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STATEMENT OF THE PROBLEM

OBJECTIVES

HYPOTHESES

RESEARCH METHODOLOGY

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FINDINGS

RECOMMENDATIONS/SUGGESTIONS

CONCLUSIONS

SCOPE FOR FURTHER RESEARCH

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APPENDIX/ANNEXURE

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CONTRIBUTIONS TO BOOKS

- Sharma T., Kwatra, G. (2008) Effectiveness of Social Advertising: A Study of Selected Campaigns, Corporate Social Responsibility, Edited by David Crowther & Nicholas Capaldi, Ashgate Research Companion to Corporate Social Responsibility, Chapter 15, pp 287-303.

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- Schemenner, R.W., Huber, J.C. and Cook, R.L. (1987), "Geographic Differences and the Location of New Manufacturing Facilities," Journal of Urban Economics, Vol. 21, No. 1, pp. 83-104.

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- Garg, Sambhav (2011): "Business Ethics" Paper presented at the Annual International Conference for the All India Management Association, New Delhi, India, 19–22 June.

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- Kumar S. (2011): "Customer Value: A Comparative Study of Rural and Urban Customers," Thesis, Kurukshetra University, Kurukshetra.

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OUTSIDE DIRECTOR COMPENSATION IN THE ELECTRIC INDUSTRY

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ABSTRACT

Boards of directors are supposed to monitor managers' activities for firm stockholders based on the agency theory proposition. However, numerous real world examples show that boards of directors are not independent. Firm failures at the turn of century and the market crash in 2008 have led to increased stockholder activism and the passage of Sarbanes–Oxley in 2002 and Dodd-Frank Act in 2010. These factors have increased the pressure on boards to be more effective agents of the stockholders. Therefore, director compensation as an agent interest alignment tool is an important issue and our paper will investigate this issue in the electric industry around 2008.

KEYWORDS

Electiricity industry, outside director compensation.

I. INTRODUCTION

The electric industry started deregulation in the 1990s'. Recently, this industry garnered even more competition from reusable energy like solar and wind which are government subsidized. Because of this stiff competition, managers of the electric industry have received greater scrutiny from shareholders. At the same time, the role of monitoring managers became more important to boards of directors, especially outside boards of directors. However, real world anecdotes show boards of directors are friends of managers, not friends of investors. Compensation is one of the mechanisms for aligning the interests of the boards with those of the shareholders. Therefore, our study investigates the compensation structure of boards within the electric industry. We obtained our director compensation data from DirectEdgar®. Other data of firm characteristics are from Research Insight.

We found that equity compensation given to directors is aligned more with increased sales for the electric industry. However, cash director compensation continued to increase during our test period as found in previous studies. This issue was a major concern of government as our capital market crashed in 2008, but director compensation continued to increase.

II. PREVIOUS STUDIES

Several previous studies have examined executive compensation. Bryan et al. (2005) empirically studied firm performance and CEO compensation in electric utilities. Boyd (1996) showed that the boards of directors also have played a significant role. However, few studies have discussed the compensation issue of directors. Directors are more like agents of shareholders if they don't own stock. Their best interest are more like those of managers, not shareholders. To minimize this problem of misalignment of interests of directors, shareholders turn to equity-based compensation. However, this is an empirical research question we need to test using real world data. We assume firm performance is related to director compensation as previous studies have assumed.

Boyd (1996) developed a model of director compensation with firm performance and found four variables are significantly related to director compensation: equity ownership by directors, firm size, firm profitability, and resource richness of the board. However, Boyd emphasized that director compensation varied considerably over industries and firms. Therefore, our study focuses only on the electric industry. In addition, we divide compensation into three categories: cash-based, equity-based, and total compensation.

The electric industry experienced deregulation in the 1990s' and improved firm-level performance and efficiency (Peterson, 2007). Recently, Granderson and Prior (2013) also found that productivity grew from 1996 to 2000 in the U.S. electric utility industry. However, Liu and Yu (2013) found earnings management behavior in the Chinese utility industry. In a similar context, Wollan (2005) found that electric utility firms change the composition and character of their boards in response to the newly deregulated environment. Therefore, the electric industry is a good example to understand firm performance and director compensation issues.

Next we discuss relevant factors related to director compensation.

Director Equity Ownership: Holderness and Sheehan (1988) found empirically that directors with higher stock ownership did not necessarily compensate themselves more. However, Boyd (1994) found that directors with higher stock ownership showed lower management compensation. This result suggests a better alignment between director and shareholder interests. From previous discussions, we propose our hypothesis as follows:

Hypothesis 1: Compensation of directors in the electric industry is related to their stock ownership.

Firm Size: Larger firms may have higher political costs to maintain their reputations and chances of litigation. Higher political costs to maintain good reputations as socially responsible firms requires higher compensation for managers as well as directors. Gregg et al. (1993) showed that firm size was the major factor in

setting director compensation. However, Brick et al. (2002) showed mixed results. They found that firm size when measured by the log of the number of employees was positively related to total director compensation. However, they found that firm size when measured by the log of sales was negatively related to total director compensation. Therefore, our second hypothesis is proposed as follows:

Hypothesis 2: Compensation of directors in the electric industry is related to firm size.

Firm Performance: We assume that CEO and director compensation are related to firm performance. However, empirical research results testing the relationship between firm performance and director compensation are mixed. Cubbin and Hall (1983) found a positive relationship between firm performance and director compensation using U.K. data. However, Crystal (1991) found no relationship between firm performance and director compensation using U.S. data. Brick et al. (2002) found that the one-year average lagged ROA was positively related to director cash compensation, but the one-year lagged ROA was negatively related to the fraction of noncash compensation. However, three-year stock returns were positively related to the fraction of noncash compensation. In addition, Subrahmanyam et al. (1997) found negative abnormal returns relative to the portion of outside directors' compensation in bidding banks. Our hypothesis three is proposed as:

Hypothesis 3: Compensation of directors in the electric industry is related to firm performance.

Resource dependency theory posits that firms are subject to numerous external factors (Boyd, 1996). These include: shareholders, regulators, suppliers, employees, and competitors (Pfeiffer, 1987; Pfeiffer & Salancik, 1978). Resource dependency theory suggests that successful firms are those that minimize the adverse influence of those external factors. It views the board of directors as providing expertise, information, and access, minimizing the impact of external factors. If the number of board members measures individual resource richness and expertise, our fourth hypothesis is proposed as follows:

Hypothesis 4: Compensation of directors in the electric industry is related to resource richness.

The investment opportunity set of the firm may influence directors' equity compensation. Equity compensation will align director interests more closely with those of other shareholders. If directors increase their shareholdings over time, their interests are more like those of shareholders. Yermack's (2004) empirical results showed that this holds for directors' compensation. Guay (1999) found firms with greater investment opportunities utilize a greater portion of equity-based compensation. However, Booth and Deli (1996) found a negative relationship between a firm's investment opportunity set and the number of outside directors. Therefore, our fifth hypothesis is proposed as follows:

Hypothesis 5: Equity-based compensation of directors in the electric industry is related to the firm's investment opportunity set.

Recently increased criticism from the general public about CEO and director compensation, has caused firms to move away from per-meeting fees to retainer compensation structures. Additional retainer pay is appropriate for directors serving on committees that impose substantial extra demands (Goldstein & Venulex, 2011). For example, the median expected salary for a typical compensation and benefits director in the U.S. is $136,876 (Salary.com, 2013). There are some differences according to the work and time commitment of each director. The fees for each meeting are not trivial and directors may perform more monitoring activities and have more commitment if they meet more frequently. Therefore, our sixth hypothesis is proposed as follows:

Hypothesis 6: Compensation of directors in the electric industry is related to number of meetings.

III. METHODOLOGY

Compensation data for the electric industry was collected for 2006 – 2009 from DirectEdgar®. Internal directors generally do not get paid compensation for their service on the board, but external directors get paid compensation and therefore, we focus on external directors as have other studies (Boyd, 1996).

Director compensation is composed of cash or stocks or combination of both. Therefore, we analyze them separately and jointly.

Stock Ownership: Stock ownership of external board members is measured as the percentage of stock owned by those directors.

Firm Size: Net sales is a frequent measure of firm size. It has a high correlation with other measures of firm size (Shalit & Sankar, 1977). We use the log of sales to obtain a more normal distribution of our size measure. We also use the log of total assets (Yermack, 2004) as a measure of firm size. Additionally, because there may be a significant difference between the book value of assets and their market value for many electric utility firms, we use market capitalization as an additional measure of firm size.

Profitability: We use two traditional measures of profitability: Return on Assets and Return on Equity. Return on Assets is measured as Net Income divided by Total Assets and Return on Equity is measured as Net Income divided by Total Equity.

Resource Richness: We use the number of external directors. Boyd (1996) found that firm performance was linked to having fewer board members, but more environmentally connected directors. Presumably, external directors are brought onto the board for their knowledge and connections. Hence, we also use the number of external board members as a measure of resource richness.

Investment Opportunity: Yermack (2004) used two measures of investment opportunities: Tobin's Q (measured as the market value of equity plus book value of debt divided by total assets) and research and development expenditures scaled by total assets. We use Tobin's Q.

Control Variables

Leverage: More highly leveraged firms should use less equity compensation to lessen the impact of the agency costs of debt. We use the ratio of the book value of total debt to the book value of total assets as our measure of leverage.

Cash scarcity: Financial contracting theory predicts a shift to equity compensation in the presence of cash scarcity. The balance sheet amount for cash does not necessarily measure the scarcity of cash. It may have just been borrowed, or may be committed to a particular end. A more telling measure of the scarcity of cash is the payment of dividends. We follow Yermack (2004) and use a dummy variable as the indicator of the payment (1) or nonpayment (0) of dividends and hence cash scarcity.

Model

DC = PSOD + FP + FS + BOD + TQ + LV + CS + TF,

where,

DC is Director Compensation in log form. Here we use the logarithm of the director cash and equity compensation and the combination of both compensations as our dependent variables similar to Brick et al. (2002). PSOD is the percentage of stock owned by directors. FP is Firm Performance. We use net income divided by total assets and net income divided by total equity as our variables. FS is Firm Size, as log of sales, log of total assets, and total market value. BOD is Resource Richness, measured as the mean number of external directors as defined in Boyd (1996). TQ is the investment opportunity set. We use Tobin's Q with the market value of equity plus book value of debt divided by total assets used as Tobin's Q measure. LV is the leverage ratio. We measured leverage as total debt divided by total assets, and used it as a control variable. CS is Cash Scarcity, a control variable. We use dividends paid or not as a measure of cash scarcity; using a dummy variable with (0) being the absence of dividends and (1) as the payment of dividends.

IV. RESULTS

Table 1 presents the descriptive statistics for all electric utility firms during 2006-2009. Mean log of sales is 9.47 and mean log of total assets is 9.92 for the U.S. electric industry. Net income to total assets are 3.1% and net income to total equity is 10.5%. Leverage ratio is 36.64%. The U.S. electric industry has a strong leverage ratio for our test period. Tobin's Q is 0.86. The Tobin's Q ratio seems too low even though the electric industry was under regulation. This implies that the U.S. electric industry does not have much investment opportunity. However, dividend payout ratio is 84.72%, which means most firms pay dividends. Average number of board of directors are 11 and they meet 10 times a year. Mean log value of cash, equity, and total compensation for our sample firms are 5.890, 5.833, and 6.197, respectively. This is comparable to director compensation in the oil and gas industry. Each year, regression results of our models of director compensation of electric utility firms are not very consistent. Therefore, we report combined all data and 2009 regression results for further analysis.

TABLE 1: DESCRIPTIVE STATISTICS; ALL YEARS (2006-2009)

Variable	N	Mean	Std Dev	Minimum	Maximum
LSA	148	9.4661994	0.6103933	7.551462	10.2755187
LTA	148	9.9204308	0.5863669	8.090776	10.7163874
NITA	148	0.0305687	0.0270435	-0.06955	0.2110664
NITE	148	0.1047436	0.0759373	-0.1958	0.4195363
TDTA	148	0.3664123	0.0768905	0.19811	0.6981689
Tobin Q	144	0.860255	0.2552879	0.422867	2.0902919
DIV	144	0.8472222	0.3610289	0	1
MV	144	7931761215	9661396799	24865000	53978980000
TCPD	147	775777.35	304987.14	179000	1733258
TEPD	147	681265	722278.76	-4657900	5033791
TCompD	147	1572393.73	923483.79	-4148155	5420331
PSOD	147	0.0041909	0.0107126	0.000109	0.0891062
BOD	147	11.0748299	2.0543587	5	19
BM	147	10.1428571	4.9545883	4	50

Variable definitions:

LSA : Log of Sales
LTA : Log of Total Assets
NITA : Net Income/Total Assets
NITE : Net Income/Total Equity
MV : Total Market Value of Equity
Tobin's Q : The Market Value of Equity plus Book Value of Debt/Total Assets
TDTA : Total Debt/Total Assets
DIV : If Dividend is paid 1; 0 otherwise
PSOD : Percentage Stock Owned by Directors
BOD : Total number of Board of Directors
BM : Number of Board Meetings
TCPD : Total Cash Compensation Paid to Directors
TEPD : Total Equity Paid to Directors
TComPD : Total Compensation Paid to Directors

Table 2 shows regression results for each year. Interestingly, the cash-based compensation model shows the highest adjusted R-squared values for all three years. The equity-based model is worse in 2008. This is the year of the market crash and directors may have wanted to be paid in cash. The overall results are similar to those of previous individual years as shown in Table 3. For all years, only the cash-based model seems meaningful as adjusted-R squared value is 72.27% and significant. In this cash-based compensation model, only Total Number of Boards of Directors and Total Number of Board Meetings were significant at conventional levels. However, 2009 is the year where results of our model are similar to those of previous studies. Therefore, our discussion will be based on the results of Table 4. For 2009, adjusted R-squared value for the cash-based compensation model is 66.22% and the equity-based compensation model's adjusted R-squared value is 57.7%. Total combined compensation model's adjusted R-squared value of 88.18% and significant.

TABLE 2: REGRESSION RESULTS FOR EACH YEAR

		TCPD	TEPD	TComPD
Adjusted R^2	(2006)	0.5888	0.2848	0.1906
Adjusted R^2	(2007)	0.7618	0.0743	0.1902
Adjusted R^2	(2008)	0.8133	-0.1172	0.0980

TABLE 3: REGRESSION RESULTS FOR ALL YEARS

	Expected Sign	TCPD	TEPD	TCompD
Intercept		-3.97	-2.27	-3.41
LSA	+/-	1.18	0.22	0.23
LTA	+/-	0.11	0.81	1.09
NITA	+/-	0.4	-0.85	-0.26
NITE	+/-	0.86	0.72	0.31
MV	+/-	0.02	-0.07	0
Tobin Q	+/-	-1.82	1.67	1.1
TDTA	+/-	0.91	-0.89	-0.34
DIV	+/-	0.94	-2.68	-2.03
PSOD	+/-	-1.57	1.58	0.92
BOD	+/-	9.04	0.51	2.78
BM	+/-	5.45	-0.2	1.21
F-Value		33.7	2.62	6.6
Adj R-Sq		0.7227	0.1146	0.3088

Variable definitions:

LSA : Log of Sales
LTA : Log of Total Assets
NITA : Net Income/Total Assets
NITE : Net Income/Total Equity
MV : Total Market Value of Equity
Tobin's Q : The Market Value of Equity plus Book Value of Debt/Total Assets
TDTA : Total Debt/Total Assets
DIV : If Dividend is paid 1; 0 otherwise
PSOD : Percentage Stock Owned by Directors
BOD : Total number of Board of Directors
BM : Number of Board Meetings
TCPD : Total Cash Compensation Paid to Directors
TEPD : Total Equity Paid to Directors
TComPD : Total Compensation Paid to Directors

To test H1, we used PSOD. It has the expected positive sign and is significant only with the equity-based compensation model. For our test period, electric utility firm director compensation is aligned with shareholder interests with the equity-based compensation model. This implies that the U.S. electric utility firms should use more equity-based compensation for their external directors.

We used three size variables to test H2. The log of total assets has the expected positive sign and is marginally significant in the Total Compensation model. However, the log of sales and total market value variables are not significant. Our results cannot support H2. To test H3, we used the profitability variables defined as Net income/Total assets and Net income/Total equity. However, our results are not significant. Our results are similar to those of Crystal (1991) who found no relationship between firm performance and director compensation in a U.S. study.

To test H4, we used the number of external directors. We found positive and significant results from the number of external directors variables in the cash compensation and total compensation models, but the equity-based compensation model was not significant. Our results support that the number of external directors variable was positively related to firm performance.

To test H5, we use Tobin's Q, but it is not significant and positive in equity-based compensation and the combination of both forms of the compensation model. To test H6, we include the number of board meetings. However, it is marginally significant for only the combined compensation model. We cannot support H5 and marginally support H6 for the U.S. electric utility firms. H6 implies that the more meetings boards of directors have, their interests are aligned with those of shareholders. For control variables, the leverage variable is not significant. The cash scarcity variable which is measured by whether a dividend is paid or not is negative and marginally significant only in total combined compensation model.

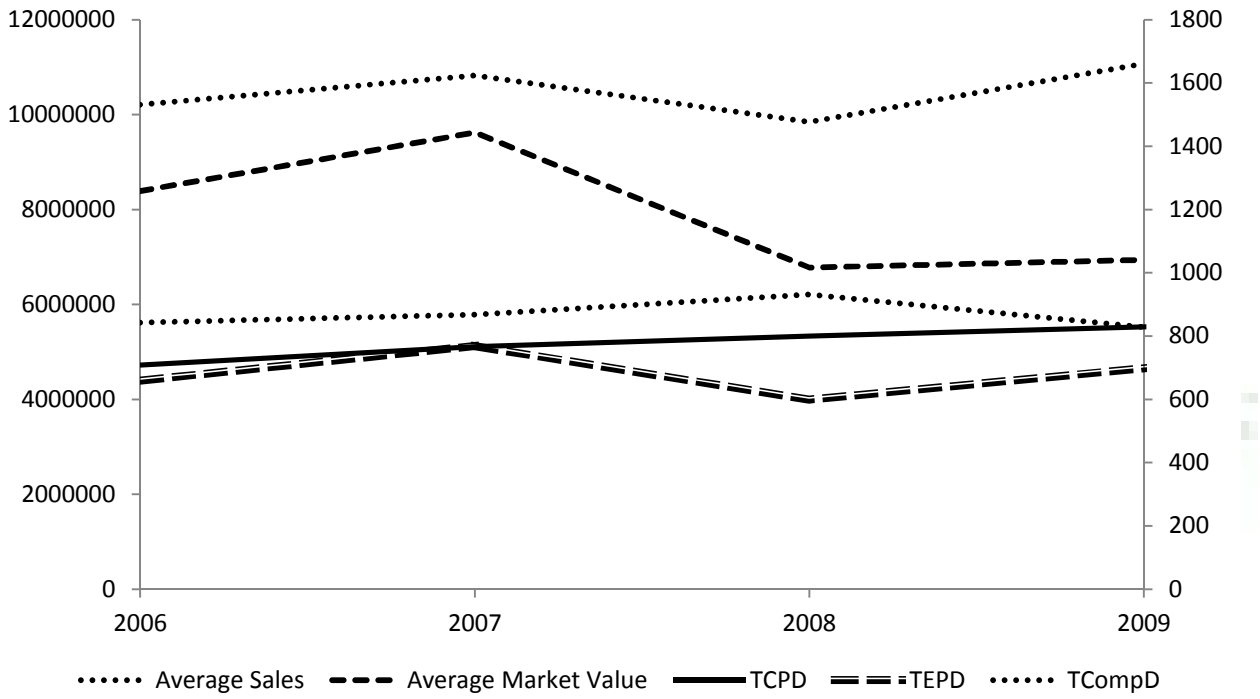
TABLE 4: REGRESSION RESULTS FOR 2009

	Expected Sign	TCPD	TEPD	TcompD
Intercept		-1.72	-1.65	-4.01
LSA	+/-	0.92	-1.08	-1.12
LTA	+/-	-0.28	1.73	2.49
NITA	+/-	0	0.79	0.37
NITE	+/-	0.92	-0.16	0.53
MV	+/-	-0.71	1.01	0.11
Tobins	+/-	-0.55	0.64	0.66
TDTA	+/-	0.42	0.15	1.5
DIV	+/-	-0.01	-1.32	-2.62
PSOD	+/-	-0.89	2.99	2.03
BOD	+/-	3.54	1.79	6.96
BM	+/-	1.75	-0.37	2.71
F-Value		7.06	5.22	24.05
Adj R-Sq		0.6622	0.577	0.8818

Variable definitions: same as table 3.

Figure 1 shows overall trends of average sales and average market values with cash-compensation, equity-compensation, and total combined compensation models. Over our test period, cash compensation continued increasing even though average market value of U.S. utility firms decreased. Average sales were down in 2008, but they increased again in 2009. Total combined compensation continued increasing until 2008, but decreased in 2009. Overall, the equity-based compensation model follows a similar pattern with average market value or average sales. This finding is similar to those of previous studies.

FIGURE 1: DIRECTOR COMPENSATION TRENDS



V. CONCLUSIONS

In this study, we exam the relationship between director compensation and firm characteristics. We use only the electric industry so that we can test our questions in a homogeneous environment. We found positive and significant results from the number of external director variables in cash compensation and total combination of compensation, but the equity-based compensation model is not significant. Our results support that the number of external directors

variable was positively related to firm performance. In addition, from Figure 1, we found that the equity-based compensation model follows a similar pattern with average market value or average sales. This finding is similar to those of previous studies.

There are limitations in our study. We may need to expand our test period since our test period includes the 2008 stock market crash. This might explain why our results are not stable before and during the market crash for the U.S. electric industry. We use only one industry and we cannot generalize our findings to other industries.

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