Benchmarking inflates CEO's salaries

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NEW YORK --It sure would be sweet to have your pay based on what the highest earners make in your industry, or better yet in any industry.

That isn't how it works for most employees, but it is certainly a reality for many of the nation's CEOs. Their already out-of-the-ballpark pay has soared over the last decade thanks largely to how benchmarks are used in determining their compensation.

What's surprising is that even after all the corporate scandals brought excessive executive pay to the forefront, most companies haven't scaled back such pay practices and remain evasive about how they use such metrics to set compensation.

For evidence of this, look no farther than the proxies corporations are now filing with the Securities and Exchange Commission. In them, companies are supposed to inform their shareholders how directors sitting on the board's compensation committee came up with the executive pay.

Yet a new study by consulting firm Equilar Inc. of 100 companies that recently filed their proxies found that only 2 percent had provided the names of peer group companies used in setting executive compensation. Worse news is that 30 percent provided no detail at all on what peers had been used for comparative purposes.

Many companies fall somewhere in between -- they give some idea of how many companies are in the peer group, but don't name any names or they just say that they benchmarked against their industry, without offering any more specifics.

And there are those who choose to cherry pick the companies with which they want to compare CEO pay. One is Goldman Sachs Group Inc., which said in its proxy report that the compensation committee had examined executive pay at "certain of Fortune magazine's list of America's 50 largest corporations" to come up with the nearly $30 million it paid CEO Henry Paulson in 2004 -- almost a 40 percent gain from the year before.

Compensation committees usually don't work alone in determining "appropriate" pay. Human-resource consultants, who mine massive databases with executive compensation information, are often hired to help define industry standards and tax implications.

The trouble is that no one wants to be the one to tell the CEO that he or she just deserves only the average salary when compared to others, especially when they keep touting the CEO's above-average abilities.

So they agree to pay the CEO above the average, and base that compensation against high-profile, high-paying companies rather than those that they might compete for in business and talent. All that ends up being plugged into the consultants' database, which ultimately boosts salary standards across corporate America.

For instance, Walt Disney Co.'s outgoing CEO Michael Eisner was paid $38 million above the industry average from 1991 through 2002. That's even though the company's performance declined when compared with others in the entertainment business, according to Robert Daines, a Stanford University law professor who co-authored a recent academic study on the link between CEO skill and pay.

Maybe the only bit of good news is that shareholders have become much more focused on such practices, and are calling for companies to increase disclosure on how pay is determined.

"There is greater scrutiny on the compensation committee, and with that scrutiny, there is a natural effect to rein in things," said Larry Schumer, vice president of compensation at Salary.com. "They boards are saying 'Lets make sure they (the CEOs) are really performing and earning this compensation.' "

Those kind of pressures are certainly pushing some companies to change their benchmarks. Mercer Human Resources Consulting, which works with many big U.S. companies, said that it has started seeing what it describes as a "move toward the median" among its clients.

Consider the recent news out of Fannie Mae, the mortgage company that is trying to clean up its act after being embroiled in an accounting scandal. According to its recent proxy, it will award restricted stock to executives based on a target equal to the 50th percentile of compensation at comparable companies, down from the 65th percentile benchmark used in recent years.

That pullback might not sound like a giant step toward changing out-of-control pay practice, but at least it is a start.

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