Compensation Consultants and Conflicts of Interest: Two Different Views

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Companies that use compensation consultants end up paying more to their CEOs, but a new Wharton study suggests that conflicts of interest between the consultant and the firm aren't to blame.

Critics contend that compensation consultants have a financial interest in pushing for excessively high CEO packages because many of them profit from doing other work for the company. A recent Congressional committee report supported the idea that such conflicts drive up CEO pay. "There's a feeling that executives are overpaid, and people want to get to the bottom of this issue," says Wharton accounting professor Mary Ellen Carter, who coauthored this latest study with Brian Cadman, a visiting professor at Wharton and a professor of accounting information and management at Northwestern's Kellogg School, and Stephen Hillegeist of INSEAD.

Their research, which included 880 large firms, found that while executives get paid more when compensation consultants are involved, the CEOs are still held to acceptable pay-performance standards. "We are unable to find widespread evidence of more lucrative CEO pay packages for clients of conflicted consultants despite anecdotal evidence to the contrary," the researchers conclude. The study is called, "The Role and Effect of Compensation Consultants on CEO Pay."

According to Cadman, it's understandable, especially in this down market, that shareholders and consumers are suspicious of highly paid CEOs. The subprime mortgage crisis has drawn even more attention to the lucrative deals that executives cash in on. "People see CEOs continuing to get high levels of compensation and they are not seeing a lot of performance in their own portfolios," says Cadman, adding, however, that his team isn't "finding much evidence that consultants are helping CEOs extract more wealth" from firms.

The issue of executive compensation and the influence of compensation consultants have been scrutinized by the House Committee on Oversight and Government Reform, chaired by Rep. Henry A. Waxman, a California Democrat. The committee issued a report in December 2007 on Fortune 250 companies that found that firms with the highest conflicts of interest with their consultants (as measured by other work the consultants did for the firm) tended to offer higher executive compensation packages.

"In many cases, the consultants who are advising on executive pay are simultaneously receiving millions of dollars from the corporate executives whose compensation they are supposed to assess," the report concluded. In some cases, the compensation consultants were paid more than $10 million for doing other work for the company.

Executive pay has attracted a lot of attention in recent months amid the turmoil in the subprime mortgage market. At a hearing in March, Waxman's committee focused on the executive pay and compensation practices of three companies, Countrywide Financial, Merrill Lynch and Citigroup.

Passive Boards

The use of compensation consultants is clearly growing. Of the 880 firms included in the Wharton study, 86% used a compensation consultant. "Little is known about the role of compensation consultants in the design of incentive schemes or how they influence executive pay levels," the researchers write. "The question has become particularly important as the use of compensation consultants has risen rapidly over the past few years. Stronger governance rules have also caused boards to rely more on the advice of independent consultants."

Compensation consultants can be useful to companies in several ways. They can offer expert advice on accounting and tax regulations that come into play in structuring executive compensation packages. They also can have access to proprietary information on industry-wide practices and on what competitors are paying. "More generally, with their specialized knowledge and expertise, compensation consultants have the ability to help the firm maximize shareholder value by designing compensation schemes that more closely align the interests of managers with shareholders," the researchers write. A pay package with a lower base pay and more cash bonuses and equity-based pay tied to firm performance would generally favor shareholders since the CEO has a financial incentive to make the company run well.

But critics of compensation consultants point to numerous downsides, claiming, for example, that "consultants help disguise and justify excessive executive pay," the researchers write. Critics also suggest that compensation consultants can recommend "compensation schemes that provide greater pay without requiring greater performance" and that pay packages like that reward the executives at the expense of shareholders, according to the paper.

Compensation consultants also may have their own interests in mind when they design executive packages if they do additional business with the firm, such as actuarial work and other benefits consulting, critics suggest. Consultants "may be under considerable pressure to recommend higher pay packages for executives in order to retain their other, potentially more lucrative, consulting business with the client firm," the researchers write.

Meanwhile, boards may find it appealing to rely on consultants' recommendations, giving them some justification to approve high executive compensation, the researchers conclude. The hiring of consultants can provide "captive boards with the opportunity to attribute compensation design to the advice of experts and the pay practice of peer firms."

Carter says that, until recently, there was very little publicly available information on the use of compensation consultants. The SEC now requires companies to include a "Compensation Disclosure and Analysis" section in their annual proxy statement, including information on whether the firm used a compensation consultant to determine executive pay.

To conduct their research, the Wharton team looked at S&P 1500 firms in the ExecuComp database for fiscal year 2006. Using the disclosure information, they were able to determine which and what type of companies utilized compensation companies. In general, the companies that relied on consultants tended to be significantly larger and have more business segments than those that didn't use them. Their CEOs also tended to have shorter tenures and own a smaller share of the firm. In addition, the companies that used consultants also had large compensation committees that met more often than firms that didn't use consultants.

The researchers found that 70% of the firms that used consultants relied on one of five large consulting firms: Towers Perrin, Mercer Human Resources Consulting, Hewitt Associates, Frederic W. Cook and Watson Wyatt. Among the remaining consultants, Pearl Meyer & Partners was used most frequently.

"We find that clients of consultants compensate their CEOs with higher levels of salary, bonus, and stock option grants (as measured by the fair value)," as well as higher total compensation, the researchers conclude. Equity pay (stock and option grants) made up 40% of the compensation for CEOs in firms that used consultants, compared to 26% for firms that didn't.

No Compelling Evidence

To examine the question of whether consultants' conflicts of interest influenced CEO pay, the researchers divided the consulting firms into two broad groups. Those that may provide no services except for compensation consultation were categorized as having no conflict of interest. The consulting firms that may provide other services were characterized as having potential conflicts of interest. The authors use three different ways of dividing the firms into these two categories -- whether the hired consultant's market strategy is *not* to provide other services, whether firms disclose that the consultant does other work, and whether the firm's auditor provides non-audit services.

"We find no evidence of rent extraction -- [i.e., giving unjustified or unwarranted pay to the CEO] -- in the form of lower pay-performance sensitivity among the clients of these consultants," the researchers write. "Overall, we do not find compelling evidence that the controversy and accusations regarding the use of potentially conflicted compensation consultants are warranted."

Their conclusions differ from those of Waxman's committee, which based its findings not only on information disclosed in proxy statements of Fortune 250 companies, but also on information specifically requested from six top consulting firms. The firms were asked to provide information on what other services they provided to companies they consulted with.

"In 2006, the median CEO salary of the Fortune 250 companies that hired compensation consultants with the largest conflicts of interests was 67% higher than the median CEO salary of the companies that did not use conflicted consultants," the Waxman report concluded. "Over the period between 2002 and 2006, the Fortune 250 companies that hired consultants with the largest conflicts increased CEO pay over twice as fast as the companies that did not use conflicted consultants."

Carter offers two explanations for the differences between the two studies. She says the Congressional committee did not take into consideration a number of variables that her study did. "The study failed to control for economic determinants of pay and therefore its conclusions should be interpreted with caution," she and her colleagues write. For example, bigger and well-performing firms tend to pay their CEOs more. If these types of firms are also the kind of firms that hire consultants to provide other services, the Committee could have been led to their conclusion, not because the conflicts led to higher pay, but because the characteristics of these firms warranted greater pay, Carter states.

Still, she acknowledges that it's possible the House committee is right and her team is wrong. The Congressional committee had the benefit of subpoena power, Carter says, so it had a clean measure of conflicts of interest because consulting firms provided proprietary information on revenues from executive compensation consultant and other services.

While Carter said she has requested, with no success, the data used by the committee, she, Cadman and Hillegeist concede that the imprecise measures they used might have led to their conclusion. According to Cadman, "without [the Committee's] data, we have no way of knowing the true cause of the difference in conclusions."

The authors add, however, that "despite subjecting our analyses to a battery of alternative tests, we are unable to provide consistent evidence of rent extraction in the presence of conflicted consultants. Overall, and contrary to recent reports, [our] analysis suggests that among firms that hire consultants, there does not appear to be widespread evidence of manipulation of CEO pay when consultants have the possibility of greater conflicts of interest."

Clearly more research is needed to sort through the CEO pay controversy, says Carter, adding that the debate is going on in a very public forum so that more light can be shed on the executive compensation system. "Some people say it's a free market and salaries are negotiated. On the other hand, some people believe the process is broken." The evidence from this study, she notes, supports the former point of view.