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How Ethics Should Help Shape Execs' Pay

By Patricia Harned, *Compliance Week Guest Columnist* — January 9, 2007

Movie director Steven Spielberg earned \$332 million from June 2005 to June 2006; professional golfer Tiger Woods earned \$90 million, and actor Johnny Depp earned \$29 million. In the business world, Yahoo's chief executive officer, Terry Semel, received \$230 million in total compensation while Berkshire Hathaway boss Warren Buffett received \$100,000. Michael Kaiser, president of the nonprofit Kennedy Center for the Performing Arts made just over \$1 million in 2005 while the average compensation for other nonprofit executives was \$92,411.

Teaching salaries, on the other hand, begin at \$42,400 in Fairfax County, Va., and only \$25,000 in less populated states. On average, federal air marshals have a starting salary of \$36,400 and park rangers start at \$20,908.

With such wide variations in salary and earnings and widespread acceptance of high pay for actors and athletes, why has the topic of excessive executive compensation become the subject of such vehement public outcry? In part, it results from some high-profile instances of executives receiving compensation beyond the average Joe's comprehension. With new disclosure requirements soon going into effect, the issue once again has risen to the surface. At the heart of the issue is a question of ethics: How much should one individual, even the top executive, receive for an honest day's work? What is fair?

Most people don't dispute that top executives of multi-billion dollar enterprises should be compensated handsomely for performing an extremely stressful and demanding job. After all, not just anybody could do the job. CEOs shoulder far more responsibility (for far more people) than celebrities do, and often have a lot shorter shelf-life thanks to the lightning-rod nature of the job. Furthermore, the capitalist concepts of free trade, open competition, profit motive and private ownership run deep in today's society—the great American Dream, after all, is to market ourselves or our products to the highest bidder and become rich beyond compare.

But other factors feed the uproar over the amount of compensation paid to top executives.

First, even though many CEOs are honest and ethical and work tirelessly for the best interest of their companies, it rankles our perceptions of fairness to hear about an executive receiving millions of dollars in pay—and often millions more in severance—when the

ABOUT THE AUTHOR



Patricia Harned has been president of the Ethics Resource Center since May 2004, serving in a variety of research and executive


positions there since 1999. In those years she has led ERC to develop research and benchmarks that measure organizational ethics and compliance program effectiveness.

Harned has also helped shape ethics training for the securities industry, commented on the ethical dimensions of regulatory efforts by both the SEC and the U.S. Federal Sentencing Commission, and testified before Congress on federal legislation. She is the primary author of the 2005 National Business Ethics Survey, has written several book chapters on corporate ethics, character development and ethics education, and serves on the editorial board of *Public Integrity Journal*.

Harned welcomes specific questions from readers on ethical dilemmas they encounter; when appropriate, she will try to address them in future columns. She can be reached via email at Pat@ethics.org.

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company he or she heads is losing money.

Second, as benefits to regular workers are reduced and real wages stagnate, the gap between executive and average worker salaries (estimated anywhere between 180 to 431 percent) becomes harder to swallow.

Third, when the structure and total amount of a CEO's pay is undisclosed or difficult to figure out, the company and the executive appear to have something to hide.

The new rules for compensation disclosure that the Securities and Exchange Commission put into effect late last year respond to this last point by demanding that companies make their disclosure in plain English and present a single, bottom-line number for total compensation to top executives. Increased transparency and accountability should help investors better understand the amount and type of top executives' total compensation as well as a company's compensation goals and objectives.

But the problem with disclosure is that the contract has been signed and at least some of the money already has been paid. By looking at executive compensation as an ethics issue, as well as from a financial and management perspective, companies can reap public rewards *before* disclosure. What reveals a company's ability to act responsibly and fairly in relation to employees and shareholders isn't so much the exact dollar value of executive pay, but the way a company deals with the whole concept of executive compensation. So what can a company—its board, the CEO, and the shareholders—do to demonstrate its willingness to act ethically in matters of executive compensation?

The board can:

- **Identify the true compensation being paid to an executive.** Investigate and disclose retirement accounts, change-in-control provisions, and other forms of hidden payouts that geometrically increase an executive's pay.
- **Keep the compensation committee independent.** CEOs should not serve on the nominating committee or have influence over its members.
- **Tie pay to performance.** Performance should drive compensation; if returns to shareholders

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SALARIES	
Below is a selection of comparative salaries. *	
Position	Salary
Steven Spielberg, director / producer	\$332,000,000
Terry Semel, Chairman and CEO, Yahoo	\$230,554,000
Tiger Woods, golfer	\$90,000,000
George David, CEO, United Technologies	\$88,712,000
Frederick Smith, CEO, FedEx	\$36,410,000
Kobe Bryant, basketball player	\$31,000,000
Johnny Depp, actor	\$29,000,000
Brian Roberts, CEO, Comcast	\$14,252,000
Rachael Ray, celebrity chef	\$6,000,000
Harold Varmus, CEO, Memorial Sloan-Kettering	\$2,491,450
Michael Kaiser, President, Kennedy Center for Arts	\$1,029,691
Bill Gates, Chairman of the Board, Microsoft	\$966,667
President of the United States	\$450,000
Donald Graham, CEO, Washington Post	\$411,000
Avg. total CEO comp (cos. with under 500 employees)	\$290,300
Emergency room physician	\$188,111
U.S. senator	\$162,100
Warren Buffett, CEO, Berkshire Hathaway	\$100,000
Nonprofit CEO, Executive Director (Overall Average)	\$92,411
First-year teacher, Fairfax County (Va.) Public Schools	\$42,400
TSA federal air marshal	\$36,400
Median weekly salary in 2005	\$34,268
National Park Service ranger	\$20,908

* Note: The data used to compile this list was taken from a variety of resources, including www.Forbes.com/lists/ for the most recent year available (2004, 2005, or 2006).

are minimal, or if the company consistently loses money, executive pay should be affected as well.

- **Recruit by character as well as by credentials.** Screen potential CEOs about their sense of obligation to others and stewardship to the corporation. One survey shows that executives who scored high on a personality traits called “agreeableness,” which includes being cooperative, friendly, altruistic, and trusting, were more likely to advocate equitable salary distributions. Executives in this group also assigned more importance to ethical issues in general.
- **Avoid basing decisions on self-interest.** Recognize that many board members are also CEOs who may find it in their best financial interest to see executive compensation generally increase.
- **Align compensation with long-term strategic and economic goals.** A CEO whose compensation is based on short-term gains may fudge the numbers to increase stock price or hide poor numbers that hurt his or her portfolio. One study of stock options from Moody’s found that companies with the highest-paid bosses were more likely to default on debts or suffer cuts in bond ratings.

The CEO can:

- **Accept pay that is reasonable for the job.** High pay is justified for high-powered, talented CEOs, but avoid the superstar mindset of demanding pay equal to (or above that of) rival companies’ CEOs.
- **Remember the job requirements.** Put corporate finances, safe goods and services, fair employment policies, and sustainable business practices before personal gains.
- **Keep track of the average worker’s viewpoint.** Nothing creates distrust faster than taking a bonus of \$10 million when front line employees are denied raises due to corporate financial setbacks.
- **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 payouts—and receives them regardless of the company’s financial outlook.
- **Offer stock options to all employees.** Knight Kiplinger, editor of the *Kiplinger Letter*, argues for using stock options to develop an ownership culture among all employees and to reward good ideas and hard work from all levels of employees. He advocates making all option grants conditional on a company’s ability to outperform its industry peers and lengthening the vesting period, to give employees incentive to stick around and focus on long-term goals.
- **Send a public message.** When he became CEO of Best Buy, Brad Anderson passed his annual option grants to outstanding non-executive employees, making a loud statement that he was aware of their contributions to the company’s success.

Shareholders can:

- **Lobby for advisory votes on compensation.** While non-binding, they send a message to the compensation committee that may result in a slower increase in executive compensation.
- **Vote with their investments.** In a recent Compliance Week column, Louis Thompson reported that having a “clear and credible compensation strategy” ranks second only to “quality of management” and far outweighs earnings per share when institutional investors make investment decisions.

Business schools also can influence the perception of what compensation is reasonable for an executive. One survey revealed that executives with more business coursework were more likely to prefer

extraordinarily high salaries and express indifference or aversion toward ethics.

Along with the transparency and accountability added by the new disclosure rules, integrating ethical considerations into all levels of the executive-compensation process leads to a better ethical climate, increased public trust, and less risk of fraud and surprise.

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