

### ACCOUNTING & AUDIT

## High Fees for Compensation Consultants Leads to Higher CEO Pay

With high CEO pay a decades-long source of agitation among observers of corporate management, it is no surprise that there has been much finger-pointing at the army of executive-compensation (EC) consultants that companies look to for guidance on this matter.

By Ben Haimowitz



With high CEO pay a decades-long source of agitation among observers of corporate management, it is no surprise that there has been much finger-pointing at the army of executive-compensation (EC) consultants that companies look to for guidance on this matter.

For example, an influential Congressional report in 2007 complained that "compensation consultant conflicts of interest are pervasive," pointing out that close to half of the country's largest corporations received CEO-pay advice from consultants that

were providing the firms with other services over which CEOs likely have the principal say. And, as the report noted, these other services, such as administering employee benefits and managing human resources, typically amount to many times the fees for EC consulting.

Taking its cue from observations along these lines, regulation of EC consultation has focused on what has come to be called cross-selling – on the danger that consultants will curry favor with CEOs through munificent pay packages as a means of tapping into the riches gained in providing other company services. Thus does the SEC require that companies disclose the fees of EC consultancies whose additional fees to the client exceed \$120,000, while exempting those below that level.

To which the consulting industry responded, following the regulation's adoption in 2009, with a wave of spinoffs, which witnessed the creation of many EC specialty firms – that is, consultancies devoted exclusively to EC. Exempt from the fee-disclosure mandate, specialty firms enjoyed a rapid increase in market share.

Given these developments, how effective is a continuing regulatory focus on cross-selling? A study in the ***Journal of Management Accounting Research***, a peer-reviewed publication of the **American Accounting Association**, raises doubts.

The new research suggests that since 2009 the reward to EC consultants for sumptuous CEO pay packages has had less to do with gaining access to additional company services (in other words, with cross-selling) than with securing repeat EC consulting at high fees. Researchers Jeh-Hyun Cho of Arizona State University, Jeong-Hoon Hyun of NEOMA Business School in France, and Iny Hwang and Jae Yong Shin of Seoul National University, Korea, write that among multi-service providers they “find no evidence that CEO pay is higher when non-EC fees are higher, providing no support for the cross-selling hypothesis.” In contrast, among the same group they “find strong empirical support for the repeat-business hypothesis suggesting that consultants receiving higher EC fees recommend higher total [CEO] compensation in an effort to secure future engagement with clients.”

Indeed, the study estimates that for every one percent increase in the average EC fee, by \$1,770, CEOs enjoy an increase of \$4,474 in total pay. In other words, “the change in CEO compensation is almost three times larger than that of EC...support[ing] the notion that when compensation consultants receive higher EC fees (i.e, they have greater incentive to secure future engagements with the client), they are more inclined to recommend higher CEO pay.”

Comments Professor Hyun of NEOMA, “What we have brought to light here is opportunism that seems to have been overlooked by the SEC. The government has focused on the potential for abuse in cross-selling, which probably has made that particular problem recede as companies and consultants have become aware of the attention it attracts. Our study is the first to uncover a quite different conflict of interest based on abnormally high EC fees that consultants have a keen interest in perpetuating.”

But, if gaining repeat EC business is so important to the consultants, why not set fees low as a way of appealing to clients' natural desire to minimize expenses? Citing prior findings of other investigators from in-depth interviews with members of corporate compensation committees, the professors explain that "EC fees are rarely mentioned as a major consultant selection criterion for the board, possibly because these are relatively small in amount...The fact that boards rarely mention EC fees as a major consultant selection criterion implies that charging a higher EC fee does not necessarily result in less chance of retention, raising the possibility that successful EC consultants could charge higher fees without fear of being replaced."

The study also takes note of prior academic research that compared specialty consultants that were spun off by big consultancies following the 2009 regulation (and therefore not required to disclose their EC fees) with multi-service EC consultancies subject to the fee-disclosure rule. The former group, it turned out, were associated with significantly higher pay packages for client CEOs, suggesting opportunism – namely, that the spin-offs were beholden to the interests of top management at the expense of shareholders. The research suggested that regulators should look especially closely at companies that hire spun-off EC specialists rather than multi-service consultancies.

But are the multi-service consultants as free of opportunism as that earlier research suggested? To find out, the authors of the new study assembled data on fees for EC and non-EC services from proxy statements of 313 large corporate clients during the five years following the 2009 regulation; then they analyzed their relationships to CEO pay, controlling for an array of factors affecting compensation. In order to test for the strength of the consultancies' incentives to perpetuate their EC services, the researchers developed a model to predict normal consulting fees based on characteristics of client companies, their CEOs, and their corporate governance. In addition, they drew on a considerable body of prior research on executive pay to assess appropriate levels of CEO compensation.

As indicated above, the study's findings suggest that the size of EC fees, but not of total non-EC billings, is a significant driver of CEO compensation, with abnormally high fees associated with excessive CEO compensation. They also find this opportunism concentrated among consultants with more than five years' tenure with clients, suggesting the connection between excessive CEO pay and repeat consulting. Unsurprisingly, they also find it over-represented among weakly governed companies, classified as such on the basis of a host of governance-related factors identified in prior management research.

The professors see their findings as of value to regulators, who, they write, "ought to reconsider the current asymmetric disclosure rule [i.e., the exemption for specialty EC consultants] that merely limits the cross-selling incentive, and require all firms to disclose EC fees regardless of whether they purchase non-EC services from the same consultant."

"What our research reveals," Prof. Hyun adds, "is that high EC fees are not the negligible factor they have often been thought to be in CEO compensation. There is no reason to

think this less true for single-purpose consultancies exempt from fee disclosure than for the multi-service providers in our study. Although disclosure does not always prevent abuses, publication of consultants' fees – and perhaps, of the length of their tenure as well – can provide clues to the kind of opportunism our work has uncovered.”

The study, “Compensation Consultant Fees and CEO Pay,” is in the spring issue of the ***Journal of Management Accounting Research***, which is published three times yearly by the **American Accounting Association**, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *The Accounting Review*, *Auditing: A Journal of Practice and Theory*, *Accounting Horizons*, *Issues in Accounting Education*, *Behavioral Research in Accounting*, *Journal of Information Systems*, *Journal of Financial Reporting*, *Journal of Forensic Accounting Research*, and *Journal of the American Taxation Association*.