COMPENSATION COMMITTEES

Comp Committees Put Peer Groups under Microscope

THE WAYS IN WHICH COMPENSATION committees and their consultants establish peer groups to determine executive compensation are receiving more scrutiny than ever.

"The peer group pool is a hotly contested item in compensation configurations," says **Kay Koplovitz**, on the board at **Liz Claiborne**.

Critics charge that CEOs are being compared to executives at other firms that aren't even their peers. The worry is that CEOs think they should be paid like the CEOs of the country's largest companies. The ratcheting up of CEO pay that comes from that thinking has been a key factor behind skyrocketing executive compensation.

Now, comp committees are taking a closer look at what individual companies make up their peer group. One reason is that comp committees have grown increasingly skeptical of comp consultants. Rather than rely solely on data that consultants have compiled from what they say is a firm's peer group, comp committee members are breaking down that peer group.

At the same time, comp committees are responding to critics. Every decision they make, including what their peer groups are, is being analyzed. Comp committees want to be sure everything they do looks fine in the daylight.

"A lot of companies now are stepping out and seeing whether the peer group they're using can be defended to an outsider," says **Paula Todd**, an executive compensation consultant with **Towers Perrin.**

Comp committees have to defend their selections of peer companies to people like **Mark Van Clieaf,** managing director of **MVC Associates**, a Florida-based consultant that specializes in building companies around their customers. Van Clieaf went so far as to write to the **SEC** to criticize executive pay, including what he sees as companies' benchmarking against "the wrong peer group."

Establishing a peer group is one of the most important—and difficult—tasks facing a comp committee, Van Clieaf says. But comp committees often fail by tying their CEO's pay to that of more complicated CEO jobs. That leads to a ratcheting up of CEO pay.

"The major problem," he says, "is that all CEO jobs are not created equal."

As an example, Van Clieaf points out that **Kimberly-Clark** and **Eli Lilly** include **Procter & Gamble** and **Johnson & Johnson**, respectively, among their peers.

"J&J and P&G, due to the higher complexity of their CEO roles," Van Clieaf writes, "should have a CEO compensation band exponentially higher than Eli Lilly and Kimberly-Clark."

"However," he continues, "faulty benchmarking is contributing to excessive compensation for less complex CEO roles."

Instead of establishing a peer group composed of actual peers, Van Clieaf argues, companies are setting the bar too high. For him there is no reason why Lilly, with $11 billion in revenues, should be in the same group as Johnson & Johnson, with revenues of $36 billion.

Companies defend their peer groups.

"We include J&J in our peer group because we compete with them for talent and in the pharmaceutical marketplace, which is both companies' core business," an Eli Lilly spokeswoman says.

Lilly determines its compensation in part through participation in a survey conducted by Towers Perrin, the spokeswoman says. The survey is blind and aggregates data from the eight companies determined to be Lilly's competitors. The data is then given to Lilly's compensation consultant at **Frederick Cook & Co.** "We use the statistics generated by the third-party consultant to set our pay," she says.

Kimberly-Clark, according to its spokeswoman, uses two different groups when determining compensation. The first is a selection of 22 companies in consumer packaged goods ranging from **Clorox**, with $4 billion in revenues, to P&G with $40 billion.

The other group used to measure compensation is larger, composed of 97 industrial companies with revenues of more than $5 billion. Kimberly-Clark has around $14 billion in revenues.

"We're comparing ourselves to peers in the consumer packaged goods area, to companies we compete with to recruit executive talent," Kimberly-Clark's spokeswoman says. "It's a group that includes both smaller companies and larger companies so that our sales fall right at the median of the group."

Companies may be able to continue using standard practices like these, but increasing scrutiny from regulators, shareholders and Congress might push more boards to reevaluate their peer groups.

One problem, however, is that directors are unlikely to admit their peer groups are inaccurate. Todd, from Towers Perrin, says a lot of directors see the danger of establishing a faulty peer group as a problem for other boards, but not theirs. "A lot of directors think that other committees are broken but theirs aren't," she says.

"Well, we see a lot of committees," she says, "and we know a lot of them are more broken than they think." ■

FIVE STEPS FOR ESTABLISHING PEER GROUPS

1. Determine the relevant factors to look at in determining peer data
2. Identitfy business competitors vs. human resources competitors
3. Determine the competitive posturing at each level of pay
4. Define the roles the board, the compensation committee and independent consultants will have in the process of determining compensation
5. Establish and evaluate the compensation philosophy on an ongoing basis