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Do qualifications matter? New evidence on board functions and director compensation☆

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ABSTRACT

Prior research suggests that the effectiveness of corporate directors depends on their qualifications. We investigate whether directors' qualifications affect the roles they perform on the board (board functions) and their compensation. On average, directors that are more qualified handle more board functions, resulting in higher pay, but this is not true for "co-opted" directors (joined the board after the CEO). However, co-opted directors are assigned more functions and receive higher pay on boards where the CEO's influence is high. We also find that some firms award directors "discretionary compensation" (compensation that is unrelated to board functions), and that the likelihood of such compensation is correlated with CEO power. Overall, our evidence generates new insights into how director roles and financial incentives are allocated across directors, and the extent to which this allocation depends on CEO power.

1. Introduction

An explicit goal of recent financial regulation has been to ensure that board members are qualified to perform their board duties. The Sarbanes-Oxley Act of 2002 required the SEC to adopt rules concerning the independence of audit committee members and the necessity to include, or explain the absence of, a financial expert. In 2009, the SEC amended Regulation S-K, requiring firms to discuss, "for each director […] the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director."[1] This regulatory focus on directors' expertise may be justified given the empirical evidence that qualifications and experience of individual directors matter for corporate outcomes.[2]

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1 Source: Regulation S-K, item 401(e).

2 Director characteristics that have been shown to affect corporate outcomes include accounting and finance expertise (Agrawal and Chadha, 2005; DeFond et al., 2005; Güner et al., 2008), legal and consulting experience (Agrawal and Knoeber, 2001; Krishnan et al., 2011), political connections (Faccio, 2006; Goldman et al., 2009), academic qualifications (Audretsch and Lehmann, 2006; Francis et al., 2015), management experience (Perry and Peyer, 2005; Fich, 2005; Fahlenbrach et al., 2010), and directors' general skill sets (Adams et al., 2018).

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In addition to increasing demand for expertise, Sarbanes-Oxley and other contemporaneous regulatory changes increased the risks and workload of directors, and director compensation has increased rather dramatically (see Fig. 1): Average compensation for an outside directorship rose from $70,000 in 1994–1996 (Yermack, 2004) to $121,000 in 2002 (Farrell et al., 2008) to $189,000 in 2010 (our data). This is comparable to the increase in executive compensation over the same period.[3] And, while research has documented these increases and macro events that contributed to the rise, little research has examined what, if anything, drives director compensation at the director level. The dearth of research on this topic may be related to the fact that the structure of director compensation has historically been very similar across, and certainly within, firms. For example, Nili (2015) suggests "In each company, directors are compensated equally regardless of their affiliation, credentials or tenure […] with some slight differentiation based on specific committee service and the position of chairman" (p. 513). However, given the importance of individual characteristics for directors, do firms have ways to compensate directors for their credentials, leading to differences in pay?

Our objective is to examine compensation at the director level, and test whether qualifications hypothesized to be important for director service are associated with higher pay. We analyze a large sample of 13,239 outside directors that hold 17,150 board positions in 1777 firms between 2006 and 2010 and find that, on average, a board member receives $172,000 per directorship, with a standard deviation of $138,000. Importantly, more than a third of this variation is driven by pay differences within firms: the standard deviation within a board averages $47,000, while the spread between the highest and lowest paid outside director on a board averages $141,000.

What explains this variation in pay among directors? Traditionally, director compensation is comprised of a fixed annual retainer that is common across all directors, and a variable component that depends on the director's roles on the board – e.g., attending meetings, serving on or chairing committees, or being Chairman of the Board (COB) or lead director (Yermack, 2004; Ryan et al., 2004; Farrell et al., 2008). Thus, within-firm variation in director pay may arise if boards explicitly compensate individual directors outside this well-documented framework—which we show they sometimes do—or may be driven by how the board allocates its functions among its directors.

We examine two primary hypotheses regarding how a firm allocates board functions among its directors. The first, following Fama and Jensen (1983), is that board duties require substantial expertise. Consistent with this notion, a large body of evidence documents the importance of qualifications of individual directors as well as the sets of skills that the entire board possesses (Adams et al., 2018). Therefore, we expect director qualifications and experience to be important determinants of their board functions and their compensation. We refer to this as the *expertise hypothesis*.

The second hypothesis is that the board assigns functions to those directors that are friendly toward the CEO. We refer to this as the *friendliness hypothesis*. The notion that CEOs may be able to influence the firm's governance structure, and generally prefer outside directors that will monitor them less intensely, is a feature of some prominent models of corporate boards (e.g., Hermalin and Weisbach, 1998; Adams and Ferreira, 2007). Further, it is consistent with empirical evidence that CEOs attempt to bias new board appointments in their favor (Shivdasani and Yermack, 1999; Cohen et al., 2012), and that CEO-appointed directors monitor less (Coles et al., 2014; Khanna et al., 2015). As Carl Icahn suggests (*Business Week Online*, November 17, 2005), "members of the boards are cronies appointed by the very CEOs they're supposed to be watching."

To test the expertise hypothesis that more qualified directors perform more board functions and receive higher pay, we construct several measures of director qualifications. We measure a director's expertise by collecting each director's lifetime experience in the areas of law, consulting, academia, accounting, finance, management, politics, and the military, as well as their education. We also control for other director attributes, such as tenure, age, and gender. Consistent with the expertise hypothesis, our results show that more qualified directors receive higher pay. Almost half of this result is driven by the fact that more qualified directors perform more board functions: A formal mediation analysis (Baron and Kenny, 1986) suggests that board functions explain up to 46% of the relation between qualifications and pay in our sample. While, to our knowledge, no prior paper has analyzed the relation between board functions and director qualifications, this finding is not unexpected.

The friendliness hypothesis predicts that directors more loyal to the CEO perform more board functions and receive higher pay. To test this prediction, we identify directors who are appointed to the board after the CEO assumed office. Hermalin and Weisbach's (1998) model of CEO bargaining with the board suggests that directors appointed over the course of a CEO's tenure are less likely to be independent from the CEO. Further, as the share of these "co-opted" directors increases, the board's monitoring intensity decreases (Coles et al., 2014) and the risk of corporate fraud increases (Khanna et al., 2015). We find that co-opted directors, on average, receive *lower* compensation, which is inconsistent with the friendliness hypothesis. We also find that this effect is partially driven by the fact that co-opted directors perform fewer board functions.

We consider several possible explanations as to why boards assign co-opted directors fewer board functions, resulting in lower pay. First, co-opted directors might be less qualified. However, our results are unaffected when we control for director qualifications. Further, in an additional analysis we find no evidence that co-opted directors are systematically less qualified. Second, co-opted directors may be less willing to take on specific board functions. To investigate this possibility, we focus on the subsample of directors who simultaneously hold both co-opted and non-co-opted positions. We find that these directors hold significantly more board functions in their non-co-opted roles than in their co-opted ones. Thus, that boards assign fewer board functions to co-opted directors may be a choice made by the board, rather than a characteristic of co-opted directors per se.

Next, we investigate whether the board functions allocated to co-opted directors depend on the CEO's influence over the board. Formally, the nominating and governance committee is tasked with assigning board functions (and appointing new

[3] Executive compensation grew from an average of $2.1 million in 1994 to $5.4 million in 2010, an average growth rate of 5.9% per year (CEO total compensation, S&P 1500 firms, based on ExecuComp data). Over the same period, outside director compensation grew from $70,000 in 1994 to $189,000 in 2010, or at 6.4% per year.