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Compensation consultants and CEO pay



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ABSTRACT

The study examines the practice of employing multiple compensation consultants. Examining data of a sample of UK companies over the period 2003–2006 we find that CEOs receive higher equity-based pay when firms employ more than one compensation consultant. An increase in the number of compensation consultants is also associated with an increase in CEO equity-based pay, whereas no decline in CEO pay takes place when firms reduce the number of pay consultants. We also observe that the market shares of compensation consultant are positively related to CEO equity-based pay.

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1. Introduction

The adoption of compensation consultants in the executive pay setting process has become a widespread practice in the corporate world. These consultants are frequently hired by a firm's compensation/remuneration committee which is responsible for the design of Chief Executive Officer's (CEO) pay package. The consultants do not only offer advices on whether to pay with bonus, options, shares, etc., but also on how much each compensation component should be. On the one hand, they are viewed as provider of useful services and helping firms to achieve optimal compensation

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contracting (Conyon et al., 2009). On the other hand, there is also a strand of literature that views pay consultants as helping firms to justify higher pay awards (Bebchuk and Fried, 2003). Looking from the critical management perspective, Ogden and Watson (2012) argue that pay consultants facilitate firms to attract and retain executives of the appropriate quality, experience and skills that are necessary to achieve business success for the firms.

Recent studies document that a vast majority of listed firms in the US and the UK employ compensation consultants. Interestingly, studies find that CEOs of these firms receive higher pay relative to those who do not employ any pay consultant (Conyon et al., 2009; Murphy and Sandino, 2010; Cadman et al., 2010; Goh and Gupta, 2010; Voulgaris et al., 2010; Armstrong et al., 2012). A notable phenomenon that remains unexplored is that many firms seek recommendations from not just one but several compensation consultants (Conyon et al., 2009; Murphy and Sandino, 2010). While studies have put forward conflicting arguments about the role of compensation consultants, none has explicitly investigated (primarily because of lack of publicly available data) how firms' CEOs have benefited from employing more than one compensation consultant. The main purpose of our study is to conduct an empirical investigation of this question. This is an intriguing issue knowing that these consultants do not come cheap. The study also explores how CEOs of firms have benefited from employing compensation consultant with large market shares.

We examine compensation consultants employed by a sample of UK listed firms. Our study is of particular interest because each and every firm in our sample uses at least one pay consultant and more than half of these firms employ multiple consultants. Although prior studies (e.g. Cadman et al., 2010; Conyon et al., 2009; Voulgaris et al., 2010) have examined whether firms with compensation consultants pay their CEOs more relative to those who do not employ any pay consultant, we are not aware of any study that has specifically investigated the practice of employing multiple compensation consultants.

Another distinct feature of our study is that we analyze data covering several consecutive years (2003–2006) whilst prior studies have examined compensation consultant data for only one year [Goh and Gupta (2010) is the only exception]. In contrast to US firms which had to disclose consultant related information with effect from December 2006, UK firms started providing this information several years earlier. We also examine how CEO pay changes when firms decide to increase or reduce the number of consultants from one year to another.

A number of important findings emerge from our analysis. First, we observe significantly higher equity-based pay for CEOs of firms that rely on more than one compensation consultants. These findings hold after controlling for firm, corporate governance and CEO characteristics. Second, we find that an increase in the number of compensation consultants is associated with an increase in equity-based compensation. But, there is no corresponding decline in CEO compensation when firms reduce the number of pay consultants. Third, we find that the market share of compensation consultants is positively related to client firm's CEO pay.

One may be tempting to argue that pay consultants may have intentionally advised toward higher CEO pay in order to secure their business interests with the client firm. Alternatively, higher CEO pay may also reflect the unintended outcome of competition among pay consultants. However, it is also important to understand the complexities of the pressures and processes confronting pay consultants in the determination of CEO pay. The critical management perspective indicates that advising toward higher pay could be a beneficial strategy to facilitate firms to secure executives of the appropriate quality, experience and skills. Furthermore, equity-based pay such as stock options can be efficient in matching managerial pay and ability (Arya and Mittendorf, 2005). Therefore, the observed increase in equity-based compensation in the presence of multiple consultants may suggest that pay consultants were competing in facilitating firms to attract executives with the right talents by advising toward higher equity-based pay.

The remainder of this paper is structured as follows. Section 2 reviews relevant studies and outlines two research questions. Section 3 describes the research method which is then followed by description of data in Section 4. Section 5 presents the empirical results of the study. Section 6 discusses the findings of the study.

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