CEO COMPENSATION: A QUESTION OF ETHICS

A Senior Honors Thesis

By

JAMES HARRISON COLE

Submitted to the Office of Honors Programs
& Academic Scholarships
Texas A&M University
In partial fulfillment of the requirements of the

UNIVERSITY UNDERGRADUATE
RESEARCH FELLOWS

April 2004

Major: Accounting

CEO COMPENSATION: A QUESTION OF ETHICS

A Senior Honors Thesis

By

JAMES HARRISON COLE

Submitted to the Office of Honors Programs
& Academic Scholarships
Texas A&M University
in partial fulfillment for the designation of

UNIVERSITY UNDERGRADUATE
RESEARCH FELLOW

Approved as to style and content by:

Clair Nixon
(Fellows Advisor)

Edward A. Funkhouser
(Executive Director)

April 2004

Major: Accounting

ABSTRACT

CEO Compensation: A Question of Ethics. (April 2004)

James Harrison Cole
Department of Accounting
Texas A&M University

Fellows Advisor: Dr. Clair Nixon
Department of Accounting

The outrageous corporate accounting and fraud scandals in the past years have all but demolished investors' faith in our accounting framework. One big area of concern is executive compensation. In 1992, Congress enacted section 162(m) of the Internal Revenue Code, which limited executive compensation that is deductible to one million dollars a year. As an alternative, stock option plans have gained popularity. The reporting for these plans is very controversial however, as different methods produce vastly different expenses, both in size and timing. Another concern of many investors is earnings management, the concept of timing revenues and expenses in order to steady and inflate earnings. This has many implications within executive reporting as the method chosen can greatly affect compensation expense, both in size and consistency, and thus manage earnings. This paper will focus on both deontological and teleological ethical models in order to show the inherent inconsistencies contained within the intrinsic method of option reporting. The study also demonstrates ethical standards already existing within the accounting field which are irreconcilable with the intrinsic method of reporting. Both teleological and deontological models are used to demonstrate the current required method's shortfalls and prove the fair value method does not in fact violate the principles.

TABLE OF CONTENTS

INTRODUCTION

The question of right and wrong has plagued mankind for centuries. Sometimes a consensus is available but in many circumstances one is not. There are many circumstances where what is determined to be legal is viewed as wrong and vice versa. The distinction between legal and ethical is not always clear, as the numerous corporate accounting scandals that have rocked America's markets have recently demonstrated. Where the line is drawn has become increasingly murky and confused as mountains of FASB statements and Internal Revenue Code changes have dimmed what exactly is expected of the accounting profession.

For this inquiry I will examine ethical models created and refined by some of history's greatest thinkers. Two ethical models, which are more applicable to business situations, are the deontological approach of German philosopher Immanuel Kant, and the utilitarianism approach of John Stuart Mill. While each approaches ethics from a different starting point, both have strong points and holes in their arguments. For our purposes, they represent the polarities of ethical thinking, and will be examined more closely in conjunction with defined regulations.

This thesis follows the style and format of The Journal of Business Ethics

MORAL THEORIES

Kant's theory relies heavily on the concept of duty in order to determine what is morally right. According to Robert Johnson, this position can be summarized in the following way, "the performance of a dutiful action is morally good only if it is no accident that its motive led to it" (Johnson, 1996). In other words, if one performs an action because it is their job, that action is only morally good if their motive was to perform the action because that action was their job. This has many implications in the accounting profession. The next question that naturally arises is what exactly is one's duty when preparing or auditing financial statements? Is it to follow Financial Accounting Standards Board standards to their precise letter or follow the spirit of the ruling? What about Federal Tax regulations? Should tax professionals seek to simply minimize the tax burden of an entity or should they seek to comply with the law?

Utilitarianists, such as John Stuart Mill, have attempted to answer the ethical question by stating that in any given situation, the greatest good for the greatest number of people will be the morally right option. Under a utilitarian system, the greatest happiness or absence from pain is the greatest good. The natural progression is from a selfish point of view to a societal point of view (Boylan, 2000). Natural happiness then progresses to a greater good. "The utilitarian system is committed to the maximization of the good; for it asserts that we always ought to produce the greatest possible balance of value for all persons affected" (Beauchamp 4). Under this system, the probable consequences of an action must be considered before the choice is made. Naturally this seems to fall in line with the FASB's framework, as the effect on shareholders must be taken into account when preparing financial documents. The more information that can be supplied would seem to be better. But one criticism of this hedonistic approach is that there is no place to draw a line. We must sometimes sacrifice integrity in order to achieve the greater good. There is a distinction between quantity and quality of pleasure (Boylan, 2000). Again, a requirement consistent with this criticism is that financial statements be decipherable to persons with a reasonable understanding of business and economic activities (FASB, 1978). Yet another question, which can be raised, is that of the standard of good in the accounting world. Is it truth? That is does doing the most good involve most honestly representing the company? Or is it the bottom line? Does doing the most good involve maximizing the bottom line? Or maximizing the return to investors? Or does achieving the greater good involve following reporting regulations to the most precise letter? The questions we will seek to answer through an in depth analysis of federal regulations as well as through a survey of qualified CPA's.

LEGISLATIVE HISTORY

In 1993, the Internal Revenue Service introduced a new law, Section 162(M) of the Internal Revenue Code, which prohibited corporations from deducting CEO payments of greater than one million dollars. As a result, many companies have turned to other benefits, such as houses, cars, and most notably stock options. Stock Options are agreements that guarantee an employee the right to buy company stock at a predetermined price. They are not required however to make this purchase. This price is often far below the market price, which allows the option holder to make a sizable unrealized gain upon purchase. Once these agreements are granted the entity has several options when reporting their options. The first is known as the intrinsic value method. Under this method, which is required by the tax laws, a corporation calculates the compensation expense as the difference between the market value of the option at the grant date and the exercise value of the option at the grant date. The Internal Revenue Code requires these values to be equal. This method of reporting has been in place since APB No. 25. The APB not being the governing body, the FASB in 1993 tried to edit the reporting requirements to mandate the fair value reporting method. This method uses sophisticated option pricing models, which take into account the present and future values of a dollar, the likelihood the executive will exercise the option, and other factors to arrive at a fair market value of the option which is then recognized as compensation expense. The outcry from the corporate world was unprecedented, however, and Congress even threatened to intervene if the FASB went through with the proposal. The FASB then elected to make the fair value method optional but recommended. It has since required the effects of this method to be disclosed in pro forma in the income statement. The purpose of this inquiry is to argue for the fair value method of stock option reporting by answering the questions posed previously. The overall objective, towards which this endeavor will simply be a step, is to provide the American public with a trustworthy business system, within which the public can be certain ethical practices are being followed.

METHODOLOGY

Much musing has been done in the past by some of history's greatest thinkers as to the question of right and wrong. Additionally, scholars have commented on these models since their inception. For the purposes of this question, I will rely on original texts as well as commentaries. Several systems will be examined in detail, including the utilitarianism, a teleological approach and a code of ethics, or deontological approach. Many people, however, feel that philosophy is not a practical endeavor that can be applied to everyday life. As such, to find what is truly objectively ethical, we must not rely solely on reasoning. Two additional sources will be employed. The first will be the Financial Accounting Standards Board statements, which provide a framework for accounting by laying out its objectives, assumptions, principles, and constraints, as well as rules for specific situations, such as how to account for stock options. Second, empirical evidence will be used. Surveys will be sent out to practicing certified public accountants. Contacts made in the professional world will distribute the web-driven, anonymous survey to their peers. The survey will be distributed to approximately 350 potential respondents. These surveys will ask questions concerning an accountants' duty and the standard of measure for the greatest good. The purpose of the survey will be to establish motives and mores which I believe already exist in order to prove the intrinsic value method unethical. The respondents were presented with the following options and asked to rank the appropriateness of each on a one to seven scale with one being "Not Acceptable" and seven being "Expected."

1) Report items Pro Forma which are material in nature

2) Withhold information to increase one's own compensation through stock option plans

3) Report information as if the executive were a shareholder

4) Report items Pro Forma in order to maximize the bottom line

5) Disclose information to increase one's own compensation through stock option plans

6) Subtly modify information to increase stock price

7) Follow accepted but not recommended guidelines to increase net income

8) Report items Pro Forma in order to satisfy fair bargaining conditions

Answers will then be analyzed in order to determine any correlation between key linked questions and hopefully establish ethical norms within the profession.

RESULTS

The surveys were distributed to approximately 325 potential respondents, with a total of 46 responding to at least some of the questions. This produced a response rate of 14%. The questions with the fewest responses received 44. Potential respondents were asked a series of questions, or scenarios, listed above, with one representing "Not Acceptable" and seven representing "Expected." The results of the survey are listed below.

1) Report items Pro Forma which are material in nature

1	2	3	4	5	6	7
4	*1*	*1*	*5*	*6*	*8*	*21*

2) Withhold information to increase one's own compensation through stock option plans

1	2	3	4	5	6	7
43	*2*	*1*	*0*	*0*	*0*	*0*

3) Report information as if the executive were a shareholder

1	2	3	4	5	6	7
4	*3*	*2*	*7*	*4*	*6*	*18*

4) Report items Pro Forma in order to maximize bottom line

1	2	3	4	5	6	7
33	*5*	*4*	*3*	*1*	*0*	*0*

5) Disclose information to increase one's own compensation through stock option plans

1	2	3	4	5	6	7
36	*2*	*2*	*4*	*0*	*0*	*1*

---

6) Subtly modify information to increase stock price

1	2	3	4	5	6	7
38	*7*	*0*	*0*	*0*	*0*	*0*

---

7) Follow accepted but not recommended guidelines to increase net income

1	2	3	4	5	6	7
11	*15*	*7*	*8*	*1*	*2*	*1*

---

8) Report items Pro Forma in order to satisfy fair bargaining conditions

1	2	3	4	5	6	7
13	*2*	*1*	*16*	*5*	*2*	*5*

DISCUSSION

TELEOLOGICAL PERSPECTIVES

First off we will address the question from a utilitarian perspective. Utilitarians view the moral worth of actions in terms of their consequences (Beauchamp and Bowie, 2001). The ethical action is the one that produces the greatest positive of the options, for the greatest number of people.

The question which must next be examined, then, is this: what is the greatest good? The maximization of profits or stock price? Question number four of my survey attempts to examine this very question. The scenario "Report items pro forma in order to maximize bottom line" shows decidedly, that the predisposition in the profession towards this sort of reporting is negative. There is an obvious skew towards the "Not Acceptable" standard. The mean response on this particular question was a 1.6, with the standard of deviation being a 1.04. This low score can only indicate one thing: responding CPAs resoundingly felt that this practice was not acceptable! So what is the acceptable measure of good then?

I argue that in this study, the greatest good is achieved by meeting the objectives of financial reporting as laid out in the FASB Statement of Financial Accounting Concepts No. 1. Utilitarian theory asserts that society ought to always produce the greatest balance of positive and the least balance of negative. According to Beauchamp and Bowie (2001), the means to this maximization is efficiency. This is exactly what is achieved when adhering to the

FASB's objectives: efficiency within the reporting process, and an efficient, decipherable financial document. Efficiency is not however a good in and of itself. It is simply a means to a good. What is this ultimate good that we seek therefore? It is the objective of accounting: to provide information that will be useful to investors, creditors, shareholders, management, and others about the amounts, timing and uncertainties of future cash flows (FASB, 1978). To achieve this objective, the greater good, we must be certain of the characteristics of the information reported.

There are certain characteristics of useful accounting information which the FASB defines in Statement of Accounting Concepts No. 2. These are understandability, comparability and consistency, relevance (including timeliness, predictive value and feedback value), reliability (including verifiability, neutrality, and representational faithfulness) and materiality (FASB 1980). We will take each applicable characteristic in its turn.

First I examine relevance. In SFAC No. 2, the FASB defines relevance in financial reporting as the ability to make a difference in a decision (FASB 1980). This fits in with Mills theory in that making a difference in decision making is contributing to the greater good of providing useful documents. However, there are several criteria of the intrinsic value method which violate relevance. In SFAC No. 2 the FASB states that information is relevant to a situation if it can reduce uncertainty about the situation (FASB 1980). Under the intrinsic value method, compensation expense is the difference between market value at grant date and exercise value at grant date, *if any.* Sometimes there is a difference, and sometimes not. This greatly reduces the predictive value of the statement in that potential investors can never know if there will be a substantial charge to earnings in a given period or not, because that depends solely on the choice of exercise price. The fair value method however, produces earnings charges more consistent from period to period, if not solely for the purpose that these charges exist. This valuable earnings management tool can make the timing and amount of future cash flows very uncertain indeed.

Further, intrinsic value reporting lacks feedback value, as the potential investor can hardly view present performance in light of past performance if charges can be manufactured in such a way. The sixth scenario posed to respondents attempted to test the professional climate towards earnings management. The question, while admittedly simple, spoke loudly that the profession is strongly opposed to this practice. In fact, with a mean of 1.2 and a standard of deviation of 0.36, almost no conclusion can be made that this practice is acceptable. Why then is it practiced in the intrinsic value method of reporting?

Next we examine comparability and consistency. Information "gains great usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time" (FASB 1980). It is hard indeed to compare two companies if they choose to different avenues for intrinsic valuation. If company

A chooses to issue at market price, while company B chooses to issue $30 below market price, company B will have a significant and most likely material non-cash charge to earnings that A so luckily avoids. This makes information about future cash flows very uncertain when dealing between two companies. The same can be said within the same organization for two different periods. However, the fair value method provides much information in this regard. First of all, this method allows users to compare the value of the compensation executives are receiving on a dollar for dollar basis. Secondly, very educated users, who understand option pricing models, can ascertain a great deal of information concerning the entity's position relative to other entities' based on the value assigned to the options, including expected future performance.

The last applicable characteristic is materiality. Again in SFAC No. 2, the FASB defines material judgments as, "primarily quantitative in nature. To pose the question: Is this item large enough for users of the information to be influenced by it" (FASB 1980)? The question that is posed then is one of quantity. Is the difference between compensation expense using the intrinsic value versus the fair value material? That is, will using these two different methods of calculating expense produce different decisions by users? I argue yes. Studies have shown that this expense can be in the millions of dollars.

Finally, from a teleological perspective, we consider the matching concept. This concept originated in FASB SFAC No. 3 (1980) and was further modified in SFAC No. 6 (1985). The idea behind the concept is that expenses should be matched to the period of business for which the revenue occurred that generated said expense. Thus again we are presented with a problem. If revenue is generated by the contributions of an executive then a fair and equitable expense should be recognized in the same period as well. In fact studies have shown that company profits can be largely influenced by executives. Many have argued executive pay to be excessive on the grounds that it is not in line with the relative contribution of the executive. But as Donald Nichols and Chandra Subramaniam (2001) point out the responsibility and complexity of executive jobs far outweigh those of the average worker. Furthermore, changing conditions and increasingly difficult challenges arise daily in the office of chief executive officer (Nichols and Subramaniam, 2001) They go on to argue that if relative compensation were granted, the appropriate compensation would not be immediately evident. However, this does not lead to the conclusion that this larger compensatory amount should not be matched to its corresponding revenues and deducted accordingly, while the relatively smaller amount of the average worker is matched and deducted in full. But some may argue that if there is no expense, as required by the code for intrinsic value reporting, then no matching need occur. I however, do not consider no expense a fair and equitable expense.

DEONTOLOGICAL PERSPECTIVES

For this section I will largely rely on the results of the survey that was distributed. The first question we will examine is that of motive. Kant thought this was extremely important. In fact, the entire deontological system relies upon motive. That is to say deontologists consider things to be ethical right if they are fulfilled according to your duty, not because the deed involved some sense of personal gain or internal satisfaction, but because it was an entity's duty to act accordingly (Beauchamp and Bowie, 2001).

The first area examined will be disclosure. The question within the survey concerning disclosure were posed generally, but were designed to be applied specifically to this study. So the question I am asking becomes: was information disclosed, in this case compensation expense, because it was dutiful to disclose this information, or because the reporting entity stood to gain from the specific disclosure or withholding of compensation expense?

Scenarios number two and five were presented in order to attempt to determine the motivation behind reporting. Was it because an executive stood to gain from withholding or disclosure? Or because duty required reporting the way it was done? With regards to withholding information, respondents felt overwhelmingly that this was "Not Acceptable." In fact, this scenario received the lowest standard of deviation, at 0.35, while the mean response was 1.1. Clearly, the standard "withholding information for one's own gain is wrong" exists within the profession. On the flip side of the question, whether or not disclosure for one's own gain is acceptable, respondents were not as certain, but still heavily leaning towards "Not Acceptable." In fact, the mean response in this scenario was 1.5, while the standard of deviation was 1.24. While this is not as significant, I believe that it still points towards an established standard within the profession that "disclosure for one's own gain is wrong." Coupled together, these point to one significant reason for reporting information: duty. So the next logical question becomes: what is it our duty to report? Question number seven attempts to establish this and does so reasonably well. A mean response of 2.6 and a standard deviation of 1.48 show a healthy aversion to following accepted but not recommended guidelines. Then logically following, our duty is to report by recommended guidelines. I argue that the fair value method of reporting falls in line with duty, while the intrinsic value method does not.

Another deontologist, John Rawls, takes Kant's theory one step further. Rawls defines ethical behavior as that which it is dutiful to do under fair bargaining conditions (Rawls, 1971). These are defined as conditions that a free and rational person concerned to further their own interests would accept in an initial position of equity.

The first stone in building this argument is establishing the applicability of fair bargaining conditions. The scenario posed was whether or not executives are expected to report items as if the executive were a shareholder. This question's responses were the least notable, with a mean response of 5.1 and a standard of deviation of 2.04. While not proof of an industry standard, this does lead to the conclusion that it is between expected and acceptable to report information with this mindset. While not expected, I will call this practice appropriate, which leads to the conclusion that the fair bargaining constraints are the duty of the executive. In this area, accountants surveyed generally felt that it was between "Acceptable" and "Not Acceptable" to report pro forma items to satisfy fair bargaining conditions. The mean response to the scenario was a 3.5 and the standard of deviation a 1.99. While not staggering, I will call this "Not appropriate."

The relevance of this is becomes apparent when considering the rules of intrinsic value reporting. This method requires the expense which would have been incurred under the fair value method to be disclosed pro forma, with the effect on earnings included. Logically then, the reason to value stock options using the intrinsic value method is to maximize the bottom line seen by users. After all, if reported in the notes, the information is accessible, but reporting entities wish to convey a different figure that the one obtained under the fair value method.

Accountants did not however, feel that reporting items as pro forma in order to maximize the bottom line was acceptable. The mean response when presented with this scenario was 1.6 while the standard of deviation was 1.04. As discussed earlier, this leads to the conclusion that this practice is unacceptable. Which leads me to the following conclusions: although acceptable, reporting compensation expense pro forma (i.e. intrinsic value method) is done in order to maximize the bottom number seen by most users. This however does not satisfy the fair bargaining requirements, established as the duty of the executive, and is therefore unethical.

CONCLUSIONS

While an entirely theoretical discussion of ethical behavior is fine, little can be done if the profession does not try to adhere with the standards apparently already present. According to Alan Lovell, "human behavior is a function of many influences, and the transition from moral reasoning to moral behavior is both tenuous and troublesome (Lovell, 1995). What then is the next step? The next step is for the accounting profession to take responsibility for the standards intrinsic to its members, and for the FASB to take a stand on the issues it feels are pertinent. Nothing can be done until this occurs.

REFERENCES

Beauchamp, Tom L., Norman E. Bowie. Ethical Theory and Business. Englewood Cliffs, N.J.: Prentice-Hall, 2001.

Boylan, Michael. Basic Ethics. Upper Saddle River, N.J.: Prentice-Hall, 2000.

Financial Accounting Standards Board. (FASB). 1978. Statements of Financial Accounting Concepts Number 1. Norwalk, CT.

Financial Accounting Standards Board. (FASB). 1980. Statements of Financial Accounting Concepts Number 2. Norwalk, CT.

Financial Accounting Standards Board. (FASB). 1980. Statements of Financial Accounting Concepts Number 3. Norwalk, CT.

Financial Accounting Standards Board. (FASB). 1985. Statements of Financial Accounting Concepts Number 6. Norwalk, CT.

Internal Revenue Code. Section 162(m).

Johnson, Robert. "Expressing a Good Will: Kant on the motive of Duty." *Southern Journal of Philosophy*, Summer, 1996, XXXIV, No. 2.

Lovell, Alan. "Moral reasoning and moral atmosphere in the domain of accounting." *Accounting, Auditing & Accountability Journal*, 1995, VIII, No. 3

Rawls, John. A Theory of Justice. Cambridge, MA: Harvard University Press. 1971.

VITA

James Harrison Cole

ADDRESS
6407 Taimer Ct.
Sugar Land, TX 77479
Email: jcforjc@neo.tamu.edu

EDUCATION

Texas A & M University
Professional Program, Tax Track
GPR: 3.465

SCHOLASTIC ACHIEVEMENTS

- University Undergraduate Research Fellows Program, 2003-2004
- Mays Business School Honors Program
- Dean's List, Various Semesters

LEADERSHIP EXPERIENCE

- MSC Current Issues Awareness Committee, VP Programming 03
- Brotherhood of Christian Aggies, Treasurer June 02-May 03
- Fish (freshman) Camp Counselor 03-04
- Student Body President Campaign, Marketing Coordinator 03
- Impact Counselor 02
- Hosts Program (Helping One Student to Succeed) Fall 01

OTHER HONORS

Eagle Scout Award