Want to keep CEO pay down? Perhaps don't use a compensation consultant

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Companies that use compensation consultants end up paying more for their CEOs, according to a new study that peers into the 'black box' of CEO pay at a time when boards are under pressure to justify high payments.

The study, to be published in the upcoming edition of the *Australian Journal of Management*, and conducted by the University of Technology Sydney (UTS) and Auckland University of Technology, is the first to examine the use of compensation consultants in an Australian setting.

It finds that the top 500 ASX listed companies that use a consultant pay their CEO more than those that don't, all other things being equal.

"We took into account the size of the company, profitability, risk, debt levels and corporate and governance structures. Even after controlling for all these factors we still see higher pay on average with consultant use," says lead researcher Dr. Nelson Ma from UTS Business School.

But it is not clear, without further research, whether the higher pay associated with consultant use is due to consultants' recommendations or because a company hires a consultant to legitimise higher pay.

Around 30 per cent of companies examined used a compensation consultant to provide a formal recommendation on CEO remuneration. The findings support research from the US and UK that also shows CEOs are paid more when consultants are involved.

"There has been a lot of controversy around CEO pay, and anger over multimillion-dollar remuneration packages, particularly in light of findings from the banking royal commission," says Dr. Ma.

"If a CEO is paid $17 million or $20 million, shareholders want to know it is based on the CEO's hard work creating value, reaching targets and increasing returns, not because they have been able to find ways to line their own pocket," he says.

"The more we know about CEO pay, the better decisions shareholders and regulators can make," he adds.

Companies hire compensation consultants because they offer expertise around remuneration structures and knowledge of pay practices across a particular market.

"The process of setting pay is effectively a black box," Dr. Ma says. "Investors can't see what CEO pay is based on, and even when firms do disclose this, much of it is based on unclear targets or non-quantifiable information."

The researchers also looked at what happened to CEO pay when a company that did not previously use a compensation consultant decided to engage one. They found the CEO subsequently received a larger increase in their pay package.

Another key finding was the more a consultant is paid, the more the CEO is paid. Companies that retained a compensation consultant for more than a single year had even higher CEO pay than those who first engage a consultant.

Dr. Ma suggests this may be because the relationship is one of mutual benefit. Consultants have a financial incentive to be retained longer term and be employed to provide additional services to the company.

The exception to the results was when a Big Four accounting firm serves as the compensation consultant. For these firms there was no correlation between the use of, and fees paid to, a compensation consultant, and higher CEO pay.

"This may be because compensation consulting is a smaller percentage of their revenue and service offerings, and therefore there is less financial dependence on any individual compensation consulting client," says Dr. Ma.

The requirement for firms to publicly disclose compensation consultant use is part of a broader package of regulatory changes introduced in 2011 around executive remuneration.

The 'two strike' rule, where a company that receives two consecutive votes of more than 25% against its remuneration report must hold another vote on whether to force the board to stand for re-election, was also introduced at this time.

Some of Australia's biggest companies, including Westpac, NAB, ANZ, AMP and Telstra, have received 'strikes' from shareholders in protest against the remuneration practises of these companies.

Provided by University of Technology, Sydney