KPMG

Peer group development

Multiple markets for multiple purposes

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Benchmarking a company against organizational peers is a common exercise utilized by virtually all corporations—public and private. This is particularly true of compensation strategy and design. The use of benchmarking in the compensation field often serves as a foundation for establishing policies, programs, salary levels, and various incentives. Compensation is critical to most businesses in recruiting, rewarding, and retaining talent. In the balance are the objectives of the company as well as individuals. Most companies find particular comfort by identifying common practices among peer companies.

However, the desire to identify common practices and debate over the construction of organizational peers frequently results in overengineered peer group construction. Such overly comprehensive references potentially undermine the value of compensation benchmarking. This can occur when multiple peer groups are improperly treated as discrete reference points. Peer group construction for compensation purposes is most effective when there is a functional approach of explicitly recognizing the inherent overlap between peer group references without overreaching in order to establish impactful compensation policies and programs.

Basis of comparison

There is significant research on the use of peer groups for the purposes of compensation that is generally broken out as follows:

- *Peer group selection* – peer group selection and incentive payouts[1]
- *Peer selection in pay outcomes* – Examines the selection of a peer group and whether there is opportunistic selection of peers in setting CEO compensation[2]
- *Retention among peers* – Examines the use of peer groups and the associated labor market risk[3]

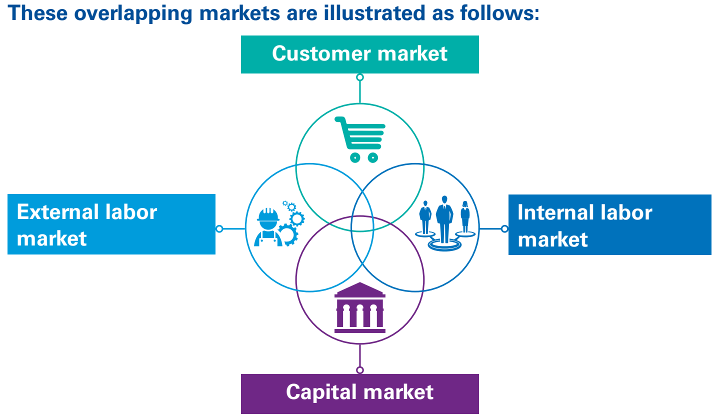
However, there are other aspects of peer group utilization that apply to both compensation planning and governance. These applications do not rely on peer group comparisons based on a discrete view of these peers, but the recognition that peer groups should be interdependent and treated more as integrated "markets" in lieu of discrete reference points.

KPMG's multiple market approach

With respect to compensation benchmarking, a framework for using peers is to recognize that in making such comparisons, multiple "markets" should be explicitly considered. Compensation structure and design should consider four types of peer groups that lead to specific questions related to compensation benchmarking. These peers provide the landscape of cross-industry comparison and lead to specific compensation-related decisions. Specifically, the markets are:

- *External labor market* – Decisions about talent acquisition from a variety of industry sectors
- *Internal labor market* – Decisions related to how current job compensation compares within a company
- *Capital market* – Decisions related to how shareholders will respond to changes in compensation
- *Customer market* – Decisions as to how compensation practices will impact how a company competes against traditional peers

These overlapping markets are illustrated as follows:



1 Bizjak, John M. and Kalpathy, Swaminathan L. and Li, Zhichuan Frank and Young, Brian. The Role of Peer Firm Selection in Explicit Relative Performance Awards (April 16, 2018). European Finance Association (EFA) Annual Conference 2017; China International Conference in Finance (CICF) 2017.

2 Brian Cadman and Mary Ellen Carter (2014). Compensation Peer Groups and Their Relation with CEO Pay. Journal of Management Accounting Research: Spring 2014, Vol. 26, No. 1, pp. 57-82.

3 Elson, Charles M. and Ferrere, Craig. Executive Superstars, Peer Groups and Overcompensation: Cause, Effect and Solution (August 7, 2012). 38 J. Corp. L. 487 (2013).

In effect, these markets should not be applied discretely, but the potential for overlapping one another should be considered. This can be illustrated in the following compensation-related issues and the impact on each market simultaneously. Consider the following scenarios:

Compensation issues	Relevant markets			
	External labor	Internal labor	Capital	Customer
Establishing compensation levels (e.g., salary, bonus and equity/long-term incentives)	Whether compensation levels enable the attraction and retention of employees where skills are typically observed and needed	The level of "fairness" and comparability between existing employees and new/incoming employees	Whether compensation levels impact the level of return required by investors	Whether compensation levels relative to industry peers impacts product/service cost
Determining incentive plan performance measures	Whether measures associated with incentives align with performance capabilities of employees and the strategic focus of competitors	Whether measures are consistent with performance focus currently/historically used	Whether measures align with how investors value business	Whether incentives drive the right performance to compete against market peers
Setting incentive plan performance goals	Whether performance measure goals align to expected performance outcomes of market peers and benchmarks	Whether goals are seen as "fair" relative to historical goals	Whether performance expectations/return are aligned with investor expectations	Whether performance goals and outcomes align to customer expectations and how payouts impact cost structure of business

Why this matters

Given the view that these markets have an impact on compensation-related decisions, there are multiple benefits for purposes of compensation structure and design, such as:

Utilize comprehensive data sets – Survey information and data would reflect a broader set of resources and analyses.

Minimize debate – Peer group selection would consider broader criteria and reflect multiple different views, shifting the discussion away from specific peers to how those different peer groups are applied.

Isolate issues – Each peer group could be used to address specific benchmarking issues such as selection of performance measures, goal setting, market compensation analysis, and incentive vehicles.

Recognize trade-offs – Compensation decisions can be made with the understanding that one program or policy choice will have implications on other market references.

In practical terms, any discussion of compensation programs, policies, or adjustments will be enhanced by considering all of these markets. Specifically, illustrating and discussing program changes market by market is a more effective way of developing compensation. This framework can help ensure the full range of issues are evaluated to improve both the quality of compensation programs and the associated governance.

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