The American Hospital Association's
CENTER FOR HEALTHCARE GOVERNANCE™

Aligning Executive Compensation with the New Health Care Paradigm:

What the Board Needs to Know

Monograph Series

About the Authors

This monograph is a compilation and update of several articles by Sullivan, Cotter and Associates, Inc. that originally appeared in *AHA's Great Boards* newsletter and *Trustee* magazine. AHA's Center for Healthcare Governance would like to acknowledge SullivanCotter authors Timothy J. Cotter, John Collins, Maureen Cotter, Bruce Greenblatt, Kathryn Hastings, Michelle Johnson, Sally LaFond and Jose Pagoaga for their contributions to this publication.

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Sullivan, Cotter and Associates, Inc., an affiliate member of AHA's Center for Healthcare Governance, is an independent consulting firm focused on assessment and development of tailored total compensation and reward programs. For more than 20 years, the firm has provided executive, physician and employee compensation and governance counsel to a wide variety of not-for profit and for-profit health care and higher education organizations, public charities, associations and foundations. The firm works closely with executives, boards and compensation committees to devise innovative solutions to attract and retain talent while satisfying not-for-profit missions, for-profit goals and regulatory requirements.

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Introduction

Strong health care leadership has never been more important—or more demanding—than it is today. The reform-era chief executive is responsible for leading organizations through unprecedented transformational change that will fundamentally alter the way health care is delivered and how consumers are engaged in a system of care. Today's CEO must have proven skills at the helm, up-to-the-minute knowledge of evolving changes in regulations, reimbursement and care delivery, and a clear understanding of the organization's short- and long-term goals. A tall order—and one that can be supported by the design of a highly competitive, performance-based compensation program.

Governing boards of health care organizations and their compensation committees face new challenges. They must effectively and responsibly govern the executive compensation program by balancing potentially competing interests: regulatory, public, constituent and employee. On one hand, compensation levels must be competitive to recruit, motivate and retain a prepared leadership team. On the other hand, compensation levels are subject to increasing affordability, public scrutiny and regulatory compliance considerations. More than ever, compensation committees are involved in goal selection and the calibration of metrics to align pay with performance.

This monograph offers guidance on proactively considering best practices in executive pay, including the changing role of incentive compensation, good governance practices to mitigate risk and choosing appropriate peer comparison data to support the compensation decision-making process.

Part I: The Changing Role of Executive Incentive Compensation

The incentive compensation plan is a tool used to focus leaders' attention on the hospital or system's most vital priorities and initiatives. As health care organizations revise their business strategies to address the ongoing transformation of care delivery and payment, the board's compensation committee should also reassess the structure and performance measures of its executive incentive compensation plan. Such an assessment can help determine whether the incentive plan and executive performance are aligned with the health system's current goals and the changing health care marketplace.

More executive pay is being put at risk, and boards are expanding the types of measures used to evaluate executive performance. The change in the amount of performance-based pay as part of executive compensation is evolving into a greater portion of executive total compensation, as organizations consider greater (at risk) annual and/or long-term incentive opportunities.

Annual incentive compensation plans have traditionally focused on rewarding operational performance, with financial results as their primary consideration. There is no question that financial performance is integral to the ongoing viability of the organization and its ability to invest in the future and meet its not-for-profit mission. However, health systems today find themselves in a position where they must expend resources to execute long-term strategies, which may impact short-term financial results. In these cases, placing a heavy emphasis on measures of annual financial success in determining executive compensation may not be the right recipe for success. Specifically, the increasing size and scale of many health

systems often is being accomplished through the execution of multi-year strategies to simultaneously address a variety of environmental factors affecting organizational performance (see the sidebar at right titled "Change Agents").

The compensation committee can benefit from reviewing the performance areas covered in its executive incentive compensation plan and how measurement and rewards are structured. The aim is to ensure these plans truly focus on driving achievement of critical organizational goals, both short- and long-term.

Sullivan, Cotter and Associates, Inc. recently conducted a study of CEO annual incentive compensation practices over the past four years in more than 50 large, not-for-profit hospitals and health systems to provide insight into the relationships among performance measures; goal weightings; and quality, patient experience and financial outcomes.

The findings indicate a shifting playing field on which health systems are attempting to juggle a growing number of priorities, as reflected by the types of incentive plan measures now being used (see Top 14 Health System Performance Categories sidebar on page 6). These priorities suggest the need for a dashboard of organizational performance measures that goes beyond the traditional focus on finance, quality and satisfaction that boards generally have used to set executive incentive compensation. Boards and their compensation committees may be concerned that adding different types of measures to rate CEO performance will come at the expense of keeping an eye on the organization's financial performance. However, study results suggest otherwise.

People, Process and Outcomes

SullivanCotter's review of performance in large health systems indicates that an increased focus on patient satisfaction in the CEO's annual incentive plan has a positive correlation to the organization's profitability. And, the relationship between employee engagement/satisfaction and financial performance appears to be even stronger.

Study findings show that organizations that place more weight on "people measures" in CEO annual incentive plans (see examples in the box on page 6, "Sample People Measures Used in CEO Incentive Compensation Plans") have better year-end net operating margins than those that place

Sidebar

Change Agents

Many environmental forces concurrently shaping health care delivery are also beginning to be reflected in executive incentive compensation measures. Recognizing the larger influences can help boards set more relevant metrics and adjust them as the health care playing field continues to evolve. Here are some of the most significant drivers of change:

- Mergers and acquisitions
- Clinical integration
- Physician employment
- Increased access
- Population health management
- Shrinking reimbursement
- Participation in health insurance exchanges
- Patients as educated consumers
- Innovation
- Specialization to achieve differentiation
- Capability to improve community health and deliver greater community benefit

Sidebar

Top 14 Health System Performance Categories

A recent review of 2,300 distinct performance measures used in CEO annual incentive plans in more than 50 large not-for-profit health care organizations resulted in 14 overall measure categories, listed below in order of most common to least common prevalence of use:

1. Finance
2. Quality
3. Patient satisfaction
4. People (employees)
5. Growth
6. Efficiency
7. Continuum of care
8. System infrastructure or integration
9. Other
10. Community
11. Philanthropy
12. Discretionary
13. Individual measures
14. Research or teaching

Source: Sullivan, Cotter and Associates, Inc., 2014.

less weight on such measures. Organizations that focus specifically on multiple patient satisfaction measures (three or more) in CEO annual incentive plans have higher patient satisfaction ratings, as well as better financial health. In addition, patient satisfaction and the rate of core measure adherence increase when an organization's workforce is engaged in providing a better care experience for patients.

Sample People Measures Used in CEO Incentive Compensation Plans

- Employee satisfaction or engagement
- Physician satisfaction or engagement
- Employee wellness initiatives
- Reward programs
- Staff retention or turnover
- Achievement of diversity goals
- Leadership development and succession planning

A more rigorous focus on patient satisfaction measures in evaluating and rewarding executive performance also increases the organization's ability to identify which entities or departments are having the greatest impact on patient satisfaction. This capability supports shared learning about successful practices that can help increase patient satisfaction throughout the organization.

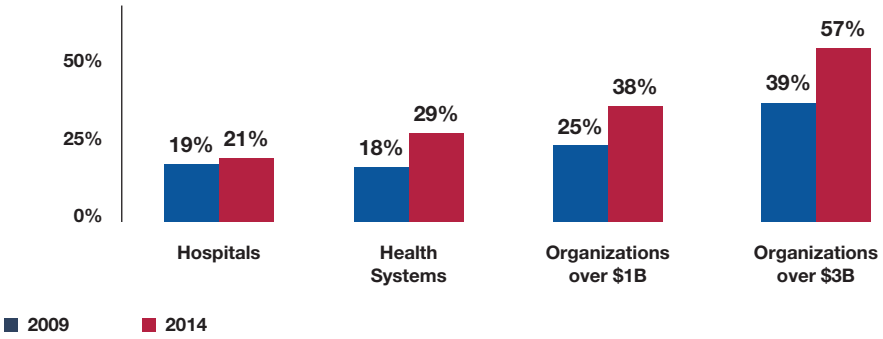
Balancing Act

Today, setting and executing the right strategy is imperative. With so much at stake, an increasing number of health care organizations are considering long-term incentive plans that tie executive pay to critical long-term strategies. Data from SullivanCotter's 2014 *Manager and Executive Compensation in Hospitals and Health Systems Survey* indicate that the prevalence of long-term incentive plans in health systems is growing (see Figure 1 on page 7). Last year, 57 percent of organizations with $3 billion or more in net revenue had long-term incentive plans in place for their executive team.

The changing marketplace is expanding the scope and focus of health system performance goals to drive the development of new strategies to achieve multiple, complex goals. While physician integration,

Figure 1

Prevalence of Executive Long-Term Incentive Plans (LTIPs)



Source: 2009, 2014 SullivanCotter Manager and Executive Compensation in Hospitals and Health Systems Survey

electronic health record implementation and clinical integration to better manage population health are some examples, each health care organization will set strategies and goals that respond to its unique circumstances and markets. Compensation committees must, therefore, understand these broad trends to set the right context for the development of appropriate performance measures for their particular executive incentive compensation program.

SullivanCotter's work with health care organizations also indicates a stronger focus on "systemness" that involves bringing all hospitals in a care system to an equal or common standard of performance or performance improvement, which typically takes several years to achieve. The drive toward systemness is one factor contributing to an uptick in the number of organizations using long-term incentive plans, along with annual incentive plans. These initiatives take time, money and attention on the part of executives to get all parts of the system working toward aligned goals and objectives. However, because long-term incentive plans are often add-ons, executive compensation committees may need to rebalance or change the level and weighting of incentive pay elements between annual and long-term plans. This ensures available resources are appropriately allocated to achieve key outcomes and that executive pay is fair and reasonable.

For example, SullivanCotter's study shows, while still prevalent, the use of financial, quality and patient satisfaction measures is trending down slightly to make room for an increase in the use of performance measures around growth, managing integration and operational efficiency, and enhancing organizational image or reputation.

Organizations that are comfortable interpreting their strategic plans to set quantitative, measurable near- and long-term goals to accomplish them often can more easily set long-term goals for rewarding executive performance. However, the requirements for effective goal-setting within executive incentive plans remain the same—goals must be clear, quantifiable and have the ability to be benchmarked.

Research also indicates that the larger the organization, the more likely it is to set

longer-term strategic or transformational goals. Setting such goals depends on the organization's structure and patient populations. For example, although the transformational goal of managing the health of entire patient populations is not yet widely used in determining executive incentive compensation, organizations with their own health plans or who care for large numbers of Medicaid patients will most likely be among the first to initiate and track population-health initiatives. However, simply changing focus or protocols does not necessarily change outcomes. Alignment between people and processes is often required to improve performance and outcomes and achieve goals.

In our experience and review of large health system executive incentive compensation practices, we have found that organizations that concentrate on a broad but focused spectrum of measures in areas that significantly affect their performance tend to work better collectively to obtain desired results. While commonly used performance measures relate to patient and employee satisfaction, finance, quality and safety, growth and integration, performance goals need to be organization-specific and able to concretely determine what level of improvement is appropriate to expect over what period of time. Establishing effective executive incentive compensation plans often depends on trustee and executive consideration of historical performance, improvement data, peer comparisons and internal and external benchmarks, as well as applying their own solid business judgment.

Redesigning Dashboards

While using a scorecard or dashboard of organizational performance measures to set annual and longer-term executive incentive goals is useful, boards should be flexible in determining what measures best reflect changing market conditions and organizational priorities, as well as the weight assigned to them. Organizations and their boards should also consider environmental changes that may impact performance. For example, in the midst of a merger, acquisition or accountable care organization development, the executive's attention is likely to be drawn in unanticipated directions that may require course corrections. Boards should take unanticipated factors into account when assessing executive performance and the CEO's capacity to achieve strategic and incentive plan goals.

Clearly, the compensation committee must understand the organization's short- and long-term goals, as well as changes in the broader health care landscape to establish and prioritize appropriate executive incentive performance measures. It also must analyze the design of pay programs and periodically re-evaluate them to ensure they are placing the right emphasis on pay-for-performance measures. Performance should be carefully evaluated at the end of the performance cycle to learn from experience and to establish performance goals for the upcoming cycle. Where possible, peer performance also should be considered in establishing benchmarks for comparison purposes.

A fundamental shift is underway in health care to reward value over volume and improve the health of patient populations, which intersects with goals to enhance community benefit and improve community health. Today, achieving these goals goes beyond managing care delivered within hospitals to influencing home care after a hospital visit or in nursing homes or other post-acute settings, which also affects the organization's bottom line.

Regardless of the setting, value-based health care requires the efficient delivery of high-quality care as needed, supported by earlier intervention through prevention and wellness initiatives to avoid or shorten hospital stays and reduce health care costs. While performance categories themselves may not change, the aspects of performance that are measured and rewarded will. Health care may be one of

the last of the major industry sectors to make this shift toward value, and change is likely to be evolutionary, as provider networks expand, quality outcomes are more aggressively pursued and value-based purchasing becomes more widespread, shifting from a system of incentives to a system of risk. Considering these shifts in determining how health care executives are paid is one way to effectively support these transitions.

Steps for Boards

Hospital and health system boards that want to update and revitalize their executive incentive compensation plan should first understand the environmental and market trends affecting incentive compensation. Then, the compensation committee should review and analyze its existing plan against the organization's operational and strategic imperatives. The results of this review can help boards prioritize performance areas and set incentive compensation metrics and plan structures to reinforce the priorities that are likely to have the greatest impact on organizational success. Seasoned trustees with diverse skills, experience and sound business judgment often are more equipped to effectively assess both organizational and executive performance and compensation (see sidebar at right titled, "10 Executive Compensation Questions").

Aligning organizational goals and strategies with executive incentive compensation requires finding the right balance between rewards linked to annual goals and rewards tied to long-term objectives. While setting stretch goals is often appropriate, boards should avoid both under- and over-reaching goals to ensure that desired executive performance can be achieved. Under-reaching goals may be viewed as establishing a plan that is really not performance-based, but status quo. Over-reaching goals may serve as a disincentive, if results are impossible to achieve. Incentive plans should be critically reviewed to ensure they focus on achieving the organization's most important operating goals and strategies.

Sidebar

10 Executive Compensation Questions

1. Are our executive compensation incentives designed to drive both the annual and long-term objectives of the organization?
2. If so, do we have the right balance between annual and long-term reward opportunities?
3. Are we adapting our executive incentive plans to the changing needs of the organization and the evolution of the health care field?
4. Do our goals align with our operating plan? Strategic plan?
5. How do our executive incentive compensation and performance expectations align with peer organizations?
6. Do we use internal and external benchmarks to set performance goals?
7. How have we historically performed in achieving our goals? What do we need to focus on to achieve our strategic objectives and mission?
8. How much stretch is in our goals? What is the likelihood of achievement?
9. How does our board executive compensation committee define value, and how will it decide how "value creation" will be measured and rewarded?
10. Who signs off on the goals each year? Does the full board see the goals and understand the impact that achieving them will have on the organization and executive pay?

Source: "Transforming Executive Incentive Compensation," Great Boards, Winter 2014

Part II: Governance — The Compensation Committee's New Agenda

Part of the compensation committee's responsibility in successfully attracting and retaining high-performing executives is to establish practices that maximize informed decision-making and mitigate regulatory and reputational risk. In an environment where the scrutiny of executive pay is normal, compensation committees should conduct a comprehensive risk assessment and adopt agenda items that will help identify organizational exposure associated with failures to:

- ensure that compensation is aligned with changing business conditions and strategies.
- adopt best practices in governance.
- preserve and enhance the image of the organization.
- ensure regulatory compliance.

By identifying these issues up front, and addressing the 10 agenda items outlined below, the committee can make informed decisions and take steps to manage these risks proactively, rather than waiting until they are identified.

1. **Re-evaluate the executive compensation philosophy.** Executive compensation is evolving and the committee should examine the premises on which the program is based:
   - What is the appropriate peer group(s) for the retention and recruitment of executives?
   - Where should the organization target executive pay?
   - Under what situations should it fall above the middle of market practice? Above the upper quartile?
   - Do executive base salaries need to be adjusted every year?
   - To what extent should executive compensation be linked to organizational performance? Individual contributions?
   - What is the business case for providing significant special benefits to executives?

2. **Respond to the changing health care environment.** The committee should assess environmental impacts on the executive compensation program and take action as required. For example:
   - Are the executives' skill sets relevant for the new environment?
   - How are incentive measures aligned with the emerging requirements for scale, value and cost?
   - As mergers or affiliations are considered, are appropriate and affordable change-in-control provisions in place?
   - As the health system becomes more fully integrated after a merger or acquisition, what is the appropriate leadership structure, how many executives are required, and how should existing compensation be modified?
   - Does the program include practices that are no longer contemporary (e.g., tax gross-ups, which involve paying an executive's tax liability for a component of the compensation program)?

3. **Conduct an assessment of the current peer group and market data relied on by the committee.** The soundness of an organization's executive compensation practices is heavily dependent on the comparability data used. Would the organization's data hold up to regulatory scrutiny? Does the peer group reflect the organization's retention and recruitment pool? Criteria to consider include:
   - *Relevance*—Markets should reflect viable retention and recruitment markets.
   - *Size*—Peer organizations should be comparable in size, as reflected by revenue, expenses, employees and other scope factors.
   - *Location*—High-cost urban areas can affect compensation levels, particularly

when there exists significant differences in the cost of living.
- *Complexity*—Number, type, and diversity of services and facilities can impact the complexity of an organization.
- *Performance*—External benchmarks (bond ratings, performance outcomes and industry rankings) also may be considered, but are not as prevalent at this time.

4. **Carefully evaluate actions likely to draw media and/or regulatory scrutiny.** Examples include:
   - Making a significant severance payment when the termination has been publicly described as voluntary.
   - IRS Form 990 disclosures of large executive increases and/or significant payments when the health system or hospital is giving little or no increases to staff, or is implementing staff reductions.
   - Using a process that does not establish the rebuttable presumption of reasonableness. (See Figure 2 on page 12).

5. **Quantify the anticipated cost and disclosure implications of major executive compensation obligations.** These include common market practices, such as severance, supplemental executive retirement plans (SERPs), deferred compensation, long-term incentives, retention incentives and accumulated paid-time-off banks. As health systems and hospitals face financial challenges as well as scrutiny, the compensation committee needs to anticipate the cost of such commitments, which can create unexpected financial strains when paid—and a firestorm of stakeholder and media indignation when disclosed on the Form 990. The committee may be well served to review pro forma Form 990s for future filings before finalizing compensation decisions.

6. **Conduct selected audits.** Publicized cases of executive malfeasance in not-for-profit organizations suggest consideration be given to periodic audits of executive compensation-related expenditures. For example, internal/external auditors could:
   - Compare what the health system or hospital actually pays its executives to what was approved by the compensation committee.
   - Review executive expense reimbursements for compliance with policy, tax regulations and system image standards.
   - Validate scores for performance measures on which incentive awards are based. Left unaddressed, these kinds of issues may result in significant reputational damage.
   - Ensure executive compensation and benefits programs follow all administrative policies and tax laws.

7. **Pay attention to internal equity.** Increasingly, there is an internal and external expectation that the average rate of compensation increase for executives should not significantly exceed the average rate of increase for other employees. While this is a complex issue with many facets, compensation committees should have substantial business justification for compensating executives markedly better than staff employees. Such justifications may include market changes, job responsibilities or scope changes, performance considerations, retention and/or recruitment issues, etc. Considerable differences may leave the organization vulnerable to employee unrest and unfavorable media attention.

8. **Assess advisor independence.** A new U.S. Securities and Exchange Commission rule covering compensation advisor independence, while not specifically applicable to the not-for-profit

Figure 2

Establishing the Rebuttable Presumption of Reasonableness

IRC Section 4958: Intermediate Sanctions, imposes excise taxes on influential persons (disqualified persons) who receive excess economic benefits from tax-exempt organizations and board members (organization managers) who approve such benefits.

If compensation is found to be unreasonable or excessive, executives and board members are subject to penalties as defined under the tax law. The following is an overview of steps necessary to establish the Rebuttable Presumption of Reasonableness.

Rebuttable Presumption of Reasonableness:		
Authorized Body	**Appropriate Comparability Data**	**Adequate Documentation**
• Compensation reviewed and approved in advance by authorized board committee (or full board). • Committee members must be "disinterested" (i.e., have no conflict of interest related to the compensation arrangement): – No business or financial relationships (including through family members). – No material interest in transactions.	• Considers all elements of compensation/ economic benefit. • Compensation paid: – By similarly-situated organizations. – For functionally-comparable positions. • Compensation surveys compiled by independent firms, considering the size and complexity of the organization.	• Adequately document decisions including: – Terms of transaction. – Date of approval. – Committee members: • Present during debate. • Voting. • Abstaining. – Description of comparability data. – Actions taken by members with conflicts of interest. • Preparation of meeting minutes before the later of the next meeting or 60 days after the final decision, and approval within a reasonable period.
If the process above is followed, the IRS may rebut the presumption of reasonableness only if it develops sufficient contrary evidence as to the reasonableness of the compensation.		

health care sector, provides an opportunity to strengthen the defensibility of the organization's compensation program. Factors to consider in assessing advisor independence include:

- Is the advisory firm providing other services to the organization and what are the associated fees for these services?
- Is the advisory firm's revenue from the health system or hospital a significant portion of its revenues?
- Does the firm have appropriate conflict-of-interest policies?
- Does the firm or its advisor(s) have business or personal relationships with board committee members and/or the CEO or senior executives?

Conflicts of interest in the executive compensation process will compromise program defensibility. The compensation committee is in the best position to determine whether any conflicts exist and to take appropriate action.

9. **Move toward greater transparency.** There is consensus that greater transparency concerning executive compensation strongly contributes to appropriate and justifiable compensation programs. The compensation committee would be well served to:
   - Review outside earned income to identify potential conflicts and ensure executives are properly focused on the organization's interests.
   - Provide a report on executive compensation programs and levels to the full governing board on a regular basis.
   - Consider the development of a Compensation Discussion and Analysis (CD&A) comparable to that of a public company, to support internal and external transparency.
   - Ensure that executive compensation is properly reported on the Form 990 and other required governmental filings. Best practice is that the board review the Form 990, including required compensation disclosures, prior to its filing.
   - Use tally sheets to assist compensation committee and board members in understanding the total current and expected cost of all economic benefits provided to each executive.

10. **Ensure a strong committee oversight process.** Good governance processes support appropriate and defensible committee decisions. For example, the compensation committee should:
   - Establish an annual calendar of its activities.
   - Receive meeting materials and adequate staff support to make informed decisions.
   - Consider adding an outside expert to the committee, if permitted under state statute, when there is a lack of internal expertise.
   - Ensure sufficient meeting time to adequately review and deliberate proposals.
   - Establish a process that obtains the rebuttable presumption of reasonableness, including for off-cycle decisions, such as new hires and retention arrangements.
   - Make use of an executive session when appropriate.

By adhering to a thoughtful and comprehensive agenda focused on minimizing reputational and regulatory risk, the compensation committee will be well prepared to confront an increasingly critical and challenging environment. Only independent and qualified committee members, with adequate internal and external information, can display the healthy skepticism and business judgment necessary to develop appropriate compensation arrangements and effectively defend them when necessary.

The third item on the compensation committee agenda above—the peer group and market data assessment process—particularly merits further analysis to ensure it reflects best practices, as well as the organization's true retention and recruitment markets.

Part III: Comparability—Selecting a Sound Peer Group

An effective peer group benchmarking methodology is vital to effective compensation committee oversight of executive compensation. By utilizing a strong process, the board and the compensation committee can be confident that their basis for executive compensation decisions is appropriate considering the organization's retention/recruitment markets. When

combined with good business judgment, it will also result in an executive compensation program that is balanced and defensible. Used properly, benchmarking is an effective, fact-based method that can serve multiple purposes, including the capability to:

- Assess the market competitiveness of each element of compensation, as well as the total package.
- Determine the appropriate mix of fixed compensation, performance-based incentives and benefits.
- Evaluate pay practices, including incentive performance measures, benefit program design, perquisites, severance, employment contract terms and other practices.
- Ensure the organization's actual compensation is aligned with the market positioning in its pay philosophy.

The peer group is the basis for supporting the organization's compliance obligations and developing "appropriate comparability data" to support the establishment of the rebuttable presumption of reasonableness (see Figure 2 on page 12) under federal tax law, which provides protection to the organization and individual board members in the event the executive compensation plan is subject to an IRS audit. The effectiveness of this tool, however, is highly dependent on how the compensation committee governs the process used in peer group selection, as well as its use of peer group data.

An initial decision in the peer group selection process is determining whether the organization's executive compensation decisions warrant the development of a custom peer group, versus using available published survey data. For some organizations, published survey data reasonably reflect its talent market and corresponding compensation levels. In that case, the predefined criteria included in surveys (such as revenue size, geography, and academic versus non-academic status) are sufficient indicators to compile appropriate data.

For other organizations, however, the complexity of their operations or geographic location may be such that general published survey data do not adequately capture the true market for executive leadership talent or scope of operations. This may occur, for example, where organizations have unique academic missions or a mix of both managed care and provider operations. Or, perhaps the organization is located in an area where the market for talent is particularly competitive or the cost of living is high. In these cases, published survey data alone may not be sufficient for compensation decisions. Instead, it may be appropriate to develop a custom peer group of organizations to use for benchmarking. Custom peer group data can be compiled from surveys, as special subsets compiled from a survey provider or from IRS Form 990 compensation disclosures.

Custom Peer Group Selection

When circumstances call for a custom peer group, a sound process for the selection and use of data is critical. To be useful and defensible, the peer group should contain organizations that are similar in several defining characteristics, and should be representative of those with which the organization competes for talent. The compensation committee should discuss and achieve consensus on the organization's competitive market for executive talent. Senior management and outside advisor points of view are valuable to this process, as well as historical retention and recruitment experiences, particularly since board members may be less familiar with the increasingly diverse set of organizations from which executive talent is drawn.

To see how well your organization's approach to selecting peer groups aligns with best practices, compare your process to the Peer Group Decision Tree in Figure 3 on page 16.

When developing a custom peer group, focus on the characteristics that the organization and its industry competitors have in common.

Examples of primary selection criteria often include:

- **Retention and recruitment market**—Consider where the organization typically draws talent. Examples of how this may play out include:
  - In major urban areas, talent may be drawn from other not-for-profit health systems with similar positions. In more rural areas, both not-for-profit and for-profit organizations may represent the talent pool due to supply and demand issues.
  - For some organizations, the scope of position responsibilities may factor into defining the peer group. Specifically, large health systems may draw talent from large corporate environments for positions in marketing, human resources, IT, finance, etc. New ventures and innovation in the health system may also draw talent from other markets such as health plans, physician groups, start-ups, etc.
- **Structure and complexity of operations**—This could describe freestanding hospitals, multi-hospital systems, integrated delivery systems or academic medical centers. In addition, consideration could be given to lines of business among peers (e.g., those that have a managed-care plan versus those that do not, those with large physician groups and those with long-term care operations).
- **Specialty focus**—Consider the degree to which specialty facilities (e.g., academic medical centers, children's hospitals, cancer centers) may play a role in the local recruitment and retention market and in market data.
- **Size**—This is an important criterion, since compensation levels are often correlated to size. For hospitals and health systems, net operating revenue is the most common factor used to consider a range of size for peer organizations. A general rule of thumb is to include organizations that are between one-half to two times the size of the organization.
- **Location**—Depending on the number of available peers and the talent market, location may be defined as the surrounding geographic area or region, or it may be defined as organizations in the same "type" of geography (e.g., urban, suburban, rural or major metropolitan area). Many organizations have a national recruitment market, in which case a broader group may be appropriate.

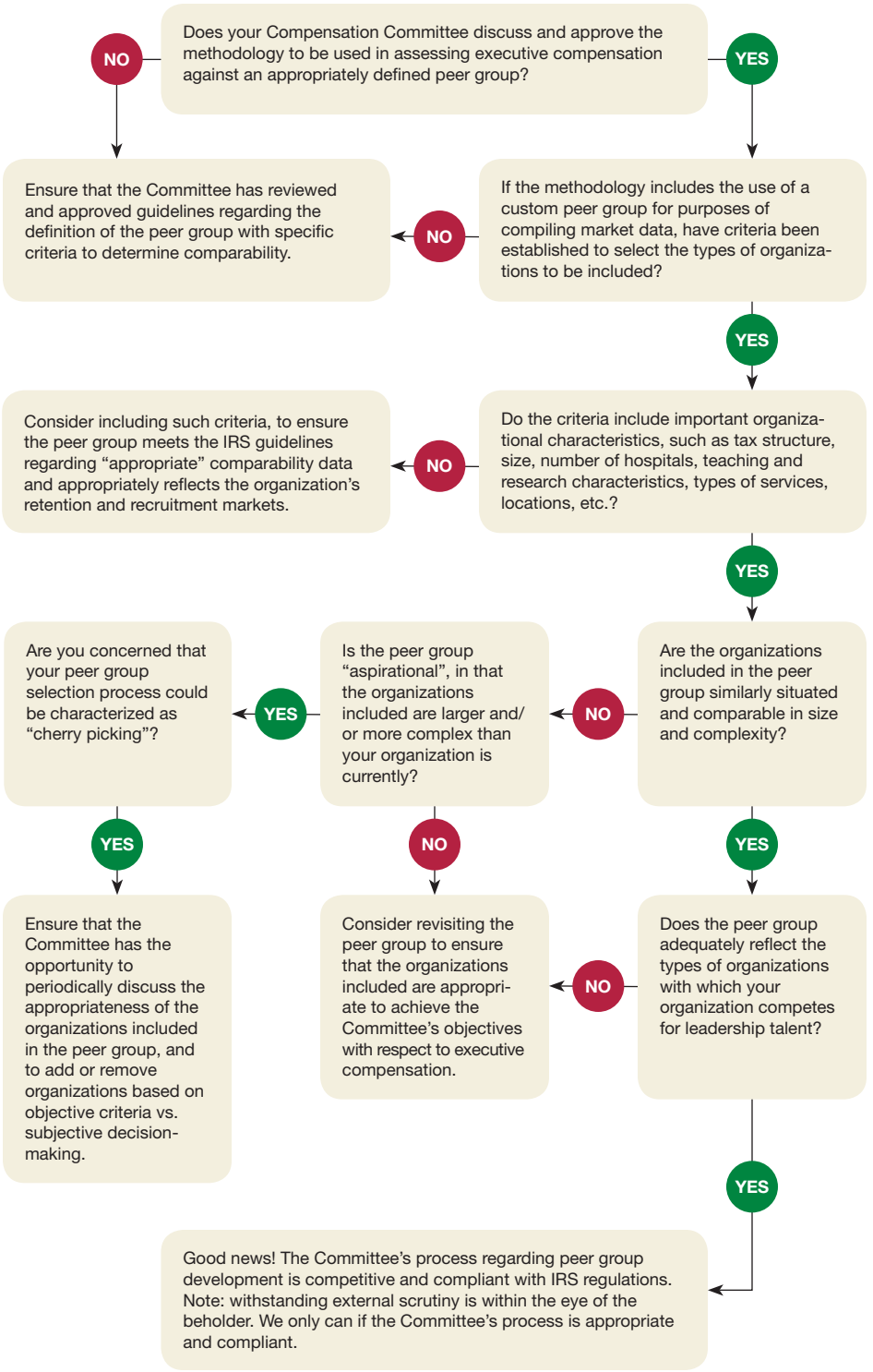
Although the IRS's intermediate sanctions regulations expressly permit the inclusion of for-profit companies in the peer groups of not-for-profit organizations, an organization should consider the circumstances that support the use of such data, and carefully document these factors. If for-profit companies are included, the data should be interpreted cautiously since it may include significant stock and other equity-based forms of compensation that are not vehicles available to executives of not-for-profit organizations.

Other criteria may also be considered. Examples of secondary selection criteria include:

- **National rankings**—Consideration may be given to various published rankings or other designations (such as *U.S. News & World Report*), that may help define a peer group. Be sure to review the limitations associated with any rankings, as well as the methodology used to identify top-performing organizations.
- **Grant funding**—National Institutes of Health grant levels and state funding may be important to determine comparability of organizations with significant research activities.
- **Bond ratings**—The comparability of bond ratings provides perspective on whether peers have similar financial stability characteristics.

Figure 3

Peer Group Decision Tree



As the compensation committee applies these criteria, it should consider how its decisions would appear to those who might scrutinize its actions, who are evaluating the chosen peer group the way that regulators would. Also consider how the media and public may consider the peer group. This foresight will be helpful in proactively responding to inquiries.

Pay-for-Performance Peer Alignment

In recent years, compensation committees have become more interested in strengthening the "pay-for-performance" components of executive compensation programs. Performance data, which are increasingly available through public sources, can be applied to the custom peer group to help determine appropriate performance targets for incentive plan goals. In addition, peer performance data can be used to assess if an organization's performance compared to peers is directionally aligned with competitive pay positioning. For instance, if the organization has a pay-for-performance philosophy of providing compensation opportunities at the 75th percentile, are the performance expectations established at the 75th percentile in terms of absolute performance or improvement expectations?

Size of the Peer Group

The selection process should result in a peer group that is sufficiently robust and reliable. The peer group ideally should contain at least 15 organizations (and larger if possible), unless the organization has unique attributes that would support the choice of a smaller group. Peer groups of fewer than 15 entities may produce less reliable data and be more easily impacted by year-over-year changes in the group. Ideally, the median revenue of the peer group should approximate the organization's size to ensure a good fit for compensation benchmarking.

The peer group selection criteria should be balanced and not too heavily focused on just one factor. For example, an organization with a particularly high concentration of regional competitors may be inclined to include primarily those organizations in its peer group, fearing the need to "stay ahead" of the competition relative to compensation. However, if the competitors are considerably larger and/or more complex, or if there are too few organizations to constitute a robust sample size, the justification of the resulting peer group may be weakened.

In addition, carefully evaluate "aspirational" peers for which comparability is difficult to demonstrate. If an organization truly is in an aggressive growth stage or undergoing a turnaround where aspirational peer-group comparisons are appropriate, the group should be balanced with peers that are more reflective of the current state of the organization's operations to ensure that decisions are made with an understanding of both the current and future competitive landscape.

Consider collecting data from multiple published survey sources, in addition to the custom peer group, as a validation tool. This will ensure a fact base that adequately captures the market. In addition, where a custom group is used, such validation allows the organization to gauge general marketplace practices, so the implications of using a customized group are understood.

Finally, ensure that potential peers have been appropriately vetted and that the compensation committee is actively engaged in the selection process. If the committee has not been directly involved in the peer group selection process, consider adding a discussion of the peer group to an upcoming meeting agenda. Request a report from management or the organization's outside advisor regarding the current peer group selection process, and develop a plan to ensure a disciplined process and sufficient committee involvement.

Peer Group Documentation and Maintenance

Whether using published survey data or a custom peer group, the compensation committee should document its review and approval process, including the selection criteria used, other supporting rationale and third-party opinions, in minutes of the meetings at which decisions occur. The definition of the competitive market and selection criteria should also be documented in the organization's executive compensation philosophy. In addition to providing institutional knowledge of peer group selection, this documentation supports the organization's compliance with regulatory requirements.

The importance of such committee review and approval has been underscored by a 2013 IRS report on executive compensation in private colleges and universities. The IRS found that one in five of the institutions examined as part of a compliance project utilized peer groups containing institutions so different in size or other criteria that regulators deemed them "not comparable." That report reinforces the importance of peer group selection and documentation to ensure compensation decision-making is appropriate.

The peer group should be periodically re-evaluated to ensure its continued appropriateness. Such a review should occur when either the organization or peers in the group undergo a material change in their scope of operations or size. In the absence of a significant change, peers should be revisited at least every three years to ensure that they continue to reflect the characteristics of the organization and remain appropriate for compensation decision-making.

In this era of mergers and acquisitions, the compensation committee may in fact wish to evaluate the peer group every year, as the market continues to evolve.

Conclusion

The changing health care field, the move to value-based health care, the reduction in health care reimbursements and continued regulatory scrutiny all contribute to the complexity of today's health care environment. The compensation committee's role in governing executive compensation in this environment is only as strong as the processes it follows. The organization is best served when the committee follows a balanced approach to executive compensation that considers both good business judgment and industry best practices, and considers its retention and recruitment market(s), especially as new jobs are developed and the scale and size of the health care organization becomes more complex.

While each compensation committee must take into account its own unique market and strategies in establishing performance measures for executive compensation, focusing on people, process and outcome performance measures is a rational response to a changing, tumultuous environment. Improving patient, employee and physician satisfaction can provide a positive counterbalance to the host of other factors, such as unpredictable revenue, cost reduction challenges, organizational realignment and major changes in payment and care delivery that also affect performance, in sometimes irrational or unintended ways.

The work of the compensation committee may never have been more challenging than it is today, but has the potential to be more far-reaching when it successfully sets a bar for leadership that helps the organization keep pace with change.

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