

A Model Capturing Ethics and Executive Compensation

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ABSTRACT. This article develops and applies a knowledge-based framework for understanding and interpreting executive compensation under the rubric of ethical consideration. This framework classifies six major ethical considerations that reflect issues in compensation design. We emphasize that these six ethical considerations are influenced by *liberty* and *equality* concepts. This framework helps to highlight areas where executive compensation has not been well spelled out.

Corporate responsibility is mainly a matter of attitudes, and the attitudes got corrupted by the mentality of the markets in the 1990s.

*Paul A. Volcker, former Federal Reserve Chairman
(Byrne, 2002a)*

Currently CEO compensation research is structured on compensation design, linking pay criteria to pay consequences, and what to pay (Gomez-Mejia and Wiseman, 1997). However, based on the development of our ethical arguments CEO compensation may be better structured and monitored as ethical considerations influenced by *liberty* and *equality* concepts. That is, we argue later that market freedom = liberty + equality. This paper integrates ethics, decision making and CEO compensation. This integration may assist organizations to better understand

traditional and new practices involving CEOs' compensation that involve ethical considerations. Hence, our framework guides the design of compensation systems that integrate ethical considerations. These systems serve as a monitoring mechanism of CEOs' behavior in decision making. We demonstrate that ethical viewpoints can advance from a weaker view of "egoism" to a more advanced state involving stakeholders. Compensation systems based on a more advanced state provide organizations, markets, and society greater benefits from the reduction of fraud, unfair practices, etc. (Rodgers and Gago, 2001).

Researchers (Garen, 1994; Jensen and Murphy, 1990) have long argued that the pay-performance scheme for CEOs suggests non-economic factors. The practitioner press has been very critical on corporate accounting reporting practices due to many recent abuses (Byrne, 2002a). That is, executives facing powerful incentives to enhance their compensation have dressed up their companies' quarterly financial results. The most central cause of the leap in executive pay in recent years is the escalating use of stock options. The value of options ascended exponentially during the bull market of the 1990s, when their prevalence in pay plans encouraged executives to manage with an eye toward improving short-term share prices rather than enhancing the long-term or intrinsic values of their companies (Mitchell, 2001).

Market freedom allows participants to transact business without being laden with heavy controls. Freedom can be expressed into concepts of *liberty* and *equality*. Liberty relates to the natural rights of individuals to self-determination. That is, corporate leaders are equally autonomous, free and

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self-directed in pursuing their profitability goals. However, they are equally vulnerable to interference by other stakeholders in the pursuit of their own financial goals. Equality, however, relates to managers' vulnerabilities due to interference by other stakeholders in the pursuit of their own financial goals. Hence, liberty depicts lightly regulated standards/rules (or loosely enforced); whereas equality indicates heavily regulated standard/rules (or strictly enforced) executive decision making. This raises the issue of equality in the marketplace. Some governmental authority must maintain each individual's ability to set and attempt to achieve goals while at the same time restricting others from interfering with those pursuits. Relevant issues relate to what fundamental principles are serving as reference points for the market place laws and economic distribution.

Liberty taken to its extreme by management can lead to large increases in executive stock options and pave the way for enormous temptation for fraud. For example, the Security Exchange Commission (SEC) noted that CEOs are paid 70% more at firms under their scrutiny (Kristof, 2002a). More market "quality" in some cases can pressure executives to be more socially responsible thereby generating meaningful changes in companies' affairs (Weaver et al., 1999). Not all shareholders have the same attitude toward or the lack of social corporate performance demonstrated by CEOs. Institutional shareholders appear to be more concerned regarding those aspects than other shareholders. For example, Graves and Waddock (1994) found a significant positive relation between corporate social performance and the number of institutions holding the shares of a company. In addition, Johnson and Greening (1999) found differences among institutional shareholders due to their representing different interests on social corporate performance.

An interesting way of addressing the balance between liberty and equality is to analyze the different stakeholders' interests in corporate responsibility. Shareholders desire to improve their economic performance during the long-term, clients want to improve the relationship of

quality-price-time-availability, suppliers aim to guarantee contracts, employees seek security, adequate conditions at the workplace, good-pay, etc. Stakeholders' influence could modify executive compensation packages. This research paper suggests a model that relates ethical behavior to a knowledge-based framework for executive compensation. Executive compensation has been traditionally designed based upon monetary returns. The incentive systems are oriented to motivate decisions that maximize corporate performance. Judgments of directors are strongly influenced under the constraint of stock price maximization (or corporate profit maximization). That is, the moral freedom of the board remains intact only if it is consistent with the end goal of profit maximization.

Our paper presupposes that the system of financial reporting was put in place before public companies became widely accessible, and it may be out of date. We address the problem by examining a two polar ethical dimension of *liberty* and *equality*. That is, certain ethical considerations are bent toward more rights (and perhaps abuses) for CEOs, whereas other ethical considerations lean towards equality of the various stakeholders in the marketplace. Ethical problems that favor liberty considerations over equality may arise due to the lengthy time lag between when management knows what is occurring and when they have to report to the public. Hence, the incentive for some executives is to manipulate the accounting information, because their compensation and prestige depend on it. For example, France's stock market regulator, the Commission des Operations de Bourse, noted that Vivendi Universal had a time lag between when it knew about its liquidity problem and when it relayed the information to investors contributing to a 70% decrease in stock value (Verrier, 2002). In the past, financial accounting systems did not require information to flow into the marketplace in a timely manner (Rodgers, 2002). Recently, however, the SEC has suggested more equality in the system by shortening the amount of time companies have to report earnings thereby improving existing regulations and stakeholders' confidence in the marketplace (Kristof, 2002b).

A framework is presented to help classify and

explain issues impacting on executive behavior into six major ethical viewpoints of social responsibility. That is, six ethical viewpoints are used to describe and discuss executive compensation behavior. They are ethical egoism, deontology, relativist, utilitarianism, virtue ethics, and ethics of care. *Ethical egoism* stresses that individuals are always motivated to act in their perceived self-interest. The *deontological viewpoint* insists on adherence to principles of individuals and the judgments associated with a particular decision process rather than on its choices. The *utilitarian viewpoint* is concerned with consequences, as well as the greatest good for the greatest number of people. *Relativism* is a meta-theory, which assumes that companies' management uses themselves or the people around them as their basis for defining ethical standards. The *virtue ethics viewpoint* views the cultivation of virtuous traits of management's character as its morality's primary function. The *ethics of care viewpoint* focuses on a willingness to listen to distinct and previously unacknowledged perspectives. In other words a company must build solidarity among employees, suppliers, customers, shareholders, and the community.

This paper is divided into three major sections. *First*, we provide a background on the executive compensation literature. *Second*, a knowledge-based model relates the six major philosophical ethical viewpoints to the executive compensation literature. *Third*, we suggest propositions to help guide management in operationalizing executive compensation packages. *Finally*, we summarize the importance of the central theme of this paper.

Executive compensation issues

Companies may compensate executives for inputs such as skills, as well as for outputs such as firm performance (Harris and Helfat, 1997; Hollensbe and Guthrie, 2000; Lepine and Van Dyne, 2001). The resource-based view (Barney, 2001; Wenerfelt, 1984) and knowledge management approaches (Foss, 1996) suggest that capabilities and knowledge form the basis for differential firm performance. Also, dynamic capabilities that

enable companies to introduce new products and services as well as adapt to changing market conditions play an important role (Helfat and Raubitschek, 2000; Teece et al., 1997). Herremans, Akathapron and McInnes (1993, p. 547) point out that "Firms are commonly assumed to incur significant private costs by pursuing social welfare benefits beyond profit maximization within the law, otherwise there would not be controversy, since maximization of profit and social welfare would coincide." These issues loom large when considering that less than 5% of CEO pay is explained by financial information performance factors (Tosi et al., 1997). Barkema and Gomez-Mejia (1998, p. 136) added that "little is known about contingency or contextual factors that may affect CEO pay and the criteria utilized to set it." For example, according to a USA Today analysis of hundreds of 2002 corporate proxy statements, stock prices may be down, but CEO pay continues to rise (Strauss, 2002). That is, while average worker salaries increased about 3.6%, many CEOs received double-digit salary increases despite a current "bear" market (Strauss, 2002).

Regarding the characteristics of the CEO, Rajagopalan and Datta (1996) found that industry factors play a limited role in explaining variations in CEO characteristics and the performance implications of such variation. Whereby, Waldman and Yammarino (1999) and Pitcher and Smith (2001) asserted that personality or leadership characteristics are necessary for understanding the way in which organizations make their decisions. However, other factors have been noted, for example Kirchmeyer (2002) affirmed that women achieve lower incomes than men in managerial positions. In addition, Appold et al. (1998) found that men are negatively affected by the presence of women, while women are not positively affected.

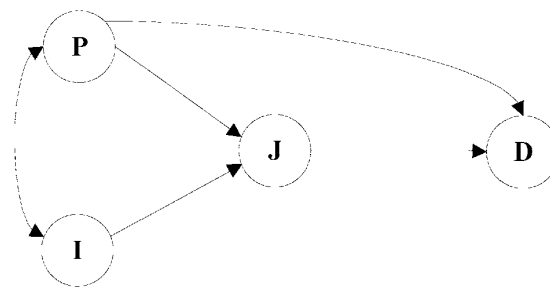
Finally, some corporate experts insist that the only way to stem the outburst of executive abuse may be to revise the corporate regulatory system as decisively as was done after the U.S. market crash of 1929, when the SEC was established (Mitchell, 2001). For example, Joseph E. Berardino (fallen CEO of Arthur Andersen) suggested the following reforms:

- (1) auditors should provide report-card grades reflecting the quality of a client's accounting, thus providing the market to premium to high mark companies;
- (2) board directors should be involved in risk management, not the verification of financial information;
- (3) change accounting rules from loopholes and legalism to principle-driven accounting similar to the International Accounting Standards Board; and,
- (4) require each accounting firm to put three to four outsiders on its board in order to reduce inbreeding (Byrne, 2002b).

Knowledge processing model

The conceptual model presented in this paper has shown to be useful in conceptualizing a number of different issues important to organizations (Culbertson and Rodgers, 1997; Rodgers and Gago, 2001). This model is particularly relevant because it clarifies critical pathways for decision making purposes and eliminates rival alternative hypotheses (Rodgers, 1997, p. 63). Researchers (Davenport and Prusak, 1998; Cook and Brown, 1999) also argue for an integrated approach that affords a view of knowledge as process oriented, dispersed, and inherently indeterminate.

The circles in Figure 1 represent the theoretical constructs of perception (P), information (I), judgment (J), and decision choice (D) (Rodgers 1992, 1997). The central insight of this modeling approach is that knowledge inputs are necessarily embedded in a context representing cognitive, behavioral, individual and social that constrains their discovery, their transfer from one set of actors to another, and their usefulness in different problems (Postrel, 2002). This insight we depict as "perception" in our model, implicitly or explicitly, drives path dependence in later stages of processing in the model. That is, what you already know biases or influences what you are likely to process next. Perception involves framing informational sources. The double-ended arrow connecting perception and information in Figure 1 represents this relation.



where P = perception, I = information, J = judgment, and D = decision choice.

Figure 1. Decision makers' processes diagram.

Further, information and perception are interdependent because information is dependent on how individuals, influenced by their framing, interpret it (e.g. Tversky and Kahneman, 1974) and information can modify individuals frames (Rodgers, 1997). In the *first stage*, perception and information affect judgment; while in the *second stage*, perception and judgment affect decision choice.

Judgment, the next step in the decision making process, requires more analysis of the information and the perceptual processes. It is in the judgment stage where analytical tools and deeper insights are used for the interpretation of information (Rodgers, 1991).

The decision-making processes of individuals can be represented in an organized manner. In order to study the methods of these decision processes it is important to break up all the paths marked with arrows in Figure 1 into sets of individual pathways. These fragments can then be independently analyzed for their contributing properties to individuals' decision processes (Rodgers, 1997). Further, it is common for decision-makers to differ in their moral philosophical values. Even if two individuals agree on the ethical principles that determine ethical behavior, it is unlikely that they will agree on the relative importance of each principle.

These differences are highlighted in Figure 1, depicting several pathways toward making a decision.

Based on Figure 1, we can establish six general pathways:¹

- $P \rightarrow D$ (1)
 $P \rightarrow J \rightarrow D$ (2)
 $I \rightarrow P \rightarrow D$ (3)
 $I \rightarrow J \rightarrow D$ (4)
 $P \rightarrow I \rightarrow J \rightarrow D$ (5)
 $I \rightarrow P \rightarrow J \rightarrow D$ (6)

There are many philosophies, which are complex in nature. We discuss six prominent approaches depicted in the model's six general pathways (Rodgers and Gago, 2001). The six philosophies discussed below are ethical egoism, deontology, relativist, utilitarianism, virtue ethics, and ethics of care. We argue that these six philosophies are intertwined with an organization's executive compensation policy. As discussed in Rodgers and Gago (2001) the corresponding pathway to each particular philosophical view is the most dominant. Other pathways may also have a parallel processing effect (Rodgers, 1991), but the weights on these pathways are not as significant.

Liberty is very prominent in those ethical viewpoints where executives make decisions and downplay other individuals' or organizations'

interests (e.g., trade unions, employees). That is, the decision context corresponds with the ethical viewpoint (e.g., egoism) where managers have maximum liberty for deciding on executive compensation packages (see Figure 2). Further, problems with market dis-equilibriums, displacement of workers, discrimination of certain labor forces can emerge from excesses of liberty. However, when managers' decisions are strongly influenced by inside/outside groups, then "individualism" tends to be replaced by "collectivism," as the right of other stakeholders dominates over the rights of the individual (e.g., ethics of care). This transition leads to more "equality" (Figure 2) or input from inside/outside stakeholders. Though, too much influence from outside groups (e.g., government) may slow down or hinder market mechanisms (Friedman, 1970). The next section describes how six ethical viewpoints relate to the "liberty" and "equality" concepts of executive compensation.

Executives' decision making motivations

(1) $P \rightarrow D$ represents *ethical egoism* that is based on individuals and firms existing solely to serve

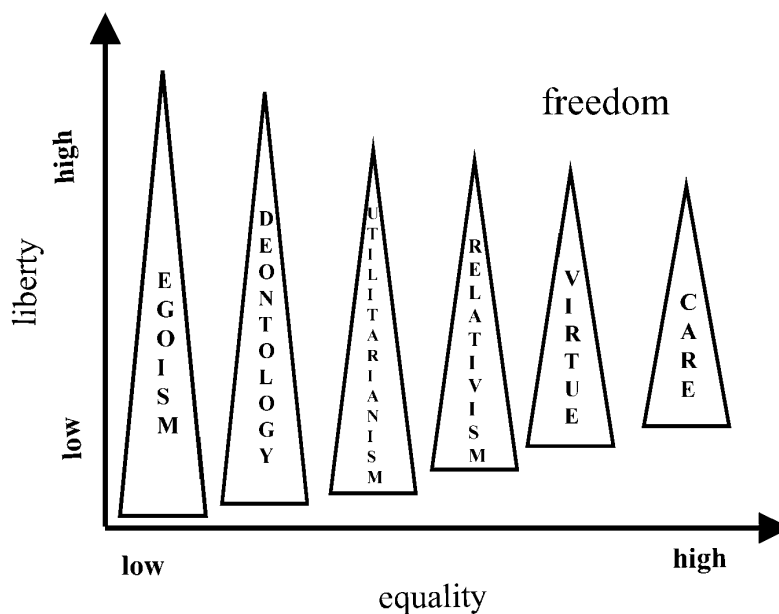


Figure 2.

their own ends (Bowie, 1991). Ethical egoists have differed in their conception of the “goodness” of consequences (Singer, 1997). That is, the extreme egoists (i.e., hedonism) define goodness exclusively in terms of pleasure (physical or materialist pursuits); while others center on less physical or material forms in defining goodness. Ethical egoists also argue that an individual need not be concerned about others’ welfare in order to serve the common good. Egoists are concerned about others only when such concerns serve as a means to achieve their own self-interests. The compensation designs using the agency theory are mostly egoist in that optimizing profits is the aim of those models. That is, executive compensations have been traditionally designed based upon monetary returns (Gomez-Mejia and Wiseman, 1997). The incentive systems are oriented to motivate decisions that maximize corporate performance. For example, Hayward and Hambrick (1997, p. 106) affirm, “hubris infects extremely confident managers who highly estimate their ability to extract acquisition benefits and consequently pay large premiums.” They also found that premiums were particularly large when there was hubris (exaggerated self-confidence) and the CEO was board chair along with a large percentage of inside directors.

When a company assumes an egoist viewpoint, the compensation system promotes those decisions (D) based upon CEO’s perceptions (P) or framing of maximizing earnings, paying little attention to potentially harmed parties. The typical egoist compensation system offers monetary incentives beyond a fixed salary, for achieving economic objectives for the company. For example, when CEO is paid:

S	fixed amount	if incomes $\leq \bar{I}$
S + % I	variable amount	if incomes $> \bar{I}$ on incomes (I)

The compensation for CEOs under the agency theory is economic. The shareholders perceive that CEOs are adverse or neutral to risk, adverse to effort and evaluate the information available as complete, moral hazard or adverse selection. Thus, the most adequate model of compensation

could be fixed amount, fixed amount including a variable amount, variable amount less a fixed amount, combinations of the previous forms conditioned to signals provided by information systems (Harris and Raviv, 1978, 1979; Holmstrom, 1979; Shavell, 1987).

Proposition 1: P \rightarrow D will be the most dominant pathway for decisions with extreme weight on “liberty,” and no consideration for “equality” when profit maximization is the most dominant theme in a CEO strategy.

(2) P \rightarrow J \rightarrow D depicts the *deontological viewpoint* that emphasizes the rights of individuals and the judgments associated with a particular decision process rather than on its choices. In some cases, the legal structures of corporations have created significant disadvantages for long-term management and strong competitive advantages for short-term management. For example, Seidel et al. (2000) demonstrated that members of racial minority groups will negotiate smaller increases to their initial salary offers than their white counterparts. Job candidates whose social networks include a tie to the hiring organization will negotiate larger increases to initial salary offers than candidates who do not have a tie to the organization. Members of racial minority groups will have fewer ties to an employing organization than their white counterparts.

Porac et al. (1999, pp. 113–114) suggested that “Managerial performance and compensation are active concerns to shareholders, and the fate of top management is at stake in any performance comparison.” Categorical knowledge is incorporated in compensation allocations. They construct several rules supported by evidence. One rule is concerned with the CEO salary: the higher the pay of a firm’s CEO, the greater the number of peers its board will select from outside the firm’s primary industry. Another rule states that the more powerful a firm’s outside owners, the greater the number of peers its board will select from the firm’s primary industry. Also, the more active a firm’s outside owners, the greater the number of peers its board will select from the firm’s primary industry. In addition, the more powerful a firm’s outside owners, the fewer peers

its board will select from the firm's primary industry. Finally, the more active a firm's outside owners, the fewer peers its board will select from the firm's primary industry.

If a company assumes a deontological approach, the compensation system is driven by rules outlining a CEO's perception (P) regarding pay based on analysis or judgment (J) of performance arriving at a compensation decision. For example, if the rule for the composition of the company's board is inside the firm's primary industry and/active outside owners then:

S	fixed amount	if incomes $\leq \hat{I}$
S + % I	variable amount	if incomes $> \hat{I}$ on incomes (I)

If the rule for the composition of the company's board is outside the firm's primary industry and/inactive outside owners then:

S'	fixed amount	if incomes $\leq \hat{I}$
S' + % I	variable amount	if incomes $> \hat{I}$ on incomes (I)

Being $S' > S$

Proposition 2: CEO high salary is tied to board members outside the firm's primary industry and/or less active outside owners; then the $P \rightarrow J \rightarrow D$ pathway will be the most dominant displaying from extreme to moderate weight on "liberty," and no favorable treatment for "equality."

(3) $I \rightarrow J \rightarrow D$ reflects the utilitarian viewpoint, which is concerned with consequences, as well as the greatest good for the greatest number of people. Where an ethical egoist weighs the good and bad consequences of performing a certain action as it relates to herself, a utilitarian weighs the good and bad results of an action on everyone affected by it. Utilitarianism is based on collective "economic egoism." For example, Odgen and Watson (1999) claimed that stakeholder and stockholder interests are compatible. They allude to the "incomplete contracting" literature. They further stated that it "contains the argument that economic efficiency frequently requires firms' executives to exercise their discretion in a way favoring the interests of other stakeholders, such as customers and suppliers. The executives do so

because, if other stakeholders perceived that managerial discretion was always being exercised in favor of one participant – for instance, shareholders or the executives themselves – they would be unwilling to do business with the firms" (p. 527).

Ezzamel and Watson (1998) assert "exceptionally high pay may be justified if senior executives generate significant additional wealth for other stakeholders" (221). They further argue that changes in executive pay are not closely related to firm performance measures. The reason is that executives are paid at least the going rate. CEOs' previous experiences and the analysis provided by external consultants are sources of information for compensation. Ezzamel and Watson (1998) demonstrate that "the exploratory power of the cash compensation models was significantly improved by the addition of pay anomaly variables. Compared to the total cash compensation models, the salary – only models provided stronger evidence of the bidding-up process" (230). Finally, Stajkovic and Luthand (2001) identified money, social recognition and performance feedback as the three incentives most used in organizations. Hence, a more motivated manager (by non-monetary and monetary aspects) would have a positive impact on future performances (monetary).

For example, the judgment phase assigns values regarding economic information (I). These judgments (J) are oriented to achieve the maximum of utility for the collectivity (Pareto, 1967). The firm is viewed as a collectivity composed of employees, shareholders, clients, suppliers, etc. The CEO is required to make economic decisions for achieving the "best" in economic terms for that collectivity (e.g., environmental income = savings in costs of purchased parts and components, waste disposal, quality improvements). The CEO is paid:

S	if incomes $\leq \hat{I}$
S + (% I)	if incomes $> \hat{I}$
S + (% I) + (% E)	if incomes $> \hat{I}$ and environmental incomes $> \hat{E}$

Proposition 3: CEO exceptional high pay will be justified if significant additional wealth is generated for

other stakeholders, where inequalities are compensated in economic terms; therefore $I \rightarrow J \rightarrow D$ pathway will be the most dominant with moderate weight on "liberty."

(4) $I \rightarrow P \rightarrow D$ highlights the *relativist viewpoint*, which assumes that decision-makers use themselves or the people around them as their basis for defining ethical standards. Relativism is a characteristic of a company operating differently due to the rules or laws (or lack thereof) governing another country. That is, most shareholders desire to maximize economic performance, while some stakeholders aspired to maximize social performance. Depending on the influence that they may exert, executive compensations will incorporate, or not, economic performance and social performance (with rules for solving conflicts among them, agreements on predominance). For example, Zajac and Westphal (1996, p. 520) illustrated that participation in expanding the outsider ratio of directors on the board "is negatively related to subsequent appointments to boards with low control over management." Related to CEO compensation they claimed "... increasing CEO compensation contingency is negatively associated with subsequent appointments to boards with low control (fewer additions and more subtractions) and positively associated with appointments to board with high-control boards (more additions and fewer subtractions). Conversely, decreased compensation contingency has the opposite effect" (1996, p. 523). Westphal and Zajac (1997) found the presence of CEO-directors prevents an increase in board independence. Further, Conyon and Peck (1998) demonstrated that top management pay and corporate performance are more aligned in companies with outsider-dominant boards and remuneration committees. That's to say: when stakeholders are not very influential, CEOs' compensations are more related to economic performance (instead of social performance).

Sanders and Carpenter (1998) analyzed the case of internationalization and how it affects executive compensation. They point out that the information processing and agency literatures

suggest "a relationship between internationalization, complexity and governance. They differentiate between short and long term compensations. Stock options are an example of the second. They agree with Jensen and Murphy (1990) that long-term compensation promotes the convergence in interests with stakeholders. Internationalization promotes long-term compensation, and its implications relate more to complex environments rewarded with higher pay.

For example, multinational companies offer simultaneously different compensation packages to their executives as a result of their handling of various countries' environment. Thus, depending on the information (I) received (e.g., press, government) they frame (P) the compensation system before arriving at a decision (D). Thus CEO is paid:

$$\begin{array}{ll}
 S & \text{if incomes} \leq \hat{I} \\
 S + (\%) I & \text{if incomes} > \hat{I} \text{ in country} \\
 & \text{A (Europe) and country B} \\
 & \text{(Africa)} \\
 S + (\%) I + (\%) E & \text{if incomes} > \hat{I} \text{ and} \\
 & \text{environmental incomes} > \\
 & \hat{E} \text{ in country A}
 \end{array}$$

Proposition 4: CEOs' compensation will be rewarded based on shareholders' criterion of economic performance or stakeholders' criterion of social performance; hence the $I \rightarrow P \rightarrow D$ pathway will be the most dominant for decision making with moderate weight on both "liberty" and "equality."

(5) $P \rightarrow I \rightarrow J \rightarrow D$ under scores the *virtue ethics viewpoint*, which is the classical Hellenistic tradition represented by Plato (1997) and Aristotle (1984), whereby the cultivation of virtuous traits of character is viewed as morality's primary function. In Aristotle's moral philosophy, the notions of virtue and happiness are central. Virtues are ideal traits that are necessary for an individual to attain a state of harmony within, and to attain such a state in relation to his/her social environment. Some executives are concerned with the prestige of their companies, and may feel more committed. In this sense, Smidts et al. (2001) demonstrated that employees per-

ceived external prestige of their companies, which strongly influenced their organizational identification.

Some models developed in the agency theory indicated that managers are motivated by not only salary-effort-risk but also their image and reputation. Thus, Holmstrom and Ricart (1986) advocated that "reputation" influence should be considered in agency relationships. That is, if the agency relationship is established during more than one period, the agent is concerned about his/her reputation. Holmstrom and Ricart further argued that given an investment decision, a manager not only expects to achieve a monetary return but also a reputation return. Kanodia et al. (1989) pointed out the importance of executive reputation in the capital and labor markets. Dejong et al. (1985) and Mendelson (1985) alluded to reputation as an element (exogenous or endogenous) that introduced dynamics in the agency relationships. Finally, Fudenberg and Levine (1989) as well as Milgrom and Roberts (1988) pointed out that reputation is fundamental for understanding the relationships established among individuals in the short and long term. Individuals might renounce their immediate satisfaction for a longer-term benefit, and negative reputation may adversely affect the value of executives in the market.

Virtue compensation systems consider not only economic efficiency (CEO's achievement on incomes, sales, costs), but also their perceived (P) frames influencing selected economic information (I) (e.g., CEO's reputation in the industry, consideration among the employees, relationships with authorities). The influential selected information is included in the analysis or judgment stage (J) of compensation systems as social objectives to achieve for reward decisions (D). They may have a positive impact, or not, in the company performance

For example, the CEO is paid:

S	if incomes $\leq \hat{I}$
S + (%) I	if incomes $> \hat{I}$
S + (%+plus) I +	if incomes $> \hat{I}$ and the CEO scores L in the corporate ethics code

Proposition 5: CEOs' pay that is augmented by reputation will follow $P \rightarrow I \rightarrow J \rightarrow D$ decision making pathway with less weight on "liberty" and moderate weight on "equality."

(6) $I \rightarrow P \rightarrow J \rightarrow D$ represents the *ethics of care viewpoint*, which focuses on a willingness to listen to distinct and previously unacknowledged perspectives. In other words a company must build solidarity among employees, suppliers, customers, shareholders, and the community. Freeman (1984) stated that "the stakeholder approach is about groups and individuals who can affect the organization, and is about managerial behavior taken in response to those groups and individuals (1984, p. 48). Albert (1993) introduced a stakeholder model that treats the corporation as serving the social goals beyond stock price maximization. He further stated that this model is situated in cultures in which cooperation and community are highly prized.

Institutional shareholders appear to be more concerned about broader issues than are other shareholders. For example, Johnson and Greening (1999) affirmed that they present diverse interests than other investors on social corporate performance. Also, institutional investors own more than half the equity of U.S. corporations (Useem, 1984). They have different interest in those corporations, and they are owners with large blocks of shares (typically, more than 5 percent of a firm's total shares), thereby influencing CEO compensation as compared to other shareholders (David et al., 1998). David et al. (1998) demonstrated that a pressure-sensitive ownership had a positive and significant effect on compensation level, however results also indicated a positive and non-significant effect on the proportion of long-term incentives. Hence, a pressure-resistant (without business relationships) ownership reduces pay more than pressure-sensitive ownership. Bouma and Kamp-Roelands (2000) identify internal and external stakeholders' expectations regarding improving environmental performance, preventing environmental accidents, ensuring compliance with legislation, the provision of reliable information, control of waste handling in a multinational firm. They find differences in the

emphasis among internal and external stakeholders. Internal stakeholders showed “more concern with the efficiency of generating information while external stakeholders were more concerned with the comparability of information” (2000, p. 140).

Westphal and Milton (2000) argued that experience and network ties affect the influence of demographic minorities on corporate boards. However, they also asserted “While the presence of demographic minorities on boards is typically viewed favorably by corporate stakeholders, the academic literature on organizational demography and social conformity is more pessimistic about the extent to which demographic minorities can successfully influence group decision making” (p. 367).

Finkelstein and Boyd (1998) recognized that social, political and strategic factors may influence CEO compensation. They found evidence that discretion explained an important part of the variance pay among high performance companies. The variables examined for discretion were: market growth, R&D intensity, advertising intensity, demand instability, capital intensity, industry concentration and regulation. Further, they determined the potential marginal product and the riskiness of a CEO position. The result of these two elements is that CEO compensation is equal to cash + long term compensation. However, they obtained different results for different discretion variables. Finally, Deckop et al. (1999, p. 425) found that “for employees low in value commitment a pay-for performance system appears to be a disincentive for engaging in OCB” (organizational citizenship behavior). “The positive evidence is that pay-for-performance plans do not appear to discourage OCB for value-committed employees.” Hence, the CEO is compensated based upon information (I) constructed following ethical rules. The CEO perceives (P) social values (e.g., equality, moral) influencing judgments (J) of economic profit as a useful tool for achieving social profits (D).

For example, the CEO is paid:

$$\begin{array}{ll} S & \text{if social incomes} \leq \bar{I} \\ S + (\%) I & \text{if social incomes} > \bar{I} \end{array}$$

Proposition 6: CEO's compensation is monitored more with a pressure-resistant (without business relationships) ownership; therefore I → P → J → D pathway is more dominant with lesser weight on “liberty” and heavier weight on “equality.”

Conclusions

Understanding and describing the motivating belief function of how management drives its operations can provide for a better monitoring system for executive compensation. The presented decision making model is a way to assist in six major activities and processes influencing management's decisions. This paper discusses six ethical viewpoints and propositions captured in the decision making model that may help guide future research in the area of executive compensation. First, the very structure of the ethical egoist, not to mention the norms that have come to govern it, demands stock price maximization as the corporate goal. Second, though the deontological or rule based theme may suggest that this approach is a highly regulated one, the reality is that corporate law does relatively little as a governance matter for executive compensation. For example, federal regulation of capital markets provides little regulation beyond the requirements of disclosure and the prohibition against fraud. Third, utilitarianism allows for only a partial solution by not addressing serious issues of market reform regulations. Fourth, relativistic market behavior provides for unstable and very unpredictable environments in that there is no degree of uniformity of actions affecting the well being of stakeholders. Fifth, the virtue ethics or organizational identity approach helps to measure the pulse of market players, but this type of behavior is typically short term in nature leaving the long term expectations to the overall market forces. Finally, the ethics of care or general stakeholders' viewpoint is one that gathers momentum by acknowledging individuals or organizations can be affected by its actions.

The six ethical viewpoints described above allow for a broader examination into the two building blocks of market freedom, namely

“liberty” and “equality.” Market mechanisms for freedom allow participants to transact business (liberty) without being laden with heavy controls (equality). Hence, executive compensation falling under this rubric can convey fairer reward systems. Managers armed with the knowledge of the six ethical viewpoints may be able to better structure their contracts given the stakeholders involved.

Note

¹ Rodgers (1992, 1997) performed a covariance structural analysis with unobservable variables, based on a survey of loan officers’ and novices’ decision processes in order to derive covariance among *perception, information, judgment, and decision*. The results of his calculation from his survey, the coefficients, represent the coherence between the analyzed variables. A coefficient, r , is a number such that: $-1 \leq r \leq +1$.

Even though we are not interested in the actual real values of these coefficients or in their respective signs, we are interested in their approximate sizes. That is, we use negative and positive signs to represent the *depth of coherence* of the variables on a particular path. A positive sign implies strong coherence while a negative sign implies a weak one, respectively. In order to give direction to a necessary pattern, we assume that any coefficient that is larger than or equal to 0.5, in absolute value, will be considered supportive of a high coherence and thus will receive a positive sign, while any coefficient that is smaller than 0.5, in absolute value, receive a negative sign and imply a weak coherence of the variables associated with that path. Each path can have a positive (+), negative (–), or zero (0) flow going through it that can be represented numerically with the data collected by Rodgers’ original survey with actual loan officers. The sign of the flow is dependent upon the relative importance of the use of that pathway for reaching a decision.

In Figure 1, weak pathways are either (–) or (0). In other words, all the paths drawn are the pathways with large absolute value coefficients, thus they are the ones influencing individuals’ decision choices the most. Since this analysis is not just a theoretical exercise, we need only find the combinations that *make sense* for our specific application, i.e., a decision *must be made* by our decision makers. Therefore, all zero pathway combinations can be disregarded when

they lead to no decision. Hence, all the pathways drawn represent logically possible pathways that yield decisions. Even with this reduction in number of combinations, it is clear: decision makers’ processes can involve a series of complicated steps. These six pathways are viewed as the most dominant and influential for decision making dominated by particular ethical perspectives.

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