cost that firms should deduct from earnings as an expense (Guay et al., 2003). Aboody et al. (2004a) find that investors view stock-based compensation expense as an expense of a firm, rejecting the claim that option expense cannot be measured reliably enough to be reflected in financial statements.

[19] The Stock Option Accounting Reform Act (H.R. 3574), approved by the US House of Representatives, mandates the expensing of stock options granted to the CEO and the next four proxy-named executives of a company but does not require the expensing of stock options for all other employees.

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