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## BEYOND THE PLAYGROUND - PICKING YOUR PEERS



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Your parents always told you to pick good friends - those that you share things in common, those with similar personalities, goals, and attitudes. They warned you to stay away from the kids that were trouble. The ideals that our parents have instilled in us in picking our friends are those that Corporate America should also embrace when selecting peers from a business standpoint - those in a similar line of business, of comparable size, with like performance. But public companies always seem to have big eyes; they want to be friends with the "seniors" or the "big kids on campus." This is where the trouble starts.

In a recent story in the New York Times<sup>1</sup>, the latest wrinkle in the battle of executive compensation is the manner in which publicly-traded companies select peer organizations for purposes of benchmarking compensation. The concern raised by many, including regulators, shareholders, institutional investors and some consultants, is that companies are selecting peers for comparison purposes that are favorable to them, and which, in effect, increase their compensation levels.

Why look at peers for determining compensation levels in the first place? The answer is very simple. Companies look to others to gauge their own relative success. Whether it is in school grades, sporting events, foot races, business success, accumulated wealth, or almost all of life's endeavors, we compare ourselves against others to see how well we have done. In the area of compensation, we set the standard based on what others receive. This principle has been long established by legal precedent, in which tax courts have determined reasonable compensation by examining, in part, what similar positions within comparable organizations have paid. Another major purpose of examining peers is to gauge their financial performance with critical indices, and how compensation relates to that performance.

In both instances, the rationale is to determine how well the company is doing, and ultimately, how well the executives are paid. The rub lies not in the purpose, but rather in the way the peer group is selected. Two issues are immediately raised: should the peer list be the same for both financial comparison and compensation purposes, and who should make the selection?

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## Should Peer Lists Be Different?

In our estimation, using different lists of peer companies for different reasons does not serve any valid purpose, and only increases the likelihood of criticism that the company is "cherry picking" its peers to serve its own agenda. The same group of companies should be considered when benchmarking both performance and compensation. Theoretically, if peer companies registered performance that is consistent with that of the target company, it should be assumed that the compensation is also relatively consistent. Conversely, if the financial performance among the peer companies is well above, or below that of the target company, this would indicate that the target company's executive compensation should not be the same, but should better reflect its own financial performance. Some companies may argue that they need to differentiate peers from a financial and compensation standpoint; if this need be the case, the Compensation Committee must be able to describe the differences and have strong rationale for differentiating between financial and compensation benchmarks.

*The Board is ultimately responsible for approving and thus accountable for the peer list, even if others contributed to its development*

## Who's Responsible for Peer Selection?

Choosing the companies to be used for comparative purposes is clearly very important, given the recent changes and requirements for transparency and reporting as required by the Securities and Exchange Commission (SEC). There is no question that it is the responsibility of the Board and its Compensation Committee to finalize and approve the list of peers. This appears to be a contentious issue, since once criticism starts to fly, everyone either avoids taking responsibility or purposely points to someone else. There may be some confusion as to who actually compiles the peer list, but there should not be any question as to who is responsible for approving it. To a great degree the company's management or its outside advisors supply the information the Board relies upon in making its determination. The criteria used to evaluate the companies on that list may be open for debate, but certain standards should be used and observed. The factors to be addressed in attempting to select suitable peers typically include the company's business sector or industry, its revenue size or market cap, its relative financial performance, and its organizational complexity. Other factors may also play a role, based on the specifics of the situation, but these are secondary to those mentioned above.

**SIC and NAICS can be utilized to begin building a peer list based on industry criteria.**

Using the Standard Industry Classification (SIC) or North American Industry Classification System (NAICS), a company can typically identify other companies that are in the same general lines of business. We recognize that there may not be other public companies within the specific code in every situation, in which case an effort will have to be made to identify organizations that have as many similar characteristics as possible. Where specific industry matches are not possible, general industry groupings such as consumer products, durable goods manufacturing, etc., may be a starting point for use in selecting peers.

In those instances where comparable companies fall into more than one category, being similar but not exactly on target, multiple peer groups can be identified. For example, "A" peers may have most factors in common such as industry and size, but have a different performance profile. "B" peers would contain those companies which are similar except for more variability in their

financial performance. “C” companies may be similar in industry and other variables, but have revenues that are outside of the normal parameters. Although the “B” and “C” groups should not be used for direct comparison, they can be used as indicators of trends and types of compensation programs utilized.

The standard revenue parameters for use in selecting peers include companies that are one-half to double in size of the target company. The rationale is that compensation generally falls into discrete bands that correlate to revenue size. Therefore, it is acceptable to include companies that range from \$500 million to \$2 billion as peers for a \$1 billion target company. On the other hand, including a \$5 billion dollar company in the “A” list would not be appropriate since it is outside of the normal parameters; however, this company could be included in the “C” list, as an indicator of future compensation levels that could be expected.

## Being Objective

The selection of suitable peers should not appear in any way to be self-serving. They should not be selected because they will make the target company look good, or raise the level of compensation of the executives. When companies are selected for the peer list using a systematic process, consistent with good practice, the list should provide a realistic and representative universe of comparable organizations against which to compare.

<sup>1</sup> The New York Times Sunday Business, “Peer Pressure: Inflating Executive Pay”, by Gretchen Morgenson, November 26, 2006.

## QUESTION OF INDEMNIFICATION

The on-going barrage of negative publicity over excesses in executive compensation have for the most part been leveled at the executives themselves, the Boards and Compensation Committees who have approved the pay packages, and to a lesser degree, against the consultants that have provided the advise. With this in mind, some of the more high-profile compensation consulting firms have asked to be indemnified against possible suits by shareholders or other parties, based on the advice they render on executive compensation matters. This new phenomenon in which consultants are seeking waivers covering the advice they provide was identified in a recent article in The Journal News<sup>2</sup>.

No one likes to be sued, which for a consultant is even worse than having their recommendations and advice be trashed or ignored. Consultants generally take great pride in having their recommendations put into practice, and in making a positive change in the way their clients conduct their business. Consultants should never forget that they are working for the company, its Board and shareholders. Their responsibility is not to “go out on a limb” in an attempt to take advantage of some loop holes to enrich a few, at the expense of many. There should be a high degree of professionalism in the work of any consultant, and clearly, they must stand by their

advice and recommendations.

To ask for a waiver to cover any negative outcome arising from that advice raises a lot of red flags. Does this mean they won’t stand behind the credibility of their data? It certainly sends the wrong message, and brings into question the validity of the consultant’s recommendations to its client.

Consider the recent cases of food poisoning, in which patrons have become sick and even died because of E-coli bacteria. The analogy would be that upon entering a restaurant, each diner would be required to sign a waiver of responsibility before they would be allowed to order their meals. If consultants are so uncertain of the reliability of their work, and cannot manage their own internal quality to the point that there is a significant question concerning the potential risk of law suit because of the advise they render, they should consider changing their occupation.



<sup>2</sup> The Journal News, “Exec-pay advisors look for shield from lawsuits over compensation”, by Robert Schmidt, Sunday, November 19, 2006.

# BOARD OF DIRECTOR EVALUATIONS: A GOOD GOVERNANCE TOOL



Business ethics, corporate leadership, good governance. These are today's buzzwords and "good as gold" standards that few can argue with. As we unfortunately know from the seemingly unending corporate scandals, these buzzwords that should be the standards for corporate management have not been uniformly applied. Recognizing that the starting point for good governance starts with the Boards of Directors, the SEC has mandated that tighter controls be placed on the Boards

themselves. Part of this requirement is that the Boards conduct and report on their own performance. In addition, the New York Stock Exchange, Standard & Poor's, and other agencies have added their weight to the requirement for boards to conduct self-evaluations.

As many organizations are ending their fiscal years and thus need to report on this review process, what are the requirements and options open to boards for conducting these performance reviews? Unfortunately, the requirements *only* specify that performance reviews be conducted; they do not answer the important related issues. Among the many unanswered questions are:

- Who will actually conduct the evaluation - the Board, the company's internal auditors, an independent third party, or outside legal counsel?
- How often will these evaluations be conducted? There is an inference that twice a year is appropriate, but this is not specified.
- What issues and metrics will be used to evaluate the Board and its committees?
- What governance areas should be addressed?
- What methodology should be used for actually conducting the review?

Due to the void created by the lack of definition in the regulations and the large number of unanswered questions, there are an ever-increasing number of "ready made" solutions being made available. Whether the Board uses an off-the-shelf review process or creates its own system, there are certain issues that must be addressed. These include, but are not limited to, an evaluation of:

- A review of procedural issues
- Completeness of documentation
- Adherence to board by-laws and committee charters
- Reliance upon appropriate and qualified outside counsel
- Individual members' contribution and involvement
- The effectiveness at advancing the organization and the interests of its shareholders

The bottom line is to determine how effective the Board is at protecting and enhancing the shareholders' value, and, to what extent, how individual Board members contribute to the achievement of the organization's goals.

**Boards are becoming increasingly more accountable to regulatory agencies relative to how well their organization is managed.**

***Good governance includes maintaining a Board of Directors that is effective at meeting organizational goals and recognizes shareholder needs.***