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Non-compensation-related consultant service and CEO compensation

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ABSTRACT

This study examines how consultants' non-compensation-related consulting service (NCS) affects the contractual usefulness of accounting and stock information in executive compensation, as reflected in pay-performance sensitivity. The hypothesis is based on anecdotal evidence suggesting that consultants' provision of NCS is likely to adversely affect the quality of CEO compensation plans. We investigate whether the consultants providing NCS are involved in potential conflicts of interest. The results show that CEO pay is higher in companies where consultants provide NCS and have a higher NCS fee ratio. The pay-performance sensitivity in CEO compensation decreases when consultants engage in NCS. The overall results are consistent with NCS representing a conflict of interest and compromising the quality of compensation committees.

1. Introduction

A recent congressional report in the US (Waxman, 2007) points out a correlation between consultants' provision of non-compensation-related consulting service (NCS) and the level of CEO compensation. In response, the US Securities and Exchange Commission (SEC) mandates that all firms disclose all fees paid for compensation consultants' services, including compensation-related service and NCS, for fiscal years ending on or after December 20, 2009. This action is further based on the premise that consultants are willing to sacrifice their independence from CEOs in exchange for NCS engagement fees, and that disclosures of such fees attract the scrutiny of shareholders. NCS fees could impair consultant independence by making consultants economically dependent on the CEOs, reducing the consultants' objectivity. To investigate the validity of these concerns, we take advantage of the disclosure of compensation consultant fees and other related services fees in 2009 and investigate the influence of compensation consultants and their provision of NCS on CEO pay quality.

This paper examines whether compensation consultants providing NCS are effective in improving the contractual usefulness of accounting and stock information in CEO compensation, as reflected in pay-performance sensitivity (PPS). Many studies (e.g., Bebchuk and Fried, 2003; Waxman, 2007) argue that when compensation consultants provide NCS (e.g., actuarial, employee benefit, and pension services), the consultants are not independent from CEOs. Compensation consultants can have conflicts of interest because CEOs hire the consultants to provide NCS at the same time that compensation committees

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hire the same consultants for CEO compensation advice (Bebchuk and Fried, 2004). Consultants who fear losing NCS fees would be more likely to recommend pay contracts that favor the CEO at the expense of shareholders.

The literature on performance evaluation argues that the weight placed on a performance signal should increase with its precision and sensitivity to an agent's effort (Jensen and Murphy, 1990). If providing NCS does not impair consultant independence, we would expect that consultants providing NCS do not decrease the weight placed on firm performance in determining CEO compensation. In contrast, if providing NCS increases the consultant's economic dependence on the CEO, we would expect the sensitivity of CEO compensation to accounting and stock performance to be lower for firms with consultants providing NCS.

Several recent studies examine whether NCS threatens consultant independence (e.g., Murphy and Sandino, 2010; Cadman et al., 2010). This line of research uses "indirect proxies" to measure conflicts of interest (where, e.g., firms hire their auditors for significant non-audit services, indicating a willingness to allow possible conflicts of interest among their professional service providers).[1] The research has yielded mixed results for the contention that NCS impairs consultant independence. Murphy and Sandino (2010) find that CEOs earn more when compensation consultants supply extra services, but Cadman et al. (2010) produce evidence to the contrary. As the use of indirect proxies can create measurement errors, we attempt to provide additional evidence on this issue by using a more direct measure of conflicts of interest to investigate the level and pay-performance sensitivity of CEO compensation.

We limit our sample to fiscal year 2009 because of the availability of information relating to executive compensation consulting and non-compensation consulting fees in the proxy statements. We hand-collected the compensation consultant data for firms in 2009, including the executive compensation consulting and non-compensation related services fees from the compensation committee reports in the proxy statements. We use two measures to proxy the conflicts of interest: (1) an indicator for the NCS, and (2) the ratio of NCS fees to compensation fees (hereafter, the NCS fee ratio).

We find that for firms hiring consultants to provide NCS, CEOs receive higher equity and total compensation and their payments are less sensitive to their performance. In addition, the NCS fee ratio is positively associated with CEO compensation. The association between the NCS fee ratio and CEO pay-performance sensitivity is significantly negative with respect to equity and total compensation. Our results suggest that provision of NCS creates a conflict of interest which adversely affects the advice consultants offer on CEO compensation.

This study contributes to the literature in two ways. First, we augment the consultant literature by considering how consultants affect pay-performance sensitivity (Conyon et al., 2009; Voulgaris et al., 2010). Second, we contribute to the current debate on consultant independence by finding evidence that provision of NCS adversely affects how consultants design CEO compensation (Cadman et al., 2009; Murphy and Sandino, 2010). Exploiting the new disclosure rule in 2009, we can measure the influence of consultants' conflicts of interest on CEO's pay with less measurement error.

The remainder of the paper is organized as follows. Section 2 briefly describes the institutional background and the related literature. Section 3 develops the hypotheses to be tested. Section 4 delineates the research design and the data construction, and Section 5 discusses the empirical results. An additional test is presented in Section 6, and Section 7 concludes our paper.

2. Background and literature review

2.1. Required disclosure of compensation consultants

In light of the criticism that consultants are responsible for excessive executive compensation, many countries have mandated the disclosure of consultants. For example, in the UK, Directors' Remuneration Report Regulations 2002 came into force on 1 August 2002 (Conyon, 2009). For financial years ending on or after 31 December 2002, companies' annual reports must include detailed information on the levels and the structure of the pay both of executives and of the consultants that the compensation committees hire (Voulgaris et al., 2010). Also, in Canada, disclosure rules in effect since early 2005 require companies to identify their compensation consultants and illustrate the nature of any other services the consultants provide (Murphy and Sandino, 2010). The US Securities and Exchange Commission (SEC) came under pressure to follow suit since firms using compensation consultants were found to have less total shareholder return than those without such consultants (Higgins, 2007).

Since 2006, the SEC has required that companies provide a "Compensation Discussion and Analysis" (CD&A) section in their annual proxy statement to enable shareholders to evaluate the cost of leadership for public companies. Item 407(e)(3)(iii) of Regulation S–K (effective on December 15, 2006) requires disclosure of any consultant engagement on executive compensation, the scope of the assignment, whether the consultants are engaged directly by the compensation committee rather than by the management, and the material elements of the directions given to the consultants. However, the mandate in 2006 did not ask companies to disclose any NCS provided by consultants. A recent congressional report (Waxman, 2007) finds that over two-thirds of the Fortune 250 firms that hired NCS in 2006 did not disclose NCS information

[1] Cadman et al.(2010) use three proxies to measure the conflicts of interest among their consultants: (1) whether firms hire non-audit services from their auditor; (2) whether consultants are clients of Frederic Cook, or Pearl Meyer, large consultants that do not offer NCS; and (3) whether firms disclose NCS in the proxy statements. Murphy and Sandino (2010) use U.S actuaries' fees as identified from the IRS and defined-benefit plans from Department of Labor filings to measure the potential conflicts of interest.