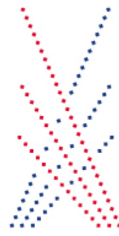

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The role of Ethics in Executive Compensation and its impact on Sustainable Development

Summary

Board of director's compensation of executives has been around a long time; however, it has attracted significant attention in recent times. With factors such as the recession, non-performance of companies and ethics of compensation have prompted the rise in debates about excessive executive pay, which could have numerous impacts on directors at present, and in the near future. Employing a qualitative research approach, this study explores the possible impacts of executive compensation and the role ethics plays in addressing some of these contemporary issues of executive compensation.

Introduction

Corporate governance has featured highly on the agenda of various economies; however, the focus on this has increased due to a number of factors. The financial meltdown and recession in late 2000s, non -performance of companies and government bailout of banks during which executives have continued to enjoy high compensations whilst, others in the society are embracing harsh austerity measures and spending cuts.

In the UK, the total compensation received by CEOs FTSE 100 firms was 560.1 million in the financial year ending. Thus, each CEOs of FTSE 100 companies in the UK took home an average of £5.7million pounds in pay bonuses, share incentives and pension contributions in 2017, which is 23% higher than the mean average of 4.6 million in 2016. In addition, data available on executive pay show that the base salary in the UK has increased year on year. Comparatively, the ONS data shows a marginal increase in pay for full time workers by 3% over this period from £34,414 to £35,423 and the average pay of the full time worker has risen by just 2% from £28,213 to £28,758 (CIPD 2018). Therefore, there are increased calls from the public and government for the executive pay to be reduced. These concerns over excessive pay have many impacts on the company and directors.

Shareholders and governments over the world have been called upon to exercise more oversight on excessive executive. Several approaches to address some of these have been implemented to date. For example, a number of shareholders now oppose excessive pay compensation. Further, the impact of concern from excessive executive pay in recent times has been

unprecedented at annual general meetings with many companies voting against remuneration reports and executive pay challenges. For example, in April, 2012, 9% of shareholder's at the Royal Dutch Shell Company annual general meeting voted against proposed executive remuneration which has increased 2% from the previous year (Paul, 2012). The equality trust in the UK is calling on the government to force medium and large firms to disclose the pay gap between their highest and average paid employee (Guardian, 2017). With the greater number of shareholders and investor voting against executive pay reports 2012 will improve accountability and will expose shareholders who have supported excessive remuneration practices in the past.

Governments all over the world are also joining in on this issue trying to find solutions to curb the impact on companies and society as a whole with 'have your say forums'. For example, in 2018, in the US, there were a number of executive compensation issues, which is changing the executive compensation landscape. These included the director compensation litigation, the impact of the recent US tax reform on performance-based compensation and the #Me Too movement, gender pay disparity and persisting gender pay disparity issues and enforcement actions by the Securities and Exchange Commission (SEC) on executive perquisite disclosure (Olshan et al. 2019; Wrightman and Martin, 2018). In 2011, Australia introduced executive remuneration reforms on consultants. A 'two strikes rule' was implemented giving shareholders more power to vote in a new board when 25% or more of votes at two consecutive annual general meeting oppose a remuneration report (Guardian, 2012). Further, the UK government has introduced executive pay reforms after collecting information from shareholders and the public on how to structure executive compensation in the future. Other companies are using the stock options to offload the huge compensation package of the company. This involves giving CEOs the option to buy more stocks in company as such, they have vested interest in the business and would take decisions that will have positive impacts on the company rather than negative ones.

Despite all these, the issue of executive compensation and its effect on the long-term sustainability persist to date. This study, therefore aims, to investigate the impact of executive compensation and the role business ethics can play to mitigate the executive compensation issues.

Impacts of Executive Compensation

The emphasis on the creation of short strategy wins in companies rather than long-term strategy creates the principal-agent issue. The principal is the shareholder who contracts out management to an agent to act on its behalf. The relationship between shareholders and agents is not framed in the contract of CEOs making shareholders vulnerable to agents who act in their interest. Hence, executives have taken decisions in their own interest, which brings losses to the companies (Weisbach, 2007).

Shareholders are increasing becoming agitated over this issue and looking for accountability through the institution of shareholders getting more control and knowledge of their businesses. In 2009, one in fifth of FTSE100 companies, shareholder activism rose from 2% to 20% in withholding support for remuneration of executive pay reports (BIS, 2011). This is because the principal has limited knowledge, and insights into the qualification, and goals of the agent. For example, Sir Fred Goodwin, CEO of Royal Bank of Scotland was fired after the collapse of the bank in 2009 in the UK, but awarded a huge compensation of 16.9million pension, which was later reduced to 90% of RBS shareholders.

Failure of corporate governance in appropriately supervising companies and the increasing calls for board of directors to step up to the challenge. One role of the board of directors is to appropriately empower and manage management and executive committee, which include setting of executive compensation, setting clear goals, structures and committees, accountabilities and policies (Paul, 2012). This also leads to low employee morale and turnover, due to one person earning about 531 times than the average worker leads to dissentients (Whelton n.d). Increasing agitation of other employees on the large disparity between themselves and executives and the average worker. A study conducted on 120 firms in the US O'Reilly (2006) found that one CEO was overpaid by 64%, COO /CFO was also overpaid by 26%, and divisional managers were overpaid by 12%. The findings show that if the CEOs are overpaid, subordinates are more likely to quit. Also, these overpayments, apart from causing high employee turnover also has a cumulative effect on the overall organisation performance and shareholder value and can lead to higher cynicism in the organisational performance.

Another impact is the creation of free agent mentality culture in organisations where there is freedom for CEOs to channel more profits into their pockets. So they move from one organisation to another without any long-term commitment seeking personal gains (Callahan, 2004)

Although there are negative impacts, research has also shown that there are positive impacts as well. The literature shows that high compensation helps to attract the best candidates into organisations. According to the Great Person Theory of Shareholder Value high compensation packages are used to attract the best people for running the company and this actually determines the market availability for such qualified persons (Whelton, n.d.; Gaibaix and Landiers, 2008). Further, it gives the company an indication of performance because the executives are motivated to give of their best in the performance of their duties (Coles et al. 2006; Strobl, 2014), although sometimes this is relative based on the performance of companies such as Northern Rock, RBS problems and bankruptcy of Leman Brothers during the recession. However, the most impact is felt when stock options are used as incentives it help align the interest of management and the shareholders and a better personal incentive to improve the company's performance. On the down side, they could take a higher risk, which could negatively affect the company. It also serves as an advertisement for the company in that a newsworthy CEO will help to advertise the goals and strategy of the company for further investment opportunities within its market. It also serves as a motivating factor for subordinates to set high goals towards a high compensation position. This means that they will work harder to improve the organisation's standing to achieve this.

The role of Ethics for Resolving Executive compensation

Given the negative impact, it raises many ethical issues on high executive compensation. Most questions posed on this issue is it right or wrong to pay executives excessive pay. Ethics is defined as issues of right and wrong. Business ethical theories are applied to business situations, activities, and decisions where issues of right and wrong are addressed (Crane & Matten, 2010). Many people have raised the issue of fairness in high executive compensations. According to Rawls (1960) justice is a virtue of social institutions, which is measured by the fairness in the allocation of benefits and burdens underlined by two principles: liberty and differences.

According to him, everyone participating in a particular practice has equal rights to the most extensive liberty consistent with everyone. Rawls differences states that inequalities are okay so far as it works to the benefit of the least advantaged or that the positions to which this difference is gained is open to all. Hence, ethics of justice espouse how the benefits and burdens of society are distributed in a just and fair manner. There are different kinds of justice and the one that resounds with executive pay is the distributive justice, which serves, as a basis for the

redistribution of resources in a given society, organisation and the most significant is the norms of fairness and ethics of virtue. Virtue ethics focuses on the character of the person acting, and a virtuous person will take morally right decisions. Ethically, if society distributes benefits in an unfair and just way, that society has to change. In recent times there are calls for executive pay as being unfair and unjust. There several ethical issues that have arisen on these issues:

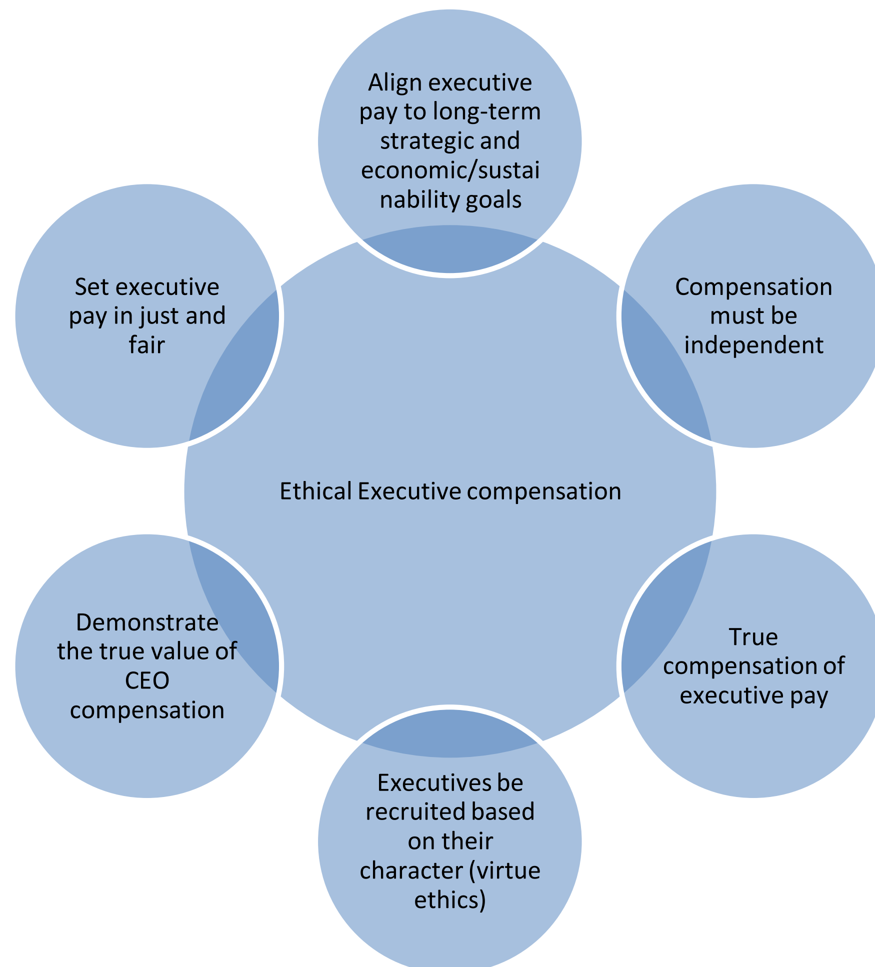
Lack of transparency in setting executive compensation hence, the call on the board for ethical practices when supervising and setting executive compensation. There is a huge issue of fairness and the justification of executive pay due to the non-transparent nature of executive pay.

Increasing disparity between executive and lower level employees pay brings to fore the unfairness in the setting of executive pay (Crane and Matten, 2016). There is a continuous widening gap in compensation in different levels of organisations; for instance, the Mercer study described previously determined that CEOs enjoyed bonuses of 141 per cent of salary in 2004, while other studies indicate that typical clerical and technical staff earns approximately 5 per cent of salary as an annual bonus.

Although some argue that executive level positions deserve high rates of pay due to the nature of the job and responsibility involved (Strobl, 2014). Others argue that the gap in executive versus employee pay has widened so dramatically that employees are under-compensated which brings about the lack of morale, disloyalty and they may even be tempted to engage in unethical behaviour, such as stealing from the company (Equality Trust 2017).

The principal-agent problems (Bruhl, 2003). Executives are hired to work in the interest of shareholders, however, executive rather act in their short-term interest with all related parties interest ignored. Compensations are therefore set and CEOs are given the incentive maximise profit at any expense. Although some companies are using incentives and other benefits to motivate executives to perform, ethical issues arise if these are geared towards short-term goals. For example, an executive may drive up short-term profits that cannot be sustained, only to collect a large bonus and leave the company before long-term financial problems are revealed. Conflicts of interest also arise because most board members are also CEOs in other companies; hence, in their own financial interest help to raise the executive pay and sets up a lucrative market based pay for all executives which will impact on them (Nichols & Subramaniam, 2001). Thus, the key research question for this study is how can ethics help to improve executive compensation for sustainable development?

Figure 1- Key factors in ethical executive compensation



From the ethical theories and executive compensation literature, the following factors in figure 1 were delineated as the key ethical fundamentals to develop a process of ethical executive compensation.

The first factor is the ability of the board of directors to act responsibly and fairly in the way of setting executive compensation in the organisation. To this, the board of directors must be set executive pay in just and fair manner to help improve the situation. Secondly, avoid obscuring the true value of CEO compensation. Much of the current public outrage stems from surprise when an executive has contracted to receive five or six times his or her public salary in stock options and other hidden pay-outs and receives them regardless of the company's financial outlook. The board must tie executive pay to performance and affected if performance

fails. Thirdly, the board must recruit executives based on their character (virtue ethics) as well as credentials and commitment to others and towards the organisation to act in a morally right way. The board must work out true compensation of executive pay. The board must adequately investigate and disclose retirement accounts and other hidden pay out to CEOs as well as the ratio of executive pay to median worker compensation. Taking advantage of hiring the best candidate and paying them what they are worth to improve performance. The use of compensation must be independent which should see that CEOs do not serve on the committee or influence others members. Board members who are CEOs must avoid basing their decisions on financial interest to increase executive pay. Finally, Boards must align executive pay to long-term strategic and economic goals rather than the short term wins to avoid CEOs taking high risk to improve their financial status at the expense of the company performance.

Methods

This study adopts a qualitative research approach using the phenomenology strategy. Using a purposive sampling approach was adopted for recruiting participants. Thirty participants will be recruited based on their years of operation and experience of executive compensation. Data will be collected using face to face semi structured interviews (Silverman, 2015). The data will be analysed using the thematic analysis to code and identify the relationship between ethics and executive compensation.

Current Progress

Currently, this study is at the literature review and development stage. The key guiding framework for the study is being developed. The ethical factors for developing an ethical executive compensation have been identified from literature to guide the empirical work.

Participation in the BAM Conference And Beyond

Up until Bam, empirical will be collected made up of both primary and secondary data. The analysed and preliminary findings on how firms are using ethical theories to resolve executive compensation issues will be would be presented at the conference. The feedback from the conference would be used to develop the article for publication in a peer-reviewed journal.

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