

DO COMPENSATION CONSULTANTS ASSIST IN SETTING EASY TARGETS IN PERFORMANCE-VESTED EQUITY PLANS FOR CEOS?

In this paper, we examine the role of a compensation consultant in executive compensation design. We find that firms hiring compensation consultants set more challenging performance targets than firms not using a consultant. The potential conflicts of interest between a client firm and its consultant (i.e., the consultant providing multiple services to the client) does not influence the target difficulty.

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The role of a compensation consultant in the design of executive compensation has not only attracted tremendous media attention, but also has evoked a heated debate among academics. Whereas Conyon et al. (2009), Goh and Gupta (2010), and Murphy and Sandino (2010) find a positive relationship between the use of a compensation consultant and the level of executive pay,¹ Cadman et al. (2010) find no evidence that compensation consultants relate to a higher CEO pay level or a lower pay-for-performance sensitivity (PPS)² when they have incentives to fawn on the CEO. This study differs from prior research by explicitly examining whether the use of compensation consultants is associated with the target choices in performance-vested equity plans for CEOs.

Using a unique set of hand-collected data on 257 listed firms in the UK from the FTSE 350 and Small Cap from 2002 to 2008, we find that (1) firms hiring at least one compensation consultant tend to set more challenging performance targets in their CEO's equity vesting than firms not using a consultant; (2) whether or not to provide non-compensation related services will not influence the target difficulty. Overall, our evidence is consistent with the view that compensation consultants assist in designing optimal compensation contracts for CEOs.

The stated aim of using a compensation consultant is to improve the efficiency of compensation design (Cadman et al., 2010). However, the reality might deviate from its original expectation. Compensation consultants may have incentives to make the compensation package in the CEO's best interest. E.g., pay consultants may have cross-selling incentives, which can compromise the independence and objectivity of

compensation consultants, and result in consultants recommending higher levels of pay and supporting contracts that lead to a weaker PPS compared with the recommendations made by consultants less subject to conflicts of interest (Cadman et al., 2010). On the other hand, studies show that compensation consultants are concerned about their reputation and associated costs, and hence have incentives to improve the efficiency of the compensation packages (Cadman et al., 2010). Our findings add new evidence to the ongoing debate and are supportive of the view that to guard their reputation as respectable service providers compensation consultants will implement compensation design in the shareholders' best interest.

Our findings firstly have implications to shareholders. It is of great importance for shareholders to vote on the appointments of compensation consultants. Despite the concern on conflicts of interest and associated firm value deprivation in case of conspiracies between self-interested management and external consultants, shareholders are able to protect firm value and optimal compensation efficiency to management by appointing a prestigious consultant. Second, our results suggest that regulators can restore and improve market-wide confidence by strengthening the monitoring of compensation consultants. More specifically, policy makers should consider establishing an evaluation system to rate consultant agents on a regular basis. Ideally, a reliable independent third party should be involved and perform the evaluation and dissemination of the results. Like the role of S&P to ensure sound functioning of bond markets, an independent rating agency who assesses on consultants' reputation and good-deeds will play a significant role in building up market discipline.

The remainder of this paper is organized as follows. Section 1 reviews the related research and develops our hypotheses, followed by a description of sample selection, research method, and regression models in section 2. Section 3 discusses the results. Section 4 concludes.

1. Literature review and hypothesis development

Setting performance targets in executive compensation is most of the time carried out by a remuneration committee that largely comprises of independent directors. The independence of the remuneration committee is promoted by the Cadbury (1992) Report, which made the following recommendation: 'boards should appoint remuneration committees, consisting wholly or mainly of non-executive directors and chaired by a non-executive director, to recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice as necessary' (Cadbury 1992, Article 4.42). Subsequently, a corporate board or its remuneration committee usually hires an external compensation consultant to provide professional advice on compensation-related issues. Conyon et al. (2009) acknowledge several reasons why the use of a compensation consultant can be more effective than designing compensation packages that are solely based on the judgment of the committee, such as infrequent meetings of the committee, no specialists in the field of executive compensation, and so on.

In the existing literature there has been a heated debate on the effectiveness of compensation consultants in designing executive compensation contracts (Conyon et al. 2011). Multiple theories have been utilized to fuel the debate. Research based on managerial power theory first questioned the use of compensation consultants. Bebchuk and Fried (2003) consider the use of pay consultants as a potential agency problem. The consultants have a tendency to favor the CEO because the CEO usually has a big say on the choices of compensation consultants.³ When a consultant does not fulfill the CEO's expectations, it will become difficult for the consultant to obtain repeat business; there is also a slim chance for the consultant to be hired by other firms due to its poor relationship with the current client. Hence, compensation consultants have strong incentives to propose, support, and justify compensation plans that are favorable to the CEO

rather than to optimize the CEO pay, and it is more likely to be so when the CEO has dominant power over the board. In sum, the use of compensation consultants is merely a camouflage of CEO's rent seeking behavior.

The empirical evidence on the use of compensation consultants in relation to CEO pay is largely mixed. Goh and Gupta (2010) observed a positive relationship between the level of CEO pay and the use of compensation consultants when firms switched their main consultant, which supports the conjecture that CEOs may engage in opinion shopping to justify their payroll. However, they did not find evidence that CEOs of firms that increased their number of pay consultants had a higher increase in their compensation packages. Conyon et al. (2009) found a positive relation between the use of consultants and the proportion of equity based compensation. Likewise, Goh and Gupta (2010) found that the proportion of equity linked compensation such as stock options and long-term incentive plans was higher in firms that hired compensation consultants. However, the interpretation of the finding should be drawn with caution because equity compensation usually comes with performance targets (either explicitly in performance hurdles attached to equity vesting or implicitly in stock price itself), and hence a higher level of equity pay means differently when the performance target difficulty is varying.

Managerial power theory also questioned the independence of compensation consultants. Bebchuk and Fried (2003, p. 79) observe 'executive pay specialists often work for consulting firms that have other, larger assignments with the hiring company, which further distorts their incentives [to design optimal compensation contracts]'. Despite that some consultants (e.g. Frederic W. Cook & Co. and Pearl Meyer) are specialized in the field of executive compensation and do not provide other business services to their clients, Conyon et al. (2009) found that in their sample of 231 UK firms 43 percent hired pay consultants that offered non-compensation related services such as auditing, tax advice, human resource management, and general strategy advice in 2003. Murphy and Sandino (2010) documented that in both the US and Canada CEO pay was higher in firms that employed a 'conflicted' consultant who provided multiple services to the same client. They also found in their Canadian sample that CEO pay was higher when the fees paid to the

consultant for other services were much higher than the fee paid for the advice on executive compensation. In contrast, Conyon et al. (2009) did not find evidence that using compensation consultants who provided multiple services lead to greater CEO pay or to more favorable compensation packages (e.g. pay decoupled from performance). The results are in line with Cadman, et al. (2010) and Armstrong et al. (2012) who neither found any evidence that the use of consultants providing other services was a primary driver of excessive CEO pay. Their findings can be interpreted within the optimal contracting framework that compensation consultants supply useful information and contribute their expertise on the design of optimal compensation packages. Indeed, compensation consultants should be concerned about their reputation as independent payroll professionals. If a consultant holds close ties with the top management of the client firm and offers outrageous pay to the CEO, it might trigger public outrage; the consultant will not want to bear the economic and social costs of public outrage because it is unlikely that other firms will hire the consultant due to the spillover costs. As Cadman, et al. (2010; p. 264) put it 'reputation and credibility incentives can limit consultants' desires to act on the cross-selling incentives'.

The current study links the role of compensation consultants to target choices in performance-vested equity compensation. The Greenbury Report released in 1995 followed the tradition of the Cadbury (1992) Report and addressed a growing concern about executive compensation in the UK. 'Grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives. Consideration should be given to criteria which reflect the company's performance relative to a group of comparator companies in some key variables such as total shareholder return' (Greenbury, 1995, p. 17). Given the debate and mixed empirical findings on the role of pay consultants in the design of executive compensation, it is far from clear whether the board will set more challenging/value enhancing performance targets to the equity vesting when a compensation consultant is hired and when the consultant also provides other services to the client firm. If the use of compensation consultants and their potential conflicts of interest with the client firms related to easily attainable targets, then it would be in line with managerial power theory that the desires to secure repeat

business and to cross-sell services compromise the compensation consultants. However, if optimal contracting theory prevails, we should observe that the use of a compensation consultant relates to challenging performance measures at equity vesting; and there should be no relationship between the potential conflicts of interest (i.e., the consultant offering non-compensation related business to the same client) and target difficulty.

2. Research design

Sample selection

Our sample consists of 257 non-financial firms, 217 firms from FTSE 350 and 40 from Small Cap during the period 2002-2008. Our data has been derived from several sources. The information on compensation consultants and performance targets is manually collected from the firms' annual reports. BoardEx provides information about executive compensation, demographics, and corporate governance features. Compustat Global provides the financial data and capital market information.

Measuring target difficulty

Similar to Kuang and Qin (2012), we measure target difficulty from two aspects and construct a multidimensional target difficulty score (DIFF) that aggregates the two scores. The first score refers to the target difficulty in absolute performance terms (i.e., annual EPS growth). In our sample, an average target requires the annual EPS growth net of inflation to be 3.6% for performance-vested stock options (PVSO) and 3.7% for performance-vested share (PVS). Since the difference in the average performance targets between PVSO and PVS is rather small, the same cut-off values are assigned. A value of 5 is assigned for the target above 5%; 4 if it is between 4% and 5%; 3 if between 3% and 4%; 2 if between 2% and 3%; and 1 if the target is below 2%.

The second score measures the difficulty in relative performance terms (i.e., TSR targets). The assumption is that targets based on an explicitly selected peer group are more challenging than those based on a market index. The more recent studies find that targets based on an explicitly selected peer group, compared to those based on an index, are more consistent with the economic motivation of relative performance evaluation and therefore more challenging. The score equals 5 if the vesting of stock

	# ExPLICITLY defined peer group	% EXPLICITLY defined peer group	# In-dustry/ Sector indices	% In-dustry/ Sector indices	# Mar-ket indices	% Market indices	# No com-parator group	% No com-parator group	# Total	% Total
New Bridge Street	76	24.44	18	24.00	66	36.26	5	31.25	165	28.25
Towers Perrin	50	16.08	8	10.67	26	14.29	1	6.25	85	14.55
Deloitte	50	16.08	11	14.67	11	6.04	0	0.00	72	12.33
Pricewaterhouse-Coopers	19	6.11	4	5.33	5	2.75	0	0.00	28	4.79
Watson Wyatt	18	5.79	7	9.33	8	4.40	3	18.75	36	6.16
Mercer HR Con-sulting	6	1.93	1	1.33	7	3.85	0	0.00	14	2.40
Kepler Associates	8	2.57	6	8.00	7	3.85	0	0.00	21	3.60
Hay	8	2.57	1	1.33	0	0.00	0	0.00	9	1.54
Other	49	15.76	14	18.67	29	15.93	2	12.50	94	16.10
No consultant used	27	8.68	5	6.67	23	12.64	5	31.25	60	10.27
Total	311	100.00	75	100.00	182	100.00	16	100.00	584	100.00

Table 1. The choices of comparator group in TSR targets for PVS vesting by main consultant

	# ExPLICITLY defined peer group	% EXPLICITLY defined peer group	# In-dustry/ Sector indices	% In-dustry/ Sector indices	# Mar-ket indices	% Market indices	# No com-parator group	% No com-parator group	# Total	% Total
New Bridge Street	6	19.35	0	0.00	14	30.43	0	0.00	20	20.20
Towers Perrin	10	32.26	2	9.52	7	15.22	0	0.00	19	19.19
Deloitte	1	3.23	1	4.76	0	0.00	1	100.00	3	3.03
Pricewaterhouse-Coopers	1	3.23	3	14.29	0	0.00	0	0.00	4	4.04
Watson Wyatt	4	12.90	1	4.76	0	0.00	0	0.00	5	5.05
Mercer HR Con-sulting	0	0.00	3	14.29	2	4.35	0	0.00	5	5.05
Kepler Associates	4	12.90	3	14.29	2	4.35	0	0.00	9	9.09
Hay	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
Other	3	9.68	4	19.05	9	19.57	0	0.00	16	16.16
No consultant used	2	6.45	4	19.05	12	26.09	0	0.00	14	14.14
Total	31	100.00	21	100.00	46	100.00	1	100.00	99	100.00

Table 2. The choices of comparator group in TSR targets for PVS0 vesting by main consultant

and stock options depends on performance relative to an explicitly selected peer group; 4 if it is an industry/sector index; 3 for a standard market index (i.e.,

FTSE 100, FTSE 250, FTSE 350, FTSE All Share, or FTSE Samll Cap); 2 for other reference groups; and 1 for no comparator group. Our sample consists of

Con- sult- ants	# '02	% '02	# '03	% '03	# '04	% '04	# '05	% '05	# '06	% '06	# '07	% '07	# '08	% '08	# Total	% Total	Share of firms using a con- sult- ant
Bridge	25	19.53	45	29.22	55	31.61	62	33.16	71	36.79	78	37.32	74	36.45	410		32.85
Tow- ers	25	19.53	25	16.23	24	13.79	26	13.90	25	12.95	25	11.96	23	11.33	173		13.86
De- loitte	10	7.81	15	9.74	13	7.47	17	9.09	21	10.88	30	14.35	30	14.78	136		10.90
PwC	8	6.25	8	5.19	13	7.47	9	4.81	12	6.22	13	6.22	19	9.36	82		6.57
Wat- son	11	8.59	13	8.44	10	5.75	13	6.95	9	4.66	8	3.83	6	2.96	70		5.61
Mer- cer	5	3.91	3	1.95	4	2.30	4	2.14	5	2.59	5	2.39	5	2.46	31		2.48
Kepler	3	2.34	4	2.60	7	4.02	9	4.81	10	5.18	14	6.70	18	8.87	65		5.21
Hay	5	3.91	6	3.90	6	3.45	5	2.67	5	2.59	4	1.91	3	1.48	34		2.72
Other	36	28.13	35	22.73	42	24.14	42	22.46	35	18.13	32	15.31	25	12.32	247		19.79
# firms with a con- sult- ant	128	64.00	154	75.12	174	78.38	187	81.30	193	81.43	209	84.62	203	80.24	1,248		78.29
# firms with no con- sult- ant	67	33.50	45	21.95	40	18.02	39	16.96	42	17.72	35	14.17	42	16.60	310		19.45
# firm with no in- forma- tion	5	2.50	6	2.93	8	3.60	4	1.74	2	0.84	3	1.21	8	3.16	36		2.26
# firm- year com- bina- tions	200		205		222		230		237		247		253		1,594	100.00	

Table 3. Use of compensation consultants during the period 2002-2008

1,594 firm-year observations; 52% (36%) of the sample granted PVS (PVSO) to their CEO from 2002 to 2008, among which 52% (81%) attached EPS targets to the equity vesting, and 73% (19%) employed TSR targets. Tables 1 and 2 show the frequency distribution by main compensation consultants of the use of the benchmark in TSR targets for PVS and PVSO, respectively. 53% (31%) of our sample used an explicitly selected comparator group in their PVS (PVSO) plans; 31% (46%) of our sample firms used a market index as the benchmark in their PVS (PVSO).

Variables of interest

We focus on the use and independence of compensation consultants. *USE* is an indicator variable equal to one if the firm uses at least one consultant, and zero otherwise. *CONFLICT* is an indicator equal to one if the main compensation consultant also provides other services to the firm, and zero otherwise. In our sample, 80% of the firms hired at least one consultant. Among all consultants, nearly half of them offered non-compensation related services. Table 3 shows the market share of the main consultants over time. Clearly, New Bridge Street is the most frequently hired consultant with approximately 33% of the market share, followed by Towers Perrin with a share of around 14% and Deloitte with 11%.

Empirical models

We use the following OLS regression model to test our hypothesis:

$$\begin{aligned}
 DIFF_{i,t} = & c + b_1 CONSULTANT_{i,t} + b_2 TENURE_{i,t} + b_3 CEOHOLD_{i,t} + b_4 OVERPAY_{i,t} \\
 & + b_5 SIZE_{i,t} + b_6 MtB_{i,t} + b_7 FIRMAGE_{i,t} + b_8 BOARDSIZE_{i,t} + b_9 BOARDINDEPT_{i,t} \\
 & + b_{10} RCDEPT_{i,t} + b_{11} RCSIZE_{i,t} + b_{12} RETURN_{i,t-1} + b_{13} EPS_{i,t-1} \\
 & + b_{14} VOLATILITY_{i,t-1} + \sum INDUSTRY + \sum YEAR + e_{i,t}
 \end{aligned} \tag{1}$$

where $CONSULTANT_{i,t} = USE_{i,t}$ or $CONFLICT_{i,t}$

Test variables:

$DIFF_{i,t}$ = The aggregated score for target difficulty in the vesting of performance share and stock options plans for the CEO; see section “Measuring target difficulty” for a more detailed description;

$USE_{i,t}$ = An indicator variable equal to one if the firm used at least one compensation consultant during the fiscal year t , and zero otherwise;

$CONFLICT_{i,t}$ = An indicator variable equal to one if the main consultant offered non-compensation related services to the client firm during year t , and zero otherwise;

Control variables:

$TENURE_{i,t}$ = CEO tenure in number of years on the board at the end of year t ;

$CEOHOLD_{i,t}$ = The natural logarithm of 1 + the value of shares held by the CEO at the end of year t ;

$OVERPAY_{i,t}$ = An indicator variable equal to one if the deviation between the CEO’s actual pay and the expected pay level which is estimated following Core and Guay (1999) lies in the top quartile of the sample during year t , and zero otherwise;

$SIZE_{i,t}$ = The natural logarithm of market value of the firm at the end of year t ;

$MtB_{i,t}$ = The market value of the firm divided by its book value measured at the end of year t ;

$FIRMAGE_{i,t}$ = The natural logarithm of 1 + the age of the firm since founded at the end of year t ;

$BOARDSIZE_{i,t}$ = The number of board members at the end of year t ;

$BOARDINDEPT_{i,t}$ = The proportion of independent directors among all board members at the end of year t ;

$RCDEPT_{i,t}$ = The proportion of executive directors among all remuneration committee members at the end of year t ;

$RCSIZE_{i,t}$ = The number of remuneration committee members at the end of year t ;

$RETURN_{i,t-1}$ = One year buy-and-hold return during year $t-1$;

$EPS_{i,t-1}$ = Earnings per share at the end of year $t-1$;

$VOLATILITY_{i,t-1}$ = The standard deviation of the

monthly returns during year $t-1$;

$INDUSTRY$ = Industry dummies identified on the basis of Fama-French 12 industry classification;

$YEAR$ = Year dummies.

3. Results

Discussion of main results

We first focus on the sample firms that granted performance-vested share (PVS) plans to their CEO

during the test period and USE measures the presence of at least one compensation consultant. This gives us 649 observations. The model is significant (F-statistics = 3.457; $p < .01$). The coefficient on USE is positive and significant ($p < .01$), suggesting that the use of compensation consultants is positively associated with the target difficulty in the vesting of PVS plans. Next, we narrow down to firms that hired at least one consultant, which leaves us 584 observations. We use CONFLICT to identify firms that used a consultant with possible conflicts of interest, that is, the consultant also offered non-compensation related services to the firm. The coefficient on CONFLICT is negative but insignificant ($p = 0.460$). We then re-run the model but focus on firms granting performance-vested stock options (PVS0) plans and find similar results. In sum, our findings suggest that firms hiring compensation consultants tend to set more challenging performance targets to the equity vesting, whereas providing other business services apart from the compensation consultancy has no influence on the target difficulty (i.e., consultants providing multiple services are unlikely to set easily achievable targets for the CEO).

4. Conclusions

This study adds to the debate on the role of the compensation consultant in the design of executive remuneration by investigating the performance target choices. We find that (1) firms using at least one compensation consultant set more challenging performance targets in their CEO's equity vesting than firms not using a consultant; (2) a consultant who supplies non-compensation related services does not influence the target difficulty. Overall, our findings are in line with the optimal contracting framework and support the view that compensation consultants assist their client firms in setting value enhancing performance targets and optimizing the CEO compensation contact. When confronted with cross-selling incentives, executive pay consultants will be constrained by their reputation and credibility considerations and hence not act on the cross-selling incentives alone.

Notes

1. Despite similar inferences, these three studies all have a different focus. Conyon et al. (2009) find that CEO pay is higher in firms that use compensation consultants. Goh and Gupta (2010) document that a CEO pay increases when the firm switches its main consultant. Murphy and Sandino (2010) focus on the conflicts of interest between consultants and their clients. Furthermore, the findings con-

cerning the conflicts of interest are largely inconclusive: Murphy and Sandino (2010) find that CEO pay is higher in companies where their consultant also provides other services, whereas Conyon et al. (2009) find no evidence of such a relation.

2. Pay-for-performance sensitivity (PPS) gives the sensitivity of managerial compensation to firm performance. So it is generally considered as a measure for the level of interest alignment between shareholders and top management.
3. Bebchuk and Fried (2003, pp. 78-79) suggest '[e]ven if the CEO is not formally involved in the selection of the compensation consultant, the consultant is usually hired by the firm's human resources department, which is subordinate to the CEO.'
4. Performance targets are often set in response to the past firm performance and firm-specific risk. Performance-vested equity plans are usually put forward in the beginning of the fiscal year and put to a shareholder vote at the annual general meeting in the UK. Hence, we control for the performance (i.e., $RETURN_{i,t-1}$ and $EPS_{i,t-1}$) and risk (i.e., $VOLATILITY_{i,t-1}$) in the immediately prior fiscal year.

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