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Corporate Ethics and CEO Compensation

Martin Mack
University of Rhode Island, mack.martin@gmail.com

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Corporate ethics and chief executive officer (CEO) compensation will be forever linked together. The dramatic increase in recent corporate scandals has driven increased scrutiny of the enormous executive salaries that CEOs collect each year. The connection between these two topics led me to explore how executive compensation plans are designed and how ethics affect executives' decision making. In this paper I try to determine which financial factors are the best indicators of a CEO's compensation. I also examine how profitable a company is with an ethical CEO compared to a company with an unethical CEO. The companies I use are the ones in the S&P 500, S&P 400 (mid-cap), and the S&P 600 (small-cap).

The factors that I use to observe a CEO's compensation are five year returns, percent growth rate in net income, percent change in revenue, and average gross profit margin. Other factors that were included are CEO tenure and the market capitalization of a company (total dollar market value of all of a company's outstanding shares). To examine ethical CEOs against unethical CEOs, I devise an equation that consists of five different ethic components (employees, community, governance, environment, and product). Each company I examined was awarded 0-10 points based on how ethical that CEO and company were for that component. Companies scoring above a 70% were seen as ethical, and the ones scoring below 70% were seen as unethical. The ethical and unethical companies were then compared and evaluated. Then I plug the ethical score result into a final regression equation to see how and if ethics play a role in a CEO's compensation.

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I. Introduction

Ethics in the corporate world has become a huge issue in the national media and in the classroom. Corporate scandals almost seem like a part of everyday life in the 21st century with the number of corporate executive officers getting caught committing fraud. One day it is Fannie Mae, MCI, or Delphi and the next it is OfficeMax, Quest or WorldCom. Then there is the one that shocks the United States, sends the American public and government into a panic, and causes the so-called experts to say that "we should have seen this coming" like the Enron Corporation scandal. The nation's response is to demand that universities teach ethics in the classroom, impose stronger governance on the CEOs, and to hold the executive officers responsible for any and all fraud committed. These are all terrific ideas that will most likely decrease the frequency of scandals, but no one knows for sure if they will have any real impact on stopping fraud committed by CEOS. One key issue or problem that has been in the public spotlight for the past couple of years, and has been the focus topic for hundreds of research papers is CEO compensation. The issue of top management compensation has received attention from more than 300 studies (GomezMejia and Wiseman, 1997). The focus point of those research papers and public discussions has been to try and find a better way to determine CEO compensation packages. Determining a CEO compensation package and contract that does not put excessive pressure on the CEO to lie on financial statements, allow outrageous perks, allow stock option scandals to occur, and allow disgraceful severance packages could be a giant step in the right direction toward an ethical foundation in the business community. Perhaps CEO compensation packages are not the root of corporate scandals, but sometimes they do push CEOs into making wrong and unethical decisions. There is plenty of literature on CEO compensation

packages, but very few have found a way to pay CEOs in a way that keeps their motivation to succeed and their determination to increase market share and stock price high, while also lowering the pressure and capability to commit corporate scandals. There is a direct relationship between CEO compensation packages, being an ethical company, and in the long-run staying competitive. As that statement indicates, companies need to come up with a CEO compensation package that is designed to keep the CEO honest and in-turn keep the company ethical.

In spite of the teaching of ethics to college students now more than ever, the increase in corporate governance, and the increase in the scrutiny of CEO scandals, fraud continues to happen at an alarming rate. Fraud hurts more than that specific company; it instead dampens the entire industry and even the economy. When major scandals occur, the public loses trust in public firms and is more cautious about their CEOs. Investors pull their money out of the stock markets when rashes of CEO scandals occur because they feel an added risk involved with investing in unethical companies. Investors have seen stocks prices drop dramatically because of CEO fraud and scandals. Therefore, investors will look towards other forms of securities in times when there is a lot of CEO corruption. Then when there is an economic downturn in the economy and the stock market, it directly affects parts of the CEO's compensation that is directly linked to stock price. The public already does not understand the need for the excessive compensation packages that executives receive; when CEOs commit fraud to further augment their compensation, it leads to increased frustration and distrust. The sweatshops in Indonesia and Africa have led to a public out-cry, but when these corporate scandals are committed on American soil and involve American citizens, it creates a different kind of public uproar. People get frustrated with the lack of ethic values in CEOs today and they categorize all CEOs as being the same. When a well-known CEO such as Steve Jobs of Apple is involved in the investigation

of a stock option scandal, the public losses all faith and trust in CEOs, and the need for a different type of CEO compensation package is presented.

The objective of this paper is to provide an up-to-date description of CEO compensation packages, a discussion on how compensation packages affect CEOs and their ethical decisions, and an idea on how to improve CEO compensation packages. My description of CEO compensation packages will be centered on how the packages are determined. Next, I discuss past CEO scandals and how they have affected their companies. I focus on major scandals that have made national and world-wide news, and have caused companies to desperately rethink their corporate strategies and image. Most of the scandals consist of backdating and spring-loading options, financial statements and accounting fraud, and using corporate money for personal affairs.[1] This positive information thus increases the company's stock price right after the CEO exercises his or her options. It includes an analysis of the different ways companies determine stock options, annual salaries, and bonuses for their CEO compensation packages. My analysis shows the influence that CEOs have on their own compensation packages, and how that affects their compensation package as a whole. Also, I show the industries compensation averages, and a performance to pay analysis to see if higher paid CEOs perform better than their competitors. My analysis is to see if a company that pays its CEO more has a better chance at increasing its market value. Market value is the entire cost of accompany if someone were to acquire it. In addition to market value, I will look to see if a higher paid CEO out performs a lower paid CEO based on a company's revenue, income, and shareholder value. I also compare ethical companies versus unethical companies. I analyze the difference between these two types

[1] Spring-loading is defined as CEO granting his or her options right before positive information about their company is leaked to the national news media.

of companies. In determining which companies are ethical and which ones are unethical I use a point system. The companies I use for my analysis are from the Standard & Poor's (S&P) 500, S&P 600 (an index of small-cap companies), and S&P 400 (mid-cap companies). I do this in order to include all types of companies, and to try and not limit my analysis to one range of income and asset companies. This way I can examine companies that have a market capitalization in the large, medium, and small range. Market capitalization is the market value of the company's outstanding shares. The S&P 600 market capitalization range is between $300 million and $2 billion, the S&P 400 range is between $2 billion and $10 billion, and the S&P 500 are companies over $10 billion. The five criteria categories used are as follows: employees, community, governance, environment, and product. Each category includes subcategories in which are used to determine if the company is ethical or unethical.

Employees	**Community**	**Governance**	**Environment**	**Product**
-no history of pay-cuts or layoffs	-viewed positively by public	-no scandals	-no clean-up costs (spillage, etc)	-safe for employees and customers
-minimum/fair wage for all employees across the globe	-active within community	-no lobbying payments	-product safe for environment	-no history of recalls
-no history of outsourcing to reduce wages	-employee diversity	-no recent SEC probes	-actions towards 'greener' society	

This chart describes the five categories and their subcategories.

Each criteria category will be evenly weighted at 20% (5 categories dividend by 100%). I give each company from the S&P 500, S&P 600, and S&P 400 a score of 1 or 0 in each category. A company receives 1 point if they meet each requirement within a category. If they do not meet each and every requirement, then they receive a 0 for that category. Each point a

company receives is equal to 20%. A perfect score is 100%, and a company is considered ethical if it receives 80% or better. If a company meets all of the requirements for a category, it is then given the full 20%. For each category in which it adequately measures up with being ethical, then the more points that company will be rewarded, and the closer that company will come to a perfect score of 100%. An S&P Company can only receive 1 or 0 for each category; there are no partial points. These ethical components will be given a score from 0-5 for each company in the S&P 500, 400, and 600. For example, if a company has no environment problems, and nothing has been written about their deposing of wastes or tearing down of rainforests for new plants then they will be given a perfect score of 1 for the environment category. On the other hand, if there are circumstances where a company has had problems in the past dealing with the environment, then they will be given a score of 0.

The severity of the problem is not considered. If there is news about anything affecting the environment, then that company will receive 0 points for that category. This will be done for each category. To split up the companies into ethical and unethical categories, I use the deciding percentage score to be 80%. I use 80% to be the deciding percentage score because I feel that for a company to be considered ethical, it should not be lacking in more than one of the categories. Obtaining a 0 in more than 1 category shows that the company is missing some ethical values. I will then examine how the ethical scores affect CEO total compensation. I do this in order to find if there is a difference in compensation based on the ethical scores of the companies. Next, I will compare the ethical companies to the unethical companies. I will examine how the ethical scores of the S&P companies are correlated to the 3 year growth rates in sales and net income. Also, I will look at how an ethical score is correlated to shareholder returns. In addition, I will examine the other variables including market capitalization, total assets, net income, ROE, and

ROA. I will plug these variables into regression equations to find the correlation between the variables and the ethical score. This will give me the opportunity to evaluate how the ethical score of a company affects the other variables. To judge how the variables and the ethical score affect each other, I will look at the intercepts, t-values, r-squares, and f-scores. Overall, I evaluate how the unethical companies compare to the ethical companies, and see which type of company performs better. I evaluate the results to see if ethical behavior rewards companies or if in fact it is, the over way around, where unethical behavior increases profitability and efficiency. I want to see if there is an outstanding factor that promotes unethical behavior or if there are a multiple of factors that play into a company being ethical or unethical.

Finally, I evaluate the results from my tests and determine if there is in reality a better way for companies to determine their CEO compensation packages. I decide if a compensation package can have an affect on a CEO, forcing him or her to behave ethically or even unethically. I come to a conclusion on whether compensation packages can also play a role in corporate scandals, and if a compensation package drawn up a certain way can reduce CEO fraud. I also evaluate the results and find if there is a way that compensation packages can improve public perception of CEOs and if a certain compensation plan can improve the quality of a CEO's work.

II. Background

Corporate scandals affect not only the people involved, but they also hurt their employees, the loyal customers, the image of that individual industry, shareholders, and the surrounding community. Furthermore, CEO and upper-management scandals are not one year things where everything gets wrapped up, and a solution is quickly found. Scandals and unethical decisions can hinder a company for years. Also, in some cases, that corporation may

never get back to where it once was in terms of market share, net income, and popularity. Once a company is involved in a scandal, its name is 'dragged through the mud', and that company's good name may never be restored again. Bristol-Myers Squibb Co. (BMY) is an example of a company who was trading around $50 a share before getting caught inflating its revenue by $1.5 billion in 2002. After the scandal BMY's stock price fell into the teens, and as of today, the company still has not regained its popularity. Today it is selling in the low 20's. A couple well-known examples are WorldCom, MCI, and the most notoriously known: Enron. Most of these unethical companies are never able to regain their high standards, and are forced to rebuild from the ground up.

CEO pay is one of the most highly scrutinized elements of the modern corporation. "It is beyond my ability to imagine how CEOs could accept obscene compensation packages in light of the stratified economy we have in this country and around the world" (Peterson 2006). CEO pay has been reaching unprecedented levels, and it does not look like we are anywhere near the ceiling of the pay scale for CEOs. One's best guess is that it will continue to increase based on recent years statistics. The average CEO of a Standard and Poor's 500 company received 15.06 million dollars in total compensation in 2006; an increase of 11.5% from 2005 (http://www.aflcio.org/corporatewatch/paywatch/pay/). Not only has CEO pay dramatically increased over the past 20 years, but it has also risen in comparison to their own company's employees' pay. In 1980, the ratio between a company's CEO pay and their employees pay was 42. In 1990 it jumped to 107, in the year 2000 to 525, and in 2006 at 364 (http://www.aflcio.org/corporatewatch/paywatch/pay/). These ratios show that while CEOs are reaping the benefits of their company's increasing income and revenues, their employees are not being given the same compensation rewards. Even when companies do not have an increase in

revenues and income, their CEOs are still being rewarded with increases in pay and benefits. While a CEO's salary is not affected when a company does not meet earning estimates, employees sometimes have to take a pay cut or, even worse, get fired when a company is not meeting its income standards. A recent article suggests that the public are not the only ones that think CEOs are overpaid: company directors also think that. "Ironically, the people who have a say in what the chief makes are the very same people who have a problem with it" (Kirdahy 2008). The article referred to a recent study done by The University of Southern California Marshall School of Business which found out that 32% of respondents (company directors) think that CEO compensation is "too high in most cases." It was a significant increase over the response of board members in the years from 1998 to 2001, when just 25% of respondents felt this way (Kirdahy 2008).

CEOs get criticized for their large salaries every year. However, CEOs are not just earning income by their bi-monthly paycheck. In addition to a CEO's salary and annual bonuses, a CEO's contract may also include such benefits as Long Term Incentive Plans (LTIPs), vested restricted stock grants, stock options, luxury travel expenses, and even personal vacations on the company's money or access to the firm's car or jet. LTIPs are incentive plans that state specific performance benchmarks. For example, a LTIP could include a benchmark for the company's stock price, reported earnings, or any other performance based indicator. If the CEO reaches or exceeds that benchmark, then the CEO is rewarded in terms of salary, restricted stock grants, or stock options. Stock options are given to CEOs and upper-management to allow them to buy the company's stock at a certain price anytime before the option expires. Restricted stock grants are similar to stock options except that a CEO is not allowed to exercise the option until a period of time passes or a certain performance goal is reached. A CEO's reported total

annual compensation does not include items such as luxury travel expenses or personal vacations, but it does include LTIPs, restricted stock grants, stock options, and stock gains along with the basic salary and bonus. In addition, total compensation includes such things as golden handshakes, golden parachutes, matching 401(k) deposits, and even tax reimbursements. A golden handshake is where a company promises payment upon retirement or termination, and a golden parachute is where executives receive payments if the company undergoes change in ownership of if executive is terminated because of change in control. CEOs also receive such perks as receiving tax reimbursements for the tax they will pay on their salary in the current year (tax-free income).

A CEO's total compensation needs to be looked at in order to gain the full understanding of what that CEO is truly earning. A great example is Steven Jobs, the CEO of Apple Inc., who had a reported $1.00 in salary for the past several years. He has received a tremendous amount of positive public exposure both for himself and the company. Jobs is even in the Guinness Book of World Records as the "Lowest Paid Chief Executive Officer". Jobs, even with a salary of $1.00, was the number one CEO in total compensation for 2007 in America. He earned a compensation of $646.60 million; most of it coming in the form of stock options. The next four on the list of best paid CEOs are Ray Irani of Occidental Petroleum at $321.64 million, Barry Diller of InterActiveCorp at $295.14 million, William P Foley II of Fidelity National Finl at $179.56 million, and Terry S Semel of Yahoo Inc. at $174.20 million. Here is a chart of the top CEOs total compensation in 2007 from forbes.com (http://www.forbes.com/lists/2007/12/lead_07ceos_CEO-Compensation_CompTotDisp.html).

Rank	Name	Company	Total Comp ($ MIL)	5-Yr Pay ($MIL)
1	Steven P Jobs	Apple	646.6	650.17
2	Ray R Irani	Occidental Petroleum	321.64	509.53

3	Barry Diller	IAC/InterActiveCorp	295.14 5	512.27
4	William P Foley II	Fidelity National Finl	179.56	NA
5	Terry S Semel	Yahoo	174.20 5	432.49
6	Michael S Dell	Dell	153.23 5,6	NA
7	Angelo R Mozilo	Countrywide Financial	141.98 5	295.73
8	Michael S Jeffries	Abercrombie & Fitch	114.64 5	193.3
9	Kenneth D Lewis	Bank of America	99.8	155
10	Henry C Duques	First Data	98.21	NA

Some other notables were Michael S Dell at $153.23 million at #6, Lawrence J Ellison of Oracle at $74.42 million at #12, and Robert J Ulrich of Target at $48.09 million at #23. The industry with the highest average CEO salary in 2007 was the technology sector at $29.62 million, and the industry with the lowest average CEO salary was the utilities. In addition, the utilities industry is highly regulated by states governments, which most likely accounts for the average CEO salary being the lowest out of all of the industries.

Companies determine top executives' compensation plans in various ways. Geiger and Cashen's (2007) article, "Organizational Size and CEO Compensation", talked about the relationships different variables have on a CEO's compensation. "The one consistent relationship is firm size" (Geiger and Cashen 2007). The market capitalization of a firm has been the most consistent variable with CEO compensation. The larger the market capitalization of a firm, the larger that company's CEO compensation will be. There are a couple of explanations for this. Companies want to have a pay gap in the different levels in the company. For example, executives should earn more than managers; managers should earn more than average employees, etc. In a larger firm, there will be more levels, thus leading to a higher executive salary (Gomez-Mejia, et al, 1987). Also, in larger corporations, the work detail sometimes becomes harder and more time consuming. The work becomes more complex. This

leads to additional human capital demanded from the executives and their pay increases in order to compensate them for it (Gomez-Mejia et al, 1987). Research done by Tosi et al (2000) found out that 40% of the variance in CEO pay is because of firm size. However, firm size is not the only determinant of CEO compensation. Geiger and Cashen (2007) realized that there was a positive relationship between research and development (R&D) and CEO compensation. "The results also show support for the argument that R&D activity is positively related to cash and total CEO compensation" (Geiger and Cashen 2007). The indicator that most people would think and want to be highly related to CEO compensation actually is not. Relationship between CEO compensation and firm performance seems to be mixed (Jensen and Murphy 1990). Jensen and Murphy's research used a total of 10,400 years of CEO compensation and performance data, and they concluded that there is in fact not a strong relationship between CEO compensation and firm performance as stock holders, board members, and the general public would want. "Pay performance sensitivity for executives is approximately $3.25 per $1,000 change in shareholder wealth" (Gomez-Mejia and Wiseman, 1997).

Studies have also been done on the effects of certain organizational and CEO characteristics on CEO compensation. One such study by Belliveau, O'Reilly, and Wade ("Social Capital at the Top" 1996) concluded that social capital considerably impacts CEO compensation in a positive manner. Belliveau et al. (1996) define social capital as, "…the resources available through social network and elite institutional ties (such as club memberships) that an individual can use to enhance his or her position." This study shows that CEOs can positively impact their compensation through social contacts. An example is when CEO A sits on another CEO's (B) board, and then CEO B sits on CEO A's board. Each CEO can help improve each others' salary and total compensation. "Pay Without Performance", written by

Lucian Bebchuk and Jesse Fried (2006) actually explores the idea that CEOs control their compensation plans because of their managerial power. This power is present because the board of directors at public companies are grateful to their CEOs because of their control over the director nomination process (Bebchuk and Fried 2006). Kirdahy (2008) reinforces Bebchuk and Freid's view with the article, "One in Three Directors Think Most CEOs Overpaid." Out of all of the respondents from the study, 32% think the CEO compensation is too high in most cases. "U.S. executive compensation practices are failing in a widespread manner, and much systematic reform is needed" (Bebchuk, Fried, and Walker 2002). This sentence alone shows the growing concern of the general public and stock holders and is increasingly becoming one-sided.

The demand for better performance such as a higher stock price (among other performance indicators) has often led company executives to go beyond ethical boundaries and commit a mixture of scandals. Many corporate scandals have occurred just in the past couple of years. One example is WorldCom, where their corporate executives tried to stop its decreasing stock price by trying to hide its declining financial position. The executives tried to accomplish this fraud in two different ways. First, they underreported line costs by inappropriately capitalizing these costs instead of expensing them, and second they inflated revenues with bogus entries. WorldCom's internal audit committee uncovered the scandal and reported it to their outside auditors (KPMG). After a full investigation by the U.S. Securities and Exchange Commission (SEC), the assets were estimated to be inflated by $11 billion. Another recent company that was involved in a major scandal was Xerox. In 2002 Xerox was caught by the SEC where they were recording revenue from copy machine leases at the beginning of the lease contract instead of over the length of the lease contract. Xerox had to pay a $10 million fine, Xerox's executives eventually had to pay a $22 million fine, and Xerox's auditors (KPMG) had

to pay a $22.48 million fine for allowing Xerox to cover up a $3 billion gap in revenue and a $1.4 billion gap in pretax earnings. AOL in 2002 inflated sales by booking barter deals and ads it sold on behalf of others as revenue to keep its growth rate up. They did this in order to increase its reported income and thus complete its deal to purchase Time Warner. Afterwards, the SEC estimated that AOL overstated its revenue by $49 million. More recently, companies have been caught by the SEC doing something called 'round-trip trading'. 'Round-trip trading' is defined as a market manipulation act used to misrepresent the number of transactions occurring on any given day through the continuous and frequent purchase and sale of a particular security. 'Round-trip trading' increases a company's volume and revenue, but in reality does not add any profit. Companies perform 'round-trip trading' so that they can increase their revenue and expenses, while at the same not changing the net income number. CMS Energy, Duke Energy, Dynegy, El Paso Corporation, and Enron Inc were all caught by the SEC doing 'round-trip trading'. Quest Communications was also involved in a scandal, occurring in 2002, where the company was caught inflating revenue using improper accounting for long-term deals. It was reported that $1.16 billion was incorrectly accounted for in sales. Some more recent scandals occurred with CVS and National Century. CVS Caremark was also caught of committing fraud in 2008, and was ordered to pay $37 million to numerous states and the federal government because they billed Medicaid programs for a more expensive formula than needed. National Century executives were convicted in March 2008 of a $1.9 billion fraud scheme. Five of the National Century upper executives were convicted of conspiracy, wire and securities fraud, and money laundering. Another recent example is of two airlines: British Airways and Virgin Atlantic. Both companies were caught price-fixing between 2002 and 2006 and the companies will pay around $200 million each. Merck and Co. settled a case in 2008 which orders the

company to pay $671 million for overcharging on two drugs. As these few examples show, CEOs have repeatedly tried to increase their performance ratios by committing fraud.

On the other hand, sometimes CEOs are just too greedy and cannot handle their own power. One example is the ex-CEO of TYCO, Dennis Kozlowski who was indicted for tax evasion. He also reportedly took $600 million from TYCO for a variety of non-company related activities. Kozlowski was accused of abusing the company's employee loan program and also for misrepresenting the company's financial condition. Stock options have been the center of scandals over the past couple of years. The Wall Street Journal defines stock options: "…which give holders the right to buy shares in the future at a present exercise price, are said to be in the money when the exercise price is below the stock price" (Burns 2008). Although stock options were once seen as the 'light at the end of the tunnel' for CEO compensation because of their pay for performance set-up, they are increasingly being criticized and are now even looked at by shareholders and the general public as risk-free money for the CEO. Ben McClure (2007) writes,

> "Companies trumpet stock options as the way to link executives' financial interests with shareholders' interests. But options are far from perfect. In fact, with options, risk can be badly skewed. When shares go up in value, executives can make a fortune from options—but when they fall, investors lose out while executives are no worse off than before. Indeed, some companies let executives swap old option shares for new lower priced shares when the company's shares fall in value. Worse still, the incentive to keep the shares price motoring upward so that options will stay in-the-money encourages executives to focus exclusively on the next quarter and ignore shareholders' longer term interests" (Lifting the Lid on CEO Compensation 2007).

This quote is similar to the general belief about stock options. Furthermore, CEOs 'cheat' even with their stock options. CEOs have been accused of in recent years of backdating and spring loading their options. Karen Krebsbach (2006) describes backdating and spring loading: "In 'backdating,' option-grant dates are retroactively set to precede a rally in the underlying shares, locking in risk-free profits for recipients; in 'spring-loading,' grant dates are scheduled for just before positive announcement or just after a negative one, anticipating a stock price rally and anticipating higher profits for recipients." CEOs plan their stock option exercise dates when they know they will earn even larger profits. For whatever reason, this is not illegal; however, it must be properly disclosed in regulatory filings. Nevertheless, CEOs and their companies continue to lie about their backdating and spring-loading, thus leading to the firing and resigning of many CEOs. Linda Chatman Thomsen (2007), the director of the SEC Division of Enforcement stated in 2007 that the SEC is investigating possible options backdating at some 160 companies. A Wall Street Journal article states that there have been at least 70 firings or resignations of corporate officials over backdating scandals (Maremont et al 2007). A paper written by Bebchuk et al in 2007 writes that at least 700 companies received or provided manipulated stock option grants. Bebchuk also writes that he identified a strong link between stock option grant manipulation and corporate governance. He writes that stock option manipulation is more likely to result when the CEO has greater influence over the company's governance board. Stock options continue to be a part of CEOs' compensation plans, and CEOs continue to manipulate them. Former UnitedHealth Group CEO William McGuire received $14.6 million the same day the company's shares fell to their lowest price for the year. Surprisingly companies also backdated their options after 9/11 (Maremont et al 2007). Since many companies' stock prices fell significantly after 9/11, CEOs backdated their options so that they would receive a payout of

a maximum amount. Option backdating and spring-loading continue to happen at hundreds of companies across the United States.

Another part of the problem with CEOs compensation plans are the often unheard of 'golden goodbyes', which include 'golden parachutes' and 'golden handshakes'. 'Golden goodbyes' are exit payout packages designed to pay CEOs sometimes millions of dollars just for resigning. 'Golden parachutes' are defined as payments executives receive if the company undergoes a change in ownership or if the executive is terminated because of a change in control. 'Golden handshakes' are defined as payments a company promises to CEOs upon retirement or termination. In addition, companies often accept a CEO's retirement instead of firing them because of the concern over the company's image, thus leading to some CEOs receiving hundreds of millions of dollars when committing a scandal. This exact thing happened in 2006 with the former CEO of KB Home, Bruce Karatz, who was caught in a backdating scandal, and upon retirement received $175 million. CEOs continue to be paid handsomely, even when they retire amidst a scandal.

In response to the growing number of corporate scandals, the U.S. government enacted the Sarbanes-Oxley Act of 2002. This federal law was in reaction to the major corporate and accounting scandals previously mentioned. The act establishes new standards for U.S. public company boards, management, and public accounting firms. The legislation covers many issues including auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure (Dalton and Dalton 2008). In addition, the Securities and Exchange Commission in 2006 revealed new disclosure rules that companies must use for disclosing CEO compensation. These new rules make previously hard to find information about

CEO compensation more visible than ever. Before the new SEC disclosure in 2006, executive compensation disclosure was not extremely effective. The SEC enacted the first executive compensation disclosure rules in 1938. These rules required companies to provide a narrative explaining the levels of compensation, put these levels in tabular form, or provide both forms of disclosure. In 1952 a separate table was required for information on pensions and deferred compensation. In 1978 the SEC required companies to provide information on all forms of executive pay. However, in 1983 the SEC changed its 1978 ruling because they did not want to overcomplicate the disclosure rules. Thus they issued new rules in 1983 that primarily only required a narrative disclosure. Then in 1992, the SEC realized the effectiveness of tabular disclosure and required companies to provide a tabular disclosure instead of a narrative one. This was also done in order to easily compare CEOs salaries among companies (Donahue). Then eventually in 2006, the 1992 SEC disclosure rules were changed. "This first major overhaul in 14 years is designed to provide investors with easily understood compensation information" (Steichen et al 2007). Some of the major highlights of the new disclosure rules were compensation disclosure for high-ranking executive officers, compensation discussion and analysis, compensation committee report, and a summary compensation table. The summary compensation table is designed to include dollar amount for all equity-based rewards (stock and stock options), amount of compensation under non-equity incentive plans, pension plan details, amount of all other compensation including perquisites of more than $10,000, and a column that totals all compensation (Steichen et al 2007). "…thanks to recent rules sent down by the Securities and Exchange Commission requiring greater disclosure of executive compensation, shareholders now can see more clearly how CEOs are being paid, including perks, retirement benefits and severance" (Marquez 2008). As this quote shows, stockholders and the general

public will now be able to see the salaries that the CEOs are really making. "Yet despite their improvement, the new rules do not result in complete disclosure" (Donahue 2008). Donahue (2008) explains that there are four areas in which the new disclosure rules are lacking:

> "1) information regarding the conflicts of interest of compensation consultants is lacking; (2) disclosure regarding performance target levels is lacking; (3) only above-market interest rate earnings on deferred compensation need be disclosed; and (4) only disclosure of perquisites exceeding $10,000 is required."

These four areas that are not included in the SEC disclosure rules show that executive compensation disclosure is not as tough and rigid as it could be. As CEO salaries continue their upward trend, the general public likewise will continue to grow frustrated with the difference in pay scale. Robert Trigaux (2006) writes, "Twenty-six years ago, CEOs received an average of $10 for every $1 earned by a U.S. worker…CEOs at larger U.S. corporations on average earn $430 for every $1 earned by the average U.S. worker." Although corporate scandals still occur and CEO compensation problems still exist, the U.S. government and U.S. companies seem to be moving in the right direction with the addition of Sarbanes-Oxley Act of 2002 and the new SEC compensation disclosure rules in 2006.

III. Hypotheses

Ethics in companies' boardrooms has begun to play a bigger role in firms' decision making recently. A study done by the 'Conference Board' (2006) said that nearly two-thirds of the 225 companies polled reported training more than 90% of their workforce in their company's code of ethics. Also, the study found that board involvement in ethics and compliance programs

jumped from 21% in 1987 to 96% in 2005 (www.management-issues.com "Boardrooms spending more time and energy on ethics compliance" 2006). This is not to say that ethics have changed the way companies' decisions have been made or to say that companies and their CEOs have reversed old decisions based on the new ethical dilemmas. Ethics play a factor, but not the largest factor; that belongs to the money aspect. However, with the increase in pressure from the media, companies have begun to realize that making unethical decisions could cost them in the near future or further down the line in their customer base and perhaps more important, financially. On the other hand, bad ethics by CEOs are reported on by the national media on an everyday basis. At the present time and in the past, companies with the highest income have created the most sales, the most enhanced and technologically advanced products, the bigger advertising budget, and the biggest compensation plans for their CEOs and top management. In addition, these companies that are in the top bracket of income have an easier time reaching out to new customers in their native country and foreign countries. There is and should be no question on why companies strive to have a higher income than their competitors. Every CEOs job and their salary depend on it. Stockholders and board members push and demand higher incomes. However, there are a couple of obvious questions that should arise: Are the majority of these companies ethically sound? Do their CEOs and upper-management pick the moral and ethical decision over the immoral and unethical one? Do ethical firms and companies perform better than unethical ones? CEO compensation has long been combined with ethics as to whether CEOs should be paid the astonishing amounts of money they receive. Many board members feel that they have to pay CEOs a lot of money in order to hire the best, and to get their CEO to perform at a higher level than the rest of the CEOs.

The concern of most board members is that if they do not pay their CEO an above-average rate, then that CEO will land a job someplace else that pays more. An example and one answer for some of these questions are in the Enron corporation scandal. Enron was able to report $1.38 billion in net income before the scandal. Also, Enron's stock price reached a high of $83 in January of 2001, and Enron was considered the 7th largest corporation based on the number of employees, the number of outstanding shares, and their revenue. Everybody knows that eventually this company came to a crashing halt, but how could this company possibly obtain this high of a level at a time when almost every decision the CEO made was unethical? The Enron Corporation ended rather abruptly because of these unethical decisions. WorldCom is also an example of a company that reached the very bottom after a scandal, but instead of crumbling and falling apart, the company tried to push through the scandal backlash. WorldCom sold at around $64 in 1999 and was then punished severely by the scandal as noted by this quote: "WorldCom shares were halted after falling to a low of 9 cents in premarket trading" (Dignan 2002). The company then filed for bankruptcy protection (Chapter 11), two years later emerged from bankruptcy, paid back the company's debts at less than dollar value, and eventually was bought out by Verizon Inc in 2005. All companies involved in scandals are affected harshly during the downfall; however, not all companies end up closing down.

As ethics progress in companies' boardrooms, CEO compensation continues to be a target by many. As stated before, one looming question is: Do these CEOs deserve the money that they make? This topic has been the center of conflicting issues in past research. Sheikh (2008) states that external performance standards do affect a CEO's compensation. One of the main points in Bebchuk and Fried's book (2004), "Pay Without Performance", states that CEO compensation does not vary significantly with firm performance.

Null Hypothesis 1: The given profitability measures of a company will reflect a CEO's annual total compensation.

I will use equation (1) to show this:

(1) [CEO Comp$_t$ = a + b$_1$ROA + b$_2$ROEPER + b$_3$Profit_Margin]

-where *CEO Comp$_t$* is the CEO's current total annual compensation, is the y-intercept, *ROA* is the return on assets, *ROEPER* is the return on equity for a company, and *Profit_Margin* is the calculated as net income divided by revenues. My data set includes years 2001 to 2006.

I believe that ROA, ROE, and profit margin are all great indicators of a CEO's profitability performance. ROA shows how efficient management is, and how good they are at using their company's assets to generate sales, and ROE shows how efficient the management is in increasing a company's profits with the shareholders investments. Profit margin shows how a CEO is able to generate profits and how much out of every dollar of sales a company actually keeps. All of these ratios show how efficient and profitable a company is run, and compared to a firm's competitors, these ratios indicate the better managed company. These ratios will gauge what a CEO's total compensation should resemble. The rationale behind my null hypothesis is that I think CEOs with larger compensation plans are simply better at their jobs. CEOs with the higher compensation plans should be the ones that are the most sought after. These CEOs should be able to improve their profitability ratios over the six years that I am using. I believe that over the long term, the higher paid or better compensation plan a CEO has, the better a firm does profit wise. This may not be the ethical or right thing, but I think that most CEOs move on to

better jobs or become disinterested in their current ones when their salaries or total compensation is not in the top tier. A better paid CEO I think will be more involved and more likely to put their maximum effort into the company. I hope to show that a higher paid CEO will have better ROA, ROE, and profit margin when compared to a lower paid CEO. CEOs that make less than their competitors I think will not put in their full effort into their duties and responsibilities.

Furthermore, a variable that has been found to be a great in judging CEO salary is the market capitalization of a company. "…the six-fold increase in an American CEO pay from 1980 to 2003 is almost wholly explained by the roughly six-fold increase in market capitalization of big U.S. companies over the same period. The trend lines of market capitalization and executive payouts rose and dipped in near-perfect tandem" (Vanderkam 2008). On the other hand, CEO tenure is a variable that has not been the focus point of many studies relating to CEO compensation. CEO tenure is usually always controlled for in a regression analysis for CEO compensation, but it normally is not one of contributing variables.

Null Hypothesis 2: CEO tenure and the market capitalization (market value) of the companies will all have an impact on a CEO's salary.

I will use this equation to try and prove my null hypothesis:

(2) $\mathbf{[CEOSal_t = a + b_1 CEO\ Tenure + b_2 ln(MarketCap_t)]}$

-where $CEOSal_t$ is the CEO's current yearly salary, a is the y-intercept, *CEO Tenure* is the length of occupancy a CEO holds in a company, and $ln(MarketCap_t)$ is the natural logarithm of

the market capitalization of the CEO's firm. My data set again includes years 2001-2006. I am using CEO salary for this equation instead of CEO compensation like equation (1).

I believe CEO tenure will be a great variable to use to determine a CEO's salary because the long-standing CEOs more than likely have increased their company's profits, revenues, market share, etc which would lead to these CEOs having a higher salary and taking a larger portion of their company's income. The opposite would be true for CEOs that do not have a long tenure with their company. With less of an opportunity to make their firm more profitable, their salaries most likely will not be as high as the long tenure CEOs. Market Capitalization seems to be a good indicator of a CEOs salary because larger firms will pay their CEOs a larger salary for obvious reasons. I will also take into consideration and exclude the companies like Apple Inc. that pay their CEO (Steve Jobs) an extremely small salary ($1), even though Apple Inc. is one of the larger companies in the United States. I take the natural logarithm of the market capitalization because this allows companies to be compared on a smaller scale. For example, the S&P 500 includes companies with a market capitalization over ten billion. These companies are made up of firms with a market capitalization of over 300 billion such as General Electric (GE) to firms with a market capitalization of just over 15 billion such as Constellation Energy Group (CEG). To compare these two companies and their two CEOs based on their market capitalization without taking the natural logarithm would be incorrect because it would not be linear realistically. I also include total assets, because if a CEO is responsible for a greater amount of assets than another CEO, then the CEO with more responsibility should be better compensated. Equation (2) I think will help show that market capitalization (enterprise value or firm value) and a CEO's tenure have a very high correlation with a CEO's salary.

Then I will run a multiple regression trying to figure out which variables contribute towards shareholder return. I will run the regression to try and show that a CEO's salary and CEO tenure affect the return of stockholders over a 3 year period.

Null Hypothesis 3: CEO salaries, CEO tenures, and net income 3 year growth rate all have a strong correlation with stockholder return over a 3 year period.

Equation (3) will be:

(3) $\mathbf{[3YrReturn = a + b_1 CEOSal_t + b_2 ln(MarketCap_t) + b_3 CEOTenure + b_4 NI3LS]}$

-where 3Yr*Returns* is the stockholder return over the past 3 years, *a* is the y-intercept, $ln(MarketCap_t)$ is the natural logarithm of the firm's current market capitalization, *CEOSal* is the CEO's annual salary, *CEOTenure* is the length of time a CEO as been the CEO of that company, and *NI3LS* is the 3 year growth rate of net income for the company. My data includes the years from 2001 to 2006.

I believe that using CEO salary as a variable against returns to stockholders over the past 3 years will show that higher CEO salaries are a reward for greater returns to stockholders. Market capitalization and CEO tenure are used as variables to predict returns to stockholders over the past 3 years because I feel that the longer a CEO is with a firm and the greater the market capitalization of that firm, the greater ability a CEO has to produce higher returns to stockholders. Combined with a CEO's salary and these three variables will in my opinion give a great predictor of returns to stockholders. I believe that I will show that larger companies with a CEO that earns a greater salary will earn a higher average return for the past three years. Net

income 3 year growth rate is used as a variable to add a measure of profitability to the equation. As stated in my hypothesis, I think that the companies will a better 3 year growth rate on net income will experience better shareholder returns for the obvious reason that a company with a higher net income rate should have their stock price and dividends increase.

To form an equation regarding corporate ethics against CEO compensation and shareholder return over 3 years, I have come up with an ethical equation.

Null Hypothesis 4: The average overall ethical score will be higher for the lower market capitalization companies compared to the higher market capitalization companies.
(S&P 600 (small-cap) > S&P 400 (mid-cap) > S&P 500)

S&P T-Tests

S&P 600		**S&P 400**		**S&P 500**	
Std Dev	0.18426	Std Dev	0.1725	Std Dev	0.20943
Student's t	105.6531	Student's t	81.6535	Student's t	91.9415
p-value	<.0001	p-value	<.0001	p-value	<.0001

The ethical equation that I will use to try and see how ethical companies perform compared to unethical companies will be:

(4) [Ethical Score = Employees + Community + Governance + Environment + Product]

-where *Employees* refers to labor standards, wages, and training. *Community* refers to community involvement and a positive image throughout the community. *Governance* refers to policies and processes set up to control corporate power. *Environment* refers to dumping of waste, and pollution of products and plants. *Product* refers to the safety and positive image of the company's product.

Some of the time, the reason a CEO or a high-ranking executive makes an unethical decision, it is to increase the company's profits or decrease a company's expenses and thus improving a company's stock price. Once an unethical decision is made that is not known to the public, the stock price will most likely positively reflect the increase in a company's profits or the decrease operating expenses. However, once a corporate scandal or unethical decision is released to the pubic, those shareholder returns will be negatively affected. The shareholder returns will be negatively affected for obvious reasons, such as bad publicity, lower projected revenues, or simply the company's stock price decreasing. Also, I think that larger companies will show greater differences compared to smaller companies. Comparing the S&P 500 to the S&P 600 (small-cap) and S&P 400 (mid-cap), the firms in the S&P 500 will show a greater difference based on ethical and unethical decisions. Companies in the S&P 500 will show greater differences than the companies in the S&P 400 (mid-cap), and the companies in the S&P 400 (mid-cap) will show greater differences than the companies in the S&P 600 (small-cap). I believe that companies in the small-cap will have the greatest ethical score, while the mid-cap and large-cap will have lower ethical scores. I think that this will occur because the companies with the higher market capitalizations will have a greater ability and the greater need to gain that however small edge over the competition. The S&P 500 companies will have the resources and power to increase revenues, profits, and stock price and influence customers by trying to find a way around a barrier, being it ethical or unethical. The mid-cap and small-cap firms will have less of an ability to influence customers positively or negatively and less of a chance to increase the firm's profitability because of fewer resources and less exposure.

With ethical companies scoring above an 80%, and thus unethical companies scoring below 80%, I believe that unethical decisions hinder a company and their employees, stockholders, and the surrounding community. Previous corporate scandals and bad ethical policies have been stated throughout the paper, and these examples have ranged from companies being greatly affected and the company going bankrupt, to having the scandals just be small bumps in the road towards greater revenue, net income, etc.

Null Hypothesis 5: There will be a high negative correlation between the ethical scores in equation (4) and a CEO's compensation, 3 year returns to shareholders, and the sales 3 year growth rate.

Equation (5) will be:

(5) [Ethical Score = a + $b_1$ln(marketcap) + b_2CEOCOMPt + $b_3$3YrReturn + b_4SALE3LS]

-where *Ethical Score* is the ethical score that I will give to each company in equation (4), *a* is the y-intercept, *ln(marketcap)* is the natural logarithm of the market capitalization of each company, *CEOCOMP* is the total compensation for each CEO, *3YrReturn* is the shareholder return over the past 3 years, and *SALE3LS* is the 3 year growth on sales. Again, my data set includes the years 2001-2006.

I use the market value within the companies because I believe that they will show that large market capitalization companies have lower ethical scores than the smaller market capitalization companies. This I believe is attributed to the lack of investor research, news generated, and people involved in the everyday business operations within smaller companies when compared

to larger companies. CEO compensation is used to show if a CEO's total compensation can be compared to the company's ethical score. Also, the three year returns to stockholders is used to determine if the ethical score of a company can be compared within reason to shareholder return over an extended period of time (3 years).

Overall, I think that a company's shareholder returns, sales growth rates, net income growth rates, net income, and sales (among other equations and values) will be greater or better in firms that pay their CEOs higher. However, I believe that a high CEO salary or compensation does the opposite, and will negatively affect a company's ethics. I think that this will be the result because companies that make ethical decisions are not rewarded in the real world. Each of us would like to believe that a good ethical company leads towards higher returns, but I do not believe that this will be the answer. On the other hand, companies that make ethical decisions will be given positive exposure and media press, while companies do not make ethical decisions will be given bad press and negative exposure. However, this good exposure I do not think will leads to much of an increase in stock price, higher revenues, or overall more customers. Also, the higher paid CEO will put more pressure on himself to succeed and thus will make unethical decisions to make sure that he is accomplishing his task of increasing shareholder value and the bottom line (net income). The CEO will aim to increase the firm's profitability and will try to keep shareholders happy by raising the company's stock price. This will happen because I feel that ethical and unethical decisions do not hold as much weight in the public eye as most of us would like to believe. After a couple of years after a scandal, the unethical decision made by a CEO and upper-management may have been forgotten by the media and the public, or may have just been forgiven by the media and public. Eventually though, an abnormal amount of bad exposure will lead customers away from those companies and will decrease those companies'

profits. However, I do not think that this will affect shareholder return over a 3 year period. Furthermore, I do not think a below average paid CEO or a CEO of a smaller company will not be as pressured compared to a higher paid CEO to increase a firm's profits and shareholder value. Additionally, I think that the size of the company (market capitalization) will affect how ethical a company can be. Companies outsource certain parts of their production-cycle or move into foreign markets to lower expenses and increase profits, but this leads to CEOs and companies sometimes making unethical decisions. Footwear manufacturers have been highly scrutinized for the outsourcing of the actual manufacturing of shoes by children and adults paid extremely low amounts. Nevertheless, the companies continue to outsource because more than anything, just to stay competitive. Obviously, not all large-cap companies make unethical decisions; however, I feel that the majority of large capitalization companies and higher paid CEO firms will result in having a lower ethical score.

IV. Analysis

Located below is an overview of a CEO's total compensation (TDC2), salary, and tenure. Total compensation (TDC2) and salary are in thousands and tenure is in years.

TDC2 Overview		Salary Overview		Tenure Overview	
Mean	5786.1	Mean	698.688	Mean	7.42015
Std Dev	25,593.69	Std Dev	384.013	Std Dev	7.31536
Q1	978.833	Q1	450	Q1	2.5
Median	2192.398	Median	649.704	Median	5
Q3	5307.294	Q3	900	Q3	9.6667
100%	2249998.8	100%	5806.65	100%	56

First, I ran nine regressions to determine which variables would be the best fit. I determined equation (1) by first running some regression equations to determine which variables would be a good fit together to avoid multicollinearity so that I did not have two or more variables with the same affects on CEO compensation. The nine variables I included were assets, revenues, sales 3 year growth rate, three year shareholder return, CEO tenure, net income, operating income before depreciation 3 year growth rate, net income 3 year growth rate, ROA, and ROE. For example, one equation reads: CEO Comp = a + b_1Assets. After running the linear regressions to find the variables that I wanted to use, I ran the regression using equation (1): **[CEO Comp$_t$ = a + b_1ROA + b_2ROEPER + b_3Profit_Margin]** which is labeled 'Model 9' in Table A. Table A presents the results of the regressions. These results examine the impact that certain variables have on CEO total compensation. The regression coefficients, adjusted R squares, sample size, and F test statistics are presented for each regression run. The t-value of each individual variable is also presented in the table.

Focusing on the output of equation (1), it seems that sales 3 year growth rate, net income 3 year growth rate, and even the three year return to shareholders were all good predictors of a CEO's total compensation. There is positive evidence that all three have significant impact on CEO total compensation. Their R-squares is not very high, but their t-values are very significant with each variable having above a 2.00 t-value. The slopes for sales and net income 3 year growth rates and 3 year return to shareholders are all high at 31.10, 31.97, and 41.21. However, ROA, ROE, and profit margin separately all have t-values below 2.00. Among the three variables used in 'Model 9', none seem to have any sort of impact on a CEO's total compensation except for ROA. These profitability measures (ROE and Profit Margin) both have t-values less than 2.00, while ROA has a t-value of just over 2.00 at 2.15. The ROA profitability

measure seems to be the only measure that affects CEO total compensation. This output refutes the null hypothesis (1) and actually shows that the selected profitability ratios do not affect a CEO's total compensation.

To find the best regression for the dependent variable 'Salary', I ran five regressions with one variable. I then ran three regressions with the best fit variables. The best regression equation is equation (2) **[$CEOSal_t = a + b_1 CEO\ Tenure + b_2 ln(MarketCap_t)$]**. 'Model 7' shows this regression in Table B. I included total assets instead of net sales in the final regression equation because the two variables looked to have similar impacts on CEO salary based on the simple linear regressions run with only one variable. Table B shows the results of these regression equations. Sample size, regression coefficients, adjusted R squares, and F test statistics are again given for the regressions. Also, the t-value is given for each variable. Market capitalization and CEO tenure seem to have a significant impact on CEO salary. Market capitalization looks to come out to be the best predictor variable of CEO salary. The output shows an r-square of .3119. A great r-square which shows that the regression line approximates the data points well. CEO tenure and market capitalization both have good t-values which show that each is a decent predictor. As expected, the t-value of the natural log of the market capitalization is very high at 65.60, while CEO tenure is lower at 2.51. The output proves the null hypothesis (2). The high r-square combined with the high t-values for both market capitalization and CEO tenure show that the variables are highly correlated with CEO salary.

To find the right variables to use for the dependent variable '3 year return to shareholders', I ran six regressions with one variable in each regression. I then took out the

variables that were similar and that affected the 3 year return to shareholders the same. I cam up with equation (3) **[3YrReturn = a + b_1CEOSal$_t$ + $b_2$ln(MarketCap$_t$) + b_3CEOTenure + b_4NI3LS]**. The results are presented in Table C. The table contains values for r-square, the coefficients, sample sizes, and the F test statistics. Also included is a t-value for each variable in each regression. Based on the results, there is significant evidence that these variables affect the 3 year return to shareholders. The output gives a high r-square of 0.1535. The log of market capitalization and 3 year growth rate in net income have the highest t-values at 12.48 and 33.39, respectively. These two variables seem to be the best predictors out of all of the variables. Salary also seems to also be a good predictor of 3 year shareholder return with a t-value of 2.83. The slopes are all relatively small with the largest belonging to the log of market capitalization. Net income 3 year growth rate and CEO tenures both have high t-values in 'Model 7', while salary does not. The output accepts the null hypothesis (3). Net income 3 year growth rate and CEO tenures tend to be better predictors of 3 year stock holder return than CEO salary, but salary is significant within a single variable regression equation.

Using the ethical score equation, **(4) [Ethical Score = Employees + Community + Governance + Environment + Product]**, I gave each company in the S&P 500, S&P 400 (mid-cap, and the S&P 600 (small-cap) an ethical score based on the stated variables. These are the overall results:

INDEX	AVERAGE **ETHICAL** SCORE
S&P 500	0.7791164
S&P 400	0.8565
S&P 600	0.89833

Examining the outcome, the S&P 500 finished with the lowest ethical score, just under .78. Both the S&P 400 and the S&P 600 finished with scores about the pre-determined 'ethical line' of .80.

The S&P 600 (small-cap) finished with the highest ethical score based on the five variables with a score of .89833.

S&P 500 Notables			**Employees**	**Comm.**	**Governance**	**Environ**	**Product**	**Ethical Score (1.0)**
MMM	3M Company	Industrials	0	0	1	0	0	**0.2**
AFL	AFLAC Inc.	Financials	1	1	0	1	1	**0.8**
SVU	Supervalu Inc.	Con Staples	1	1	1	1	1	**1**
S&P 400 Notables								
AAP	Advance Auto Parts	Con Discre	1	1	1	1	0	**0.8**
WTR	Aqua America Inc.	Utilities	1	1	1	1	1	**1**
DCI	Donaldson Co.	Industrials	1	1	1	1	1	**1**
S&P 600 Notables								
AIR	AAR Corp	Industrials	1	1	1	1	0	**0.8**
DEL	Deltic Timber	Materials	1	1	0	1	0	**0.6**
NLS	Nautilus Inc.	Con Discre	0	1	0	1	1	**0.6**

This table shows nine different companies in the 3 S&P indices. 3M Company received a total ethical score of 0.4. 3M received a 0 for employees because of a recent lawsuit against the company. "3M Co. (MMM) faces an age-discrimination lawsuit filed by five 3M employees seeking millions of dollars in damages" (cnnmoney.com '3M Faces Age-Discrimination Lawsuit' 2008). The five employees are seeking fair pay and benefits that they felt they should have received. 3M received a 0 for the environment variable because of a recent news story that 3M has been ordered to pay $56 million in cleanup damages. "3M could pay up to $56 million to clean up company-made chemicals that leaked into Washington County's water supplies…"(Wyant http://www.bizjournals.com/twincities/stories/2008/04/07/daily9.html 2008). In addition, the same article reported that 3M paid $8 million last year to clean up chemical leaks last year, and also was ordered to give $5 million to the state to research further

possible chemical leaks made by the company. This company received a 0 for the product variable because of a packaging lawsuit against 3M.

> "Fresno County brought a lawsuit against 3M co., alleging that the company sold undersized adhesive tapes. The suit stated that 3M's Scotch and Tartan brand adhesive and packaging tapes were 6% narrower than advertised. It accused the company of knowingly exaggerating the size of the adhesive tapes" (http://www.lawyersandsettlements.com/settlements/11382/3m-tartan-tape-labeling.html 2008).

3M received a 0 for community for the lack of positive exposure for the company based on the recent chemical cleanup lawsuits. 3M received a 1 for governance because there have been no recent SEC probes, they have not spent any money lobbying congress in the past couple of years, and there have been no upper-executive scandals. Another company, AFLAC, received a 0 for governance because the company spent money last year lobbying congress. "Health and life insurance company, AFLAC Inc., spent more than $3.7 million in 2007 to lobby on health insurance legislation and other issues" (<http://www.forbes.com/feeds/ap/2008/03/21/ap4802327.html> 2008). The company, Supervalu Inc. received a perfect ethical score, for among other things, it is helping of the environment by going 'green'. "'…Supervalu is committed to preserving and protecting the environment,' said Mike Erlandson, Supervalu's v.p/government affairs, who noted that the company will help sustain the expedition by supplying the team with natural and organic food" (<http://www.freshplaza.com/news_detail.asp?id=19274> 2007). Advanced Auto Parts in the S&P 400 received a 0 for the product variable because of a recently recalled item that they were selling. "There is a massive recall involving portable air compressors…the problem is the motor can overheat, which poses a fire hazard" (<http://www.wdbj7.com/Global/story.asp?S=7983778> 2008). Deltic Timber received a 0 in

the product variable because of a fire at one of the sawmills they own, killing 1 and seriously injuring 2 others. "Deltic Timber Corp. has been fined $13,500 for three safety violations at its sawmill near Waldo after a fire caused the death of one worker and injured two others" (<http://www.todaysthv.com/news/news.aspx?storyid=6044> 2008). There were many companies that received perfect scores in each of the S&Ps, but there were also many companies that received less than perfect ethical scores. Overall, the companies in the S&Ps seem to be reasonably ethical. The ethical values prove my null hypothesis (4). The average overall S&P ethical values were lower for high market capitalization companies compared to lower market capitalization companies.

Finally, with the ethical scores of all 1500 companies (S&P 500, S&P 400, and S&P 600), I ran some regression equations against certain variables. The results are in Table D. I first combined the 1500 companies and used total CEO compensation, natural logarithm of market capitalization, 3 year shareholder return, sales 3 year growth, net income 3 year growth, operating income 3 year growth, total assets, and net income. After running all of the regressions, I came up with equation **(5) [Ethical Score = a + $b_1$ln(marketcap) + b_2CEOCOMPt + $b_3$3YrReturn + b_4SALE3LS].** I decided to use 3 year growth in sales instead of 3 year growth in net income or operating income because 3 year growth in net income and operating income resulted in similar numbers. Equation (5) is shown in 'Model 9' in Table D. The output gave a decent r-square of .0829 or 8.29%. In addition, 'Model 9' came out with a respectable f-test of 29.92. The output also shows that the natural logarithm of market capitalization proved to be the best predictor of the ethical score of the S&P companies with the highest t-value out of any of the variables with a value of -10.04. Total CEO Compensation, 3

year shareholder return, and 3 year sale growth each seemed to be insignificant with t-values between -2.0 and 2.0.

Besides running regressions based on all of the S&P companies, I ran regressions against each individual S&P. I used equation (5) also for each S&P. The results of the regressions of each S&P are located in separate tables. Table E = S&P 600. Table F = S&P 400. Table G = S&P 500. Each S&P index turned out to have similar numbers; however there was one major difference. The S&P 500 came up with an r-squared of 0.0924 and an f-test result of 10.7, while the S&P 400 came up with an r-squared of 0.0166 and an f-test result of 2.44. The S&P 600 resulted in an r-square of 0.012 and an f-test of 2.39. The S&P 500 results are much more significant than the other S&P results. An analysis of the output shows that the S&P 500 ethical score regression had a higher r-square and f-test result compared to the S&P 400 and 600 showing that the S&P 500 has a better fit line than the other two S&P indexes. On the other hand, in 'Model 11' in Table D, none of the variables seemed to have a significant impact on the ethical score. The output of this regression nullifies my null hypothesis. The variables (CEO compensation, 3 year stockholder returns, and sales 3 year growth rate) are negatively correlated with the company's ethical score, and only one of the variables have much of an impact on the ethical score: log of market capitalization. Furthermore, for each S&P index, the variables have even less of an impact on the ethical score except for market capitalization.

V. Conclusion

As a result of the regressions, the variable 'market capitalization' seems to be the best predictor of a number of dependents including CEO compensation, CEO salary, and the ethical

score of a company. Table A shows that sales, operating income, net income, and shareholder return on 3 year periods all had significant affects on the dependent variable: total CEO's yearly compensation. Also, CEO tenure showed a positive relationship with total compensation. ROA, ROE, and profit margin showed little affect on total compensation when ran in separate regressions, but when combined into one regression [equation (1)], ROA proved to have some affect on a CEO's total compensation. As predicted and expected Table B shows that assets, sales, net income, and market capitalization all had a major impact on CEO salary. Based on equation (2), CEO tenure has a significant impact on a CEO's salary when ran in a regression with another variable (market cap). Table C proves that a CEO's salary, market capitalization, and net income 3 year growth rate all have significant impacts on shareholder return over a 3 year period. However, when combined into a multiple regression [equation (3)], salary and market capitalization have little impact on shareholder return, but CEO tenure and net income 3 year growth rate both have significant impact on 3 year shareholder return. Equation (4) proved that the larger market capitalization of a company equates out to a lower ethical score. The S&P 500 had the lowest average ethical score, while the S&P 600 (small-cap) had the highest average ethical score. Table D shows that total CEO compensation, market capitalization, 3 year shareholder return, net income 3 year growth rate, operating income 3 year growth rate, assets, and net income all have significant negative impact on the ethical score of a company. Equation (5) proved that market capitalization had a real significant impact on a company's ethical score when compared to a CEO's compensation, 3 year shareholder return, and 3 year sales growth rate.

Based on these results and recent studies, I have come up with a way that I believe will be the best way for a CEO to be compensated. First off, board compensation committees need to

be fully independent from the company's management. "There should be no family relationships, personal friendships, or prior business or philanthropic relationships between committee members and the executives for whom the committee is determining compensation. At a minimum, compensation committee meetings or compensation issues considered by the full board should be without the participation of the CEO, including CEOs who are also chairmen of the board" (Haeger 2007). As explained by this quote, compensation committees should not have any relationship to the CEO in any fashion. In addition, the compensation boards should be free of any other CEOs. CEOs have been known to sit on each other's boards and thus create a 'one hand washes the other' type of approach. Furthermore, not all company boards are elected by a majority vote. "Since the number of board candidates exactly equals the number of vacant seats, shareholders who don't like a candidate can only 'withhold' their vote, so even one vote is enough to get a candidate elected" (Colvin 2008). This should change to a majority vote, and each board member is allowed to vote 'yes' or 'no'.

Secondly, CEOs should not receive a salary. CEOs should only receive bonuses for reaching performance measures and they be given a significant amount of the company's stock. One example, as previously mentioned, is Steve Jobs who receives a $1.00 salary. He earns his money in stock option grants and performance bonuses. I believe that this would force CEOs to focus on increasing shareholder value. Henry Waxman is quoted: "'It seems like everybody is hurting, except for the CEOs who had the most responsibility'" (Guerrera 2008). This quote shows that when companies suffer (like the present), everybody seems to feel it except for the CEOs. If a CEO would not receive a salary, but instead only receive performance bonuses and receive the returns on the company's stock, this would then force the CEO to try to do whatever is possible to turn around the company. "Last year…the median income of an S&P 500 chief

executive nearly doubled while the average profit of their companies rose by just 12 per cent" (Guerrera 2008).

Additionally, the performance bonuses should be validated. The bonuses should only be given if the performance measures reached by the CEO are to the shareholders benefit. "…too many companies fail to ever validate whether or not performance against such measures will actually create shareholder value" (Turner 2007). Performance measures that companies set for their CEO are usually very easy to manipulate. EPS (earnings per share) is an example of a performance measure that can be manipulated just by decreasing dividends, buying back company stock, etc (Colvin 2008). The performance measures need to be relevant to the company's industry and should also be explained in detail to the shareholders on why those performance ratios were selected. "The analytic process starts with a strong understanding of the economics of the relevant industry, along with a command of the company's specific business strategy and value chain. One can then identify what specific performance measures might best correlate to long-term value creation for the company, using regression and time-series analyses to test that value link" (Turner 2008). This statement explains the idea that performance measures should be studied thoroughly, and presented to the shareholders explaining how the performance measures relate to the industry and how they will force the CEO to increase shareholder value. The performance measures should not just focus on growth in the company, but also stability and sustainability. Also, they should be examined and looked at after each fiscal year. "A budget-or plan-drive process may result in inconsistency of performance targets in different years. 'Bottom-up' plans-which often assume year-over-year growth is always required-may end up ratcheting targets unrealistically following good years (making future targets difficult to achieve) or result in lowball targets following a year of poor performance"

(Turner 2008). The performance bonuses should also be linked to the market capitalization of a company. For obvious reasons, a larger company should compensate their CEO more than a smaller company. A CEO's compensation plan should also include the company's stock because this would also make a CEO focus on increasing the company's stock price. A newly hired CEO should be given a percentage of the company's stock, and that CEO should receive bonuses based on how well the company's stock has done when compared to their industry leaders and the market as a whole. This way if the industry is down as a whole, the CEO is not penalized. In addition, the stock price bonuses would be linked to the market capitalization of the company. The companies that a CEO is compared to based on stock price should all have similar market capitalization, and the bonuses given to a CEO based on stock price performance should also be based on market capitalization. As stated before, a higher market capitalization should lead to larger bonuses. Furthermore, all bonuses for performance measures and stock price performance should be made unavailable for a number of periods (days, months, or years). "…they should be banked—unavailable to the CEO for some period of years—to prevent short-term gaming" (Colvin 2008). This idea of not giving CEOs their bonuses immediately would prevent CEOs from playing the game of increasing or decreasing certain assets or expenditures in order to make a certain performance measure reach the stated benchmark.

Moreover, all stock option grants, golden-handshakes, golden-parachutes, golden-goodbyes, and tax-free income should be a thing of the past. Stock option grants create too many problems for greed-driven CEOs who have continued to misuse them. The number of investigations by the SEC looking into CEOs backdating options or spring-loading options is increasing every year. Golden-handshakes, parachutes, and goodbyes are all excessive and unwarranted. A simple two to three month severance plan is more logical at a reasonable portion

of the CEO's annual compensation package. Tax-free income should also be scrapped because this is an unnecessary perk to CEOs. As shown by the recent articles in The Wall Street Journal, Fortune, and other various business magazines, the American public is outraged over CEO compensation. The fact that most CEOs do not even have to pay income tax on this compensation is even more offensive to the public. Getting rid of these types of compensation payments would lead to a more reasonable and better looked at annual compensation for CEOs.

Overall, my suggested way to compensate CEOs will improve the public perception of CEOs. The public perception of CEOs and their compensation packages I believe will get better if not for the lowering of the compensation packages total amount and the removal of some outrageous payments, but also because I believe my new compensation plan will improve the quality of a CEO's work and decrease the unethical opportunities a CEO will face. Backdating and spring-loading will be non-existent without stock option grants and with no more CEO created performance ratios or immediate bonuses, the CEO will be less likely to create different financial numbers or lie on financial statements. Some unethical decisions and scandals are impossible to stop such as a CEO using its company's money for personal reasons or a company trying to cover up their chemical or oil spill.

In the long run, hopefully the company boards and the government will find a reasonable CEO compensation plan that will stop the excessive rate at which compensation plans are increasing and additionally force or reward CEOs for behaving ethically. "Boards that can't manage to pay the CEO properly are damaging the company, punishing the shareholders they represent, and weakening America in a global economy" (Colvin 2008). I am optimistic that corporations are becoming increasingly aware of this idea, and that company boards and CEOs are working together to find a solution.

Table A.

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9
Dependent variable: TDC2									
Intercept	5487.37	5787.57	6119.39	5468.94	5140.58	5750.419	5876.53	5781.54	5808.06
(t-value)	20.06	18.24	14.24	20.29	13.55	22.55	22.33	22.63	21.84
SALE3LS	28.5272								
(t-value)	3.29								
OIBD3LS		41.3006							
(t-value)		4.79							
NI3LS			42.7733						
(t-value)			4.73						
TRS3YR				27.4987					
(t-value)				4.58					
TENURE					92.0601				
(t-value)					2.53				
ROA						10.49125			27.1261
(t-value)						1.68			2.15
ROEPER							0.16216		0.0553
(t-value)							0.51		0.17
Profit_Margin								14.9546	-0.9249
(t-value)								0.61	-0.03
Adj. R Square	0.001	0.0026	0.0033	0.002	0.0006	0.0002	-0.0001	-0.0001	0.0002
N	10024	8560	6396	9795	9619	10050	0.26	10031	9717
F-test	10.83	22.94	22.33	20.97	6.4	2.83	9730	0.26	1.7

Table B.							
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
Dependent variable: SALARY							
Intercept	683.482	645.35	693.95	678.547	-234	-116.47	-247.38931
(t-value)	178.55	174.75	123.89	181.17	-16.18	-7.29	-16.42
ASSETS	0.00103						
(t-value)	20.39						
SALES		0.00991				0.00472	
(t-value)		44.91				21.22	
TENURE			0.817			1.39733	1.11469
(t-value)			1.51			3.22	2.51
NIBEX				0.06335			
(t-value)				29.02			
LOGMKTVAL					124.714	104.041	125.3048
(t-value)					66.02	49.09	65.6
Adj. R Square	0.0396	0.1671	0.0001	0.0772	0.3049	0.3426	0.3119
N	10052	10051	9620	10051	9937	9464	9499
F-test	415.93	2016.78	2.27	842.4	4359.15	1650.24	2153.45

Table C.

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
Dependent variable: TRS3YR							
Intercept	9.17821	-12.236	10.3655	11.6788	11.58284	11.69828	15.02386
(t-value)	9.96	-6.2	16.02	40.25	25.91	25.27	9.48
ASSETS					-0.00000802		
(t-value)					-1.37		
SALES						-0.00004203	
(t-value)						-1.23	
SALARY	0.00328						-0.00352
(t-value)	2.83						-0.385
LOGMKTVAL		3.21866					-0.19149
(t-value)		12.48					-0.83
TENURE			0.10942				0.07868
(t-value)			1.78				2.17
NI3LS				0.2054			0.2032
(t-value)				33.39			32.03
Adj. R Square	0.0007	0.0157	0.0002	0.1511	0.0001	0.0001	0.1535
N	9796	9710	9388	6257	9792	9791	5917
F-test	8	155.69	3.16	1114.56	1.87	2.35	269.22

Table D.

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9	Model 10	Model 11
Dependent variable: Ethical_Score											
Intercept	0.84294	1.14889	0.85756	0.84326	0.85066	0.84809	0.84434	0.85124	0.83847	0.8424	1.15373
(t-value)	151.91	38.88	122.42	129.17	126.55	125.6	151.2	150.82	111.88	141.55	38.2
TDC2	8.466E-07										-5.22E-08
(t-value)	-2.16										-0.63
LOGMKTVAL		-0.03818									-0.03712
(t-value)		-10.59									-10.04
TRS3YR			-0.00107								-0.00057997
(t-value)			-3.68								-1.96
SALE3LS				-0.000129							-0.00026055
(t-value)				-0.57							-0.84
NI3LS					-0.000274						
(t-value)					-2.03						
OIBD3LS						-0.0005168					
(t-value)						-2.71					
ASSETS							-5.203E-07				
(t-value)							-2.95				
NIBEX								-0.00001604			
(t-value)								-6.31			
ROA									0.00040213		
(t-value)									0.48		
ROEPER										-0.00607645	
(t-value)										-0.52	
Adj. R Square	0.0028	0.0789	0.0097	-0.0005	0.003	0.0053	0.0059	0.029	-0.0006	-0.0006	0.0829
N	1300	1299	1281	1299	1022	1204	1300	1300	1300	1289	1280
F-test	4.67	112.19	13.55	0.32	4.11	-2.71	-2.95	-6.31	0.23	0.27	29.92

Table F.

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
Dependent variable: Ethical_Score (S&P 400)							
Intercept	0.84952	1.13926	0.86931	0.87252	0.84013	0.85425	1.1056
(t-value)	71.57	8	75.9	64.6	62.33	73.46	7.3
TDC2	-7.413E-07						0.00000172
(t-value)	0.59						-1.56
LOGMKTVAL		-0.0364					-0.0309
(t-value)		-2.01					-1.56
TRS3YR			-0.001				-0.0007097
(t-value)			-2.3				-1.38
SALE3LS				-0.0012			-0.0006088
(t-value)				-1.89			-0.86
ROA					0.00225		
(t-value)					1.41		
ROEPER						-0.000068	
(t-value)						-0.15	
Adj. R Square	0.001	0.0087	0.0124	0.0074	0.0029	-0.0029	0.0166
N	345	345	342	345	345	342	342
F-test	0.35	4.03	5.3	3.58	1.99	0.02	2.44

Table E.

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
Dependent variable: Ethical_Score (S&P 600)							
Intercept	0.91148	0.98064	0.9105	0.90346	0.89407	0.89201	0.88577
(t-value)	90.29	11.37	85.92	94.65	83.65	88.79	9.45
TDC2	-0.00000378						-0.00000327
(t-value)	-2.29						-1.89
LOGMKTVAL		-0.0123					0.00615
(t-value)		-0.95					0.42
TRS3YR			-0.0007				-0.00041896
(t-value)			-1.69				-0.86
SALE3LS				-0.00025074			-0.00061066
(t-value)				-1.05			-1.64
ROA					0.0008946		
(t-value)					0.75		
ROEPER						0.00065989	
(t-value)						1.39	
Adj. R Square	0.0089	-0.0002	0.004	0.0002	-0.0009	0.002	0.012
N	469	468	461	469	469	467	460
F-test	5.22	0.91	-1.69	1.09	0.57	1.92	2.39

Table G.

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
Dependent variable: Ethical_Score (S&P 500)							
Intercept	0.077783	1.06592	0.80074	0.77699	0.77164	0.77542	1.07368
(t-value)	80.82	11.97	62.08	58.95	56.4	76.25	11.91
TDC2	8.67E-08						-4.5656E-08
(t-value)	-0.95						-0.5
LOGMKTVAL		-0.0303					-0.02956
(t-value)		-3.27					-3.1
TRS3YR			-0.0016				-0.00153
(t-value)			-2.76				-2.5
SALE3LS				-0.00003785			0.00066667
(t-value)				-0.05			0.88
ROA					0.00060752		
(t-value)					0.41		
ROEPER						0.0000387	
(t-value)						0.25	
Adj. R Square	-0.0002	0.0924	0.0137	-0.0021	-0.0017	-0.002	0.0285
N	486	486	478	485	486	480	478
F-test	0.91	10.7	7.63	0	0.17	0.06	4.5

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