BoardBrief

Knowledge Resources for Governing Effectiveness

The Board's Role in CEO Compensation and Performance Evaluation

Healthcare CEOs and their boards must build and sustain vibrant, trust-based relationships in order to successfully navigate the opportunities and challenges in today's complex and fast-paced health care world. That trust requires leadership excellence in a number of key areas, including clear and consistent communication, adherence to well-defined roles and responsibilities, and clear CEO performance expectations and accountabilities that are appropriately rewarded using responsible compensation assessment policies and procedures.

The board is responsible for ensuring that the CEO is appropriately and fairly compensated. Internal Revenue Service (IRS) Code allows the IRS to impose financial penalties on tax-exempt organizations that engage in "excess benefit transactions." An excess benefit is defined as the difference between the value the organization receives from the individual and the value of compensation provided to the individual. Therefore, an excess benefit transaction can occur when an individual's compensation is considered above fair market value or is "unreasonable." This underscores the importance for the board of trustees to establish and follow a written policy outlining CEO compensation and its relationship to the CEO's performance evaluation.

Ensuring Performance and Alignment: The Purpose of the CEO Evaluation

The CEO evaluation process begins with a clear definition of the role of the compensation and performance review process in building leadership loyalty and commitment, and ensuring leadership success and continuity. It is important to remember that the process is about more than simply evaluating the CEO's compensation. It is an opportunity to strengthen the board/CEO relationship, and ensure that both the board and CEO have mutually-agreed upon goals and expectations.

The purpose of the CEO evaluation is to set specific direction on board expectations for CEO and overall organizational performance. It is to ensure a consistent focus by the CEO, and continuous leadership accountability, renewal, focus and success. It defines the essential CEO functions and personal attributes required by the board, and encourages two-way communication between the board and CEO as they determine those functions and attributes and discuss how they will be measured.

In addition, the CEO evaluation identifies performance areas requiring increased attention by the CEO, and defines the leadership competencies most critical to organizational success. Finally, the evaluation links the CEO's achievement to his or her compensation.

CEO Engagement. Boards should carry out their CEO compensation assessment by involving the CEO as a meaningful partner in the process. The CEO should be engaged in the process early-on to ensure that he or she agrees with the compensation committee's work plan, and that there is enthusiastic CEO buy-in to the compensation philosophy. The CEO should also provide input to the compensation committee to enable it to best understand his or her contribution to organizational success. This is typically done later on in the process, when the CEO reports on the results of his or her personal objectives and success in achieving board-defined performance objectives.

The Board's Role in CEO Compensation

When determining CEO compensation the board should take into account a variety of factors, including:

- Overall organizational performance in meeting board expectations;
- The challenges and risks faced by the CEO;
- A comparison of the CEO's compensation with his or her peers who lead organizations with a similar size and scope;
- The risk or volatility of the position;
- The CEO's tenure with the organization; and
- The implications of the loss of the CEO in the event that inadequate compensation causes the CEO to seek employment elsewhere, or become the target of executive recruiters who are constantly on the lookout for high performers to recruit for their clients.

Elements of CEO Compensation and Performance Review

After the responsibility for the process is established, a CEO evaluation and compensation policy should be established, based on the organization's mission, vision and business strategy, and including the goals and values the organization seeks to reward. Specific components the policy should include, but not be limited to:

- A statement of the board's and/or compensation committee's responsibility.
- A summary of the organization's philosophy regarding executive compensation. Compensation philosophy should recognize the importance of CEO compensation in stimulating high-performance and rewarding achievement of board-approved priorities. The philosophy should outline the organization's position regarding the compensation level relative to comparably situated CEO's, and define the organization's philosophy regarding pay-for-performance. It should be tailored to and support the organization's culture, mission and strategy, and should directly relate to the values and goals the organization seeks to reward.
- The organization's major strategic objectives, and the connection of the compensation and performance evaluation to them;
- A summary of board-approved criteria to be used in the performance evaluation;
- The relationship of the performance incentive plan to the annual salary review;
- The process for determining the amount of incentive compensation to be awarded;
- The methods and timing of incentive payments;
- The process for dealing with payment in the event of CEO death, disability or termination; and
- A summary of the compensation review calendar.

The Compensation Review Process

Establishing "rebuttable presumption." Boards of trustees should understand that their actions regarding executive compensation will be examined by the IRS, and any failure may be subject to penalties, as well as potential media attention and other public scrutiny. There are three key steps the board must take to ensure that the CEO's compensation is reasonable and rewarding, yet not excessive; and to establish a "defensible" compensation position:

First, the executive's compensation must be approved by the board or by a compensation committee whose members have no conflicts of interest. Secondly, the board or compensation committee should collect and use relevant data to establish fair market compensation levels when approving executive compensation. Resources for comparability data include compensation surveys or studies, use of an independent compensation consultant or review of Form 990 filing by similarly situated organizations. Lastly, the basis for compensation approval must be adequately documented in the board's written or electronic records.

When trustees ensure adherence to these three compensation principles they have established what the IRS refers to as "rebuttable presumption," which provides the board with some measure of defense or protection.

The key to rebuttable presumption is to ensure that the board's actions and decisions are supported with solid evidence. It means ensuring the board has a clearly established process for setting compensation, that it uses reliable comparative compensation information in evaluating the CEO's compensation plan, that it evaluates the CEO's specific skills and accomplishments in carrying out board-approved plans and priorities, and that the CEO's total compensation package is able to withstand excess benefit scrutiny.

Compensation Comparison. The *Hay Group's Healthcare Compensation Study*, one of the most comprehensive and widely used compensation benchmarking resource in health care, is an excellent resource for data on comparing CEO compensation to defined peer groups. The Hay Group annually compiles healthcare compensation trends by gathering compensation data for hospital CEOs and other health care executives in approximately 800 health care organizations throughout the country.

In addition, compensation may also be compared to data derived from other reliable hospital CEO salary surveys from state hospital associations. When comparing their CEO's salary to the salaries of CEOs across the country, boards should consider inflation implications; the comparability of the organization's size, location and challenges faced to the organizations included in the survey; and current market trends for base pay and incentive pay compensation structures.

Benchmarking. Comparing the CEO's compensation to his or her peers is not only good practice so that the board ensures it is paying appropriately – it's also required by the Internal Revenue Service. The IRS requires that the CEO's compensation is compared to:

- Compensation levels to those paid by similar organizations, both taxable and exempt, for comparable positions;
- Services similar to those provided by the executives in a similar geographic area;
- Compensation surveys compiled by independent firms; and
- Written offers from similar organizations competing for the services of the organization's executive.

Legal Language

There are other legal terms that trustees need to understand in the area of executive compensation, including disqualified person, excess benefit and intermediate sanctions.

Disqualified Person. For example, a "disqualified person" in compensation matters, according to the IRS, is any executive who can exercise "substantial influence" over the organization.

Examples of persons with substantial influence include persons making substantial contributions to the organization, those who draw compensation based on revenues from activities under the CEO's control, persons with managerial authority, or who serve as key advisors to a person with managerial authority, and trustees actively involved on the board at the time an executive of substantial influence earns an "excess benefit."

Excess Benefit. An "excess benefit" is an economic benefit that exceeds the value of the disqualified person's services. The excess benefit is the difference between the value of what the organization receives, and the value of what's been given to the disqualified person. An excess benefit transaction can occur when the disqualified person's compensation is considered above fair market value, or as deemed unreasonable.

Intermediate Sanctions. Finally, "intermediate sanctions" are financial penalties imposed by the IRS on managers of tax-exempt organizations that engage in excess benefit transactions. Boards never want to see a letter from the IRS with the words "immediate sanctions" on it.

The CEO Evaluation Process

As with all major board decisions and actions, the board should start with the organization's mission, vision and values to ensure alignment with the compensation strategy. It will also need an up-to-date strategic plan with clear goals and objectives and measures of success, a current CEO job description, and a list of "leadership essentials" for the CEO.

In addition, the board will need to determine the performance factors and measures it will use to assess the CEO's performance, and a clear set of CEO objectives and priorities. Finally, the entire board and CEO need to have a shared understanding of the purpose and use of the CEO evaluation.

Best Compensation Practices

- First, assess the organization's overall performance before approving annual compensation adjustments.
- Ensure that management's representation of organizational performance is accurate and well supported with objective data,
- And that market comparability data are for truly comparable jobs.
- Make sure you involve the General Counsel to ensure coordination of legal and governance compliance issues.
- In addition, ensure strong business, strategic and charitable mission support for compensation that exceeds a predetermined level,
- Communicate compensation matters widely in a transparent manner,
- And avoid "crisis" compensation decision-making.
- Adhering to clear methodologies and philosophies will help ensure you stick to what is most important, even under times of pressure.

The Compensation Committee. The board should either establish an independent Compensation Review Committee, or undertake CEO evaluation as a "committee of the whole," where all trustees are involved in the actual evaluation and recommendation process. If a committee is utilized, it should be comprised of disinterested individuals who will have no conflict of interest influencing their decision about the CEO compensation strategy. Members should ideally include the board chair, the chair of the audit or finance committee, and at least one physician who can reflect the perspectives of the medical staff to the board. Additional members of the committee should be trustees who not influenced by outside pressure.

The critical work of this committee, like all board committees, should be spelled out in a board-approved committee charter that includes its purpose, responsibilities, composition, authority, objectives, budget and reporting requirements.

The committee should consider a number of questions in carrying out its role, such as:

- What criteria should be used in evaluating the CEO's performance?
- Who can provide perspectives about the CEO's performance that would be both objective and provide the most insight?
- How will the committee undertake the process?
- Who is responsible for ensuring that the process is legally and ethically carried out, and that critical deadlines are met?
- How will the results of the compensation assessment and performance evaluation be communicated to the CEO, and be used to motivate even greater commitment and performance?

Before beginning its work, the compensation committee should ensure that:

- A current written job description for the CEO has been reviewed and approved by the CEO;
- There is agreement by the board and CEO on the performance measures that will be used to evaluate the CEO's success;
- There is full agreement with the CEO on the basics of his or her compensation, including base pay, annual incentives and executive benefits, as appropriate;
- There is a process for regularly reviewing the compensation strategy to ensure its alignment with the organization's mission and goals, market strategy, critical success factors, changes in CEO responsibilities and the dynamics of the health care market; and
- Benchmarking data should be utilized that satisfies all IRS requirements, including an examination of compensation levels paid by similar organizations, both taxable and exempt, for comparable positions.

CEO Evaluation Goals. There are a number of typical goals that should be considered in the course of undertaking a successful CEO evaluation process:

- Expectations should be clearly identified well in advance of the evaluation;
- The evaluation should be a continuous, year-long process culminating in a formal annual performance review, with no surprises for either the board or the CEO;
- The evaluation should provide meaningful feedback to the board on the CEO's success in achieving board-approved objectives;
- The evaluation process should enhance board/CEO working relationships;
- The evaluation should link the attainment of organizational objectives with the CEO's personal performance objectives;
- Data, not subjective assessments, should be the foundation of the evaluation of compensation;
- Leadership in achieving the mission, values and vision should be a centerpiece of the evaluation; and
- Compensation should be driven by specific performance in specific areas.

Evaluating CEO Performance. The CEO should be evaluated using pre-determined criteria and goals specified in the CEO compensation policy established by the board's compensation committee, and agreed to in advance by the CEO.

The evaluation may include a "360-degree" approach that seeks feedback on qualitative performance from the board, medical staff leaders, senior management, and the CEO him or herself. Measurement should also assess performance in achieving defined objectives, including financial success, patient satisfaction, strategic performance, and more.

Potential quantitative measures may include, but not be limited to:

- Financial and operating performance, using a variety of ratios, with comparison to peer groups;
- Market share growth;
- Physician satisfaction;
- Employee satisfaction;
- Patient satisfaction; and
- Achievement of hospital strategies/objectives.

Qualitative Measures. In addition, qualitative measures can help identify how well the CEO performs in several important areas, including:

- Leadership and strategic development;
- Medical staff relations;
- Internal operations;
- Financial development;
- Community relations;
- Board relations and development;
- Communication; and
- Ethics.

The CEO's success in accomplishing specific hospital and personal objectives should be defined by the board at the beginning of the evaluation period.

Communicating Results and Driving CEO Performance Improvement

The communication and discussion of the CEO's evaluation should be used to strengthen the relationship between the CEO and the board, enhancing communication and identifying both strengths and potential areas for improvement. When sharing the results, a meeting should be held with the board and CEO to present the findings and provide the CEO with an opportunity to give feedback.

Conducting an effective compensation and performance evaluation is an opportunity to ensure that the board and CEO communicate often and work well with one another, that the CEO is incentivized in performance areas closely aligned with the mission and vision, and that the CEO is compensated appropriately to ensure long-term retention in what can be a difficult position to fill.

Questions For the Board's Consideration

At the next board meeting, spend a few minutes discussing the following questions about the board's CEO compensation and performance evaluation process, and brainstorm ideas for improving the process.

- Does the board have a clear CEO compensation and evaluation process in place?
- Is the board confident about its "rebuttable presumption"?
- Is the board confident that the CEO is appropriately compensated compared to his or her peers?
- Is the CEO's compensation tied to his or her performance in meeting specific goals? Does the CEO know those goals in advance, and measure progress throughout the year?
- Does the board have clearly defined CEO goals and expectations that are tied to the organization's mission and vision? Are they linked to the CEO's compensation?
- When it is time for the CEO's annual review, is the board or CEO is surprised by the outcome?
- Finally, when the board thinks about its overall compensation and evaluation process, does it use the process as an opportunity to strengthen the relationship between the board and CEO and help improve the CEO's performance?

governWell™
Better governance. Better healthcare.

Illinois Office
1515 W. 22nd Street, Ste 900
Oak Brook, IL 60523
630-613-7580
blorsbach@governwell.net

Oregon Office
31090 SW Boones Bend Rd
Wilsonville, OR 97070
630-613-7580
larry@governwell.net