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TRENDS & ISSUES

A Guide for Annual Pay-For-Performance Analysis of Healthcare Executive Compensation

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As a result of industry shifts, healthcare organizations are now adopting more sophisticated approaches to variable compensation in order to properly align executive performance, business strategy, and pay. These more complex incentive programs are relatively new to healthcare, and typically have more moving pieces than the industry's more traditional "salary and bonus" approach. Newer programs often include both annual and long-term incentive plans, in addition to base salary, and represent new challenges in calibrating performance, total direct compensation level, market positioning, and cost. A carefully designed executive compensation program can be a powerful connection between the executive team and the board's vision, but only if it is properly evaluated and maintained.

As an organization completes its fiscal year or performance cycle, the compensation committee should utilize pay-for-performance analytics to evaluate the effectiveness of the variable compensation program. While every organization is different, most pay-for-performance analyses will include some or all of the following:

- The organization's performance against its overall performance scorecard

- The executive team's performance against:

  - Each individual annual incentive plan metric
  - The overall annual incentive plan
  - Each individual long-term incentive metric
  - The overall long-term incentive plan

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- Overall amount of annual and long-term incentive awards earned, expressed in dollars and as a percent of base salary:
  - Across all participating executives
  - Within each executive level or tier
  - By each executive
- Base salary and total cash compensation market compa-ratios for:
  - All participating executives
  - Each executive level or tier
- Total cost of variable compensation, expressed as a percent of operating margin or earnings

The example outlined below shows how a compensation committee can review the performance-pay alignment, evaluate the ongoing use of current measures and metrics, modify award opportunity levels, change measure weighting, reassess the likelihood of achievement of targeted performance, and ensure that total direct compensation levels are positioned appropriately against market competitors based on performance.

Performance

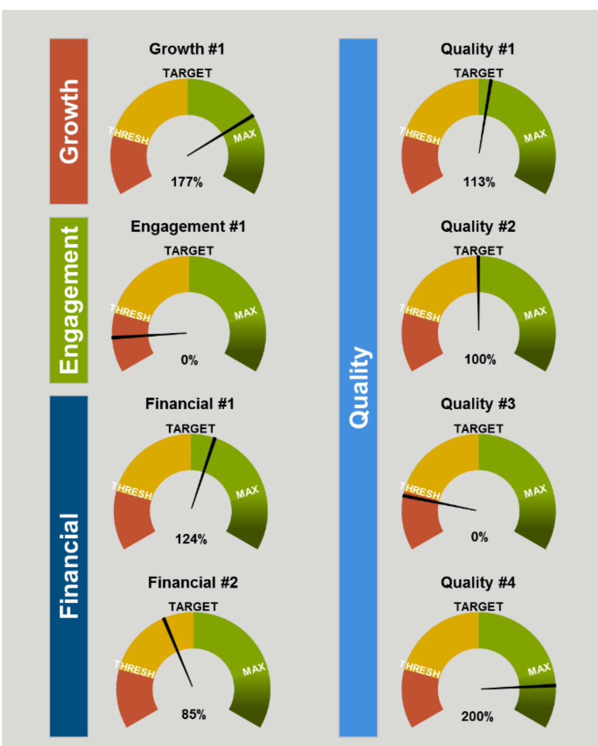

Chart A

In chart A, the committee is armed with data outlining the organization’s performance against the eight metrics that comprise its annual incentive plan.

The compensation committee can clearly see how well the executive team performed against each metric, and the analysis can drive a robust conversation between the committee and the CEO regarding the team’s successes that year, specific business challenges, likelihood of achievement, and annual goal setting for the following year and beyond.

The committee can then evaluate the executive team's performance on the annual incentive plan in aggregate as shown in chart B.

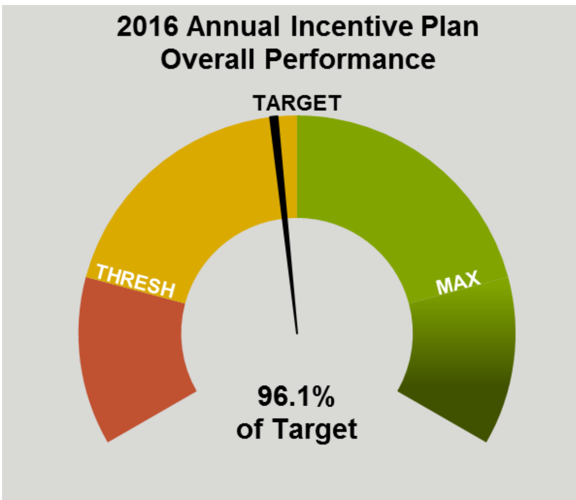

Chart B

The committee and CEO can discuss whether the overall performance level achieved accurately reflects the organization's performance in general. This conversation is most useful if held on an annual basis over the course of two to three consecutive years, as some of the individual plan metrics may no longer align with the organization's evolving strategy, and may need to be adjusted, eliminated, or replaced. The relative weighting of the individual metrics should also be assessed.

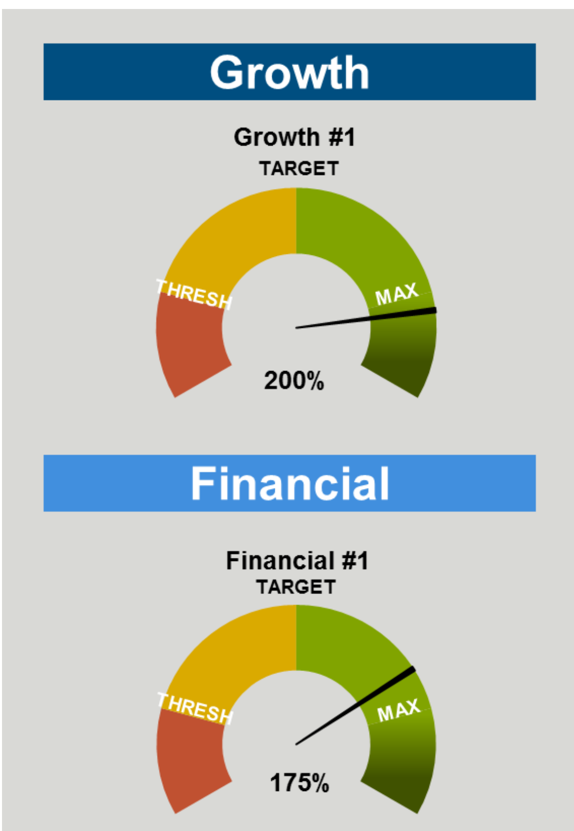

Chart C

Similarly, the executive team's performance against the two metrics that comprise its long-term incentive plan during first period of that plan is shown in chart C.

Again, the data provides opportunity for committee and CEO discussion on the factors influencing performance, the rigor of goal setting, etc.

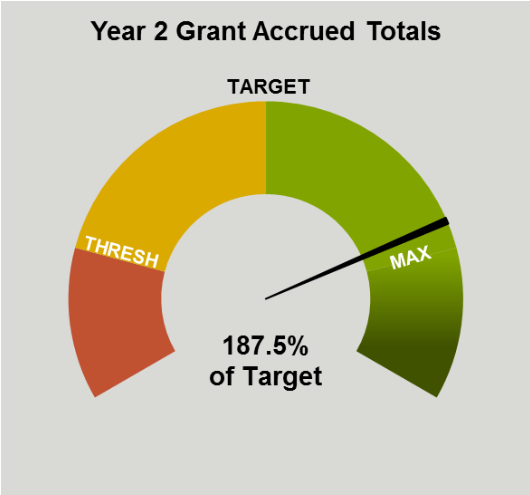

Chart D

The committee can evaluate the executive team's performance on the long-term incentive plan in aggregate (shown at left in chart D), generating a strategic conversation regarding the alignment between the team's performance against the plan and the organization's progress moving towards the future version of itself. Long-term incentive metrics should generally be maintained for periods of at least three to five years if possible and have fewer changes to metrics than the short-term plans. This annual conversation is important in making sure that the long-term plan still has integrity for the executive team and board, and continues to reflect movement towards the board's strategic vision.

Size of Incentives Earned

The committee should evaluate the size of annual and long-term incentives earned at the conclusion of a performance period. Award levels should be expressed as a dollar value and as a percent of base salary. This information is important to the committee so they can determine whether the level of performance attained is calibrated properly with the amount of compensation being delivered via each compensation component, namely the desired mix of base salary, annual incentives, and long-term incentives. Examples of the type of information needed for this evaluation are in charts E, F, and G.

	Base Salary		Annual Incentive		Total Cash	
	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2
Tier 1	$650,000	$675,000	$195,000	$129,766	**$845,000**	**$804,766**
Tier 2	$650,000	$800,000	$195,000	$153,796	**$845,000**	**$953,796**
Tier 3	$1,800,000	$1,900,000	$405,000	$273,949	**$2,205,000**	**$2,173,949**
Percent Mix of Total Cash by Year						
Tier 1	77%	84%	23%	16%		
Tier 2	77%	84%	23%	16%		
Tier 3	82%	87%	18%	13%		
Totals	**$3,100,000**	**$3,375,000**	**$795,000**	**$557,511**	**$3,895,000**	**$3,932,511**

Note: *Tier levels above include: one participant in Tier 1, two participants in Tier 2, and eight participants in Tier 3.*

Chart E

	Base Salary		Long-Term Incentive Year 1 Grant[1]			Grant[2]	
	Year 1	Year 2	Period 1	Period 2	Aggregate Total	Period 1	Aggregate Total
Tier 1	$650,000	$675,000	$185,250	$365,625	**$275,438**	$379,688	**$379,688**
Tier 2	$650,000	$800,000	$123,500	$243,750	**$183,625**	$300,000	**$300,000**
Tier 3	$1,800,000	$1,900,000	$256,500	$506,250	**$381,375**	$534,375	**$534,375**
Percent of Base Salary							
Tier 1			29%	56%	**42%**	56%	**56%**
Tier 2			19%	38%	**28%**	38%	**38%**
Tier 3			14%	28%	**21%**	28%	**28%**
Totals	**$3,100,000**	**$3,375,000**	**$565,250**	**$1,115,625**	**$840,438**		**$1,214,063**

Note: *Tier levels above include: one participant in Tier 1, two participants in Tier 2, and eight participants in Tier 3.*

Chart F

Tier	Executive	Position	LTI Target % of Base	Base Salary		Long-Term Incentive Year 1 Grant[1]			Grant[2]	
				Year 1	Year 2	Period 1	Period 2	Aggregate Total	Period 1	Aggregate Total
Tier 1	Exec #1	Chief Executive Officer	30%	$650,000	$675,000	$185,250	$365,625	**$275,438**	$379,688	**$379,688**
Tier 2	Exec #2	Chief Operating Officer	20%	$325,000	$400,000	$61,750	$121,875	**$91,813**	$150,000	**$150,000**
	Exec #3	Chief Financial Officer	20%	$325,000	$400,000	$61,750	$121,875	**$91,813**	$150,000	**$150,000**
Tier 3	Exec #4	Chief Legal Officer	15%	$225,000	$237,500	$32,063	$63,281	**$47,672**	$66,797	**$66,797**
	Exec #5	Chief Information Officer	15%	$225,000	$237,500	$32,063	$63,281	**$47,672**	$66,797	**$66,797**
	Exec #6	Chief Human Resources Officer	15%	$225,000	$237,500	$32,063	$63,281	**$47,672**	$66,797	**$66,797**
	Exec #7	Chief Marketing Officer	15%	$225,000	$237,500	$32,063	$63,281	**$47,672**	$66,797	**$66,797**
	Exec #8	Chief Medical Officer	15%	$225,000	$237,500	$32,063	$63,281	**$47,672**	$66,797	**$66,797**
	Exec #9	Chief Ambulatory Services Officer	15%	$225,000	$237,500	$32,063	$63,281	**$47,672**	$66,797	**$66,797**
	Exec #10	Chief Performance Officer	15%	$225,000	$237,500	$32,063	$63,281	**$47,672**	$66,797	**$66,797**
	Exec #11	Chief Inpatient Services Officer	15%	$225,000	$237,500	$32,063	$63,281	**$47,672**	$66,797	**$66,797**

Chart G

Market Competitiveness

The committee should also be provided with an analysis of competitive market positioning for total cash compensation, with the market data aggregated across the positions in each level or tier, and across the overall executive team. These comparisons allow the committee to determine whether there is proper calibration between level of performance, the size of the resulting incentive awards, and market competitiveness. In other words, does "target" level performance equate to "target" incentive awards (as a percent of base salary) and "target" total cash compensation positioning against the identified competitor group?

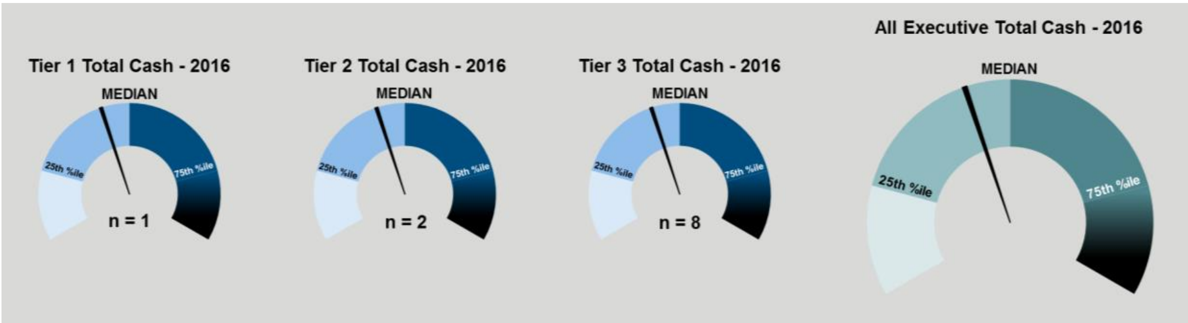

Chart H

If the pay levels within the various levels or tiers of executives are positioned differently to the market (as shown in this example), the committee should request an analysis so they can identify the contributing factors. For example, a level or tier positioned lower to the market than others may be comprised of executives whose salaries are currently low compared to the market because they are new promotions or recent hires. If the individual salaries assigned to a given level or tier are market competitive, it is possible that the committee will need to adjust the target incentive award opportunities for that level or tier.

The payout from the long-term incentive plan should be added in to the market competitiveness analysis. In general, the positioning of the overall executive team against the aggregated market data should be an important indicator to the committee as to whether incentive program performance reflects organizational performance.

As stewards of investor, donor, and taxpayer dollars, compensation committees and boards are held accountable by the healthcare organization, the community, regulators, and the press for administering efficient and effective executive compensation programs. Variable compensation programs can be very effective, but only if they are regularly evaluated and modified to maintain alignment with the organization’s strategy. In an industry changing as quickly as healthcare, compensation committees should add this pay-for-performance analysis to its annual agenda.

Note: The annual and long-term incentive plans in these examples are comprised of corporate measures only, as there are none included for department, division, team, or individual performance; those measures may need to be excluded in order to assess performance and pay by level or tier and for the entire executive team.

About the Author

Steve Sullivan, a principal with Pearl Meyer's Houston office, has more than 20 years of consulting and industry experience assisting clients in executing their strategic human resources and compensation initiatives. His focus is in the areas of executive compensation program benchmarking, design, and oversight in the healthcare industry and for tax-exempt businesses. Mr. Sullivan also advises clients in the areas of sales and performance incentives, recruitment, motivation and retention, strategic compensation program design and implementation, and organizational change. He has experience in the financial services, manufacturing, and information technology industries.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.

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