

BoardBrief

Knowledge Resources for Health Care Governing Effectiveness

The Board's Role in CEO Compensation and Performance Evaluation

Evaluating the CEO is an essential board responsibility, but it is often poorly managed because of uncertainty about the appropriate criteria, concerns about confrontation, or fear of upsetting the board/CEO relationship.

Boards of trustees are responsible for creating a CEO compensation policy and strategy, conducting the CEO evaluation, and regularly reviewing the policy and process to ensure it contributes to the achievement of the organization's mission, vision, and business strategy. Throughout the process, board members must maintain an organization-wide focus, ensuring that the CEO's compensation is aligned with the organization's goals and that no conflict of interest exists between board members and CEO compensation decisions.

Creating an Effective CEO Compensation Strategy

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 of what the organization receives from the individual and the value of what's been given 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 of establishing and following a written policy outlining CEO compensation and its relationship to the CEO's performance evaluation.

The board should either establish an independent Compensation Review Committee, or undertake CEO evaluation as a "committee of the whole," with all trustees involved in the actual evaluation and recommendation process. If a separate 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 chairman, the chairman 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 are critical thinkers not easily influenced by outside pressure.

After a committee is in place, 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 include:

- Statement of the board's responsibility;
- A summary of the organization's philosophy regarding executive compensation;
- The organization's major strategic objectives, and the connection of the compensation evaluation to them;
- A summary of board-approved criteria to be used in the performance evaluation;
- The process for determining the amount of incentive compensation to be awarded;
- The relationship of the performance incentive plan to the annual salary review;
- The methods and timing of incentive payments;
- Process for dealing with payment in the event of CEO death, disability or termination; and
- A summary of the compensation review calendar.

Evaluating CEO Performance

The CEO should be evaluated using pre-determined criteria and goals specified in the CEO compensation policy. In addition to evaluating quantitative measures, evaluation of the CEO may include a "360-degree" approach that seeks feedback on qualitative performance from the board, medical staff leaders, senior management and the CEO.

Quantitative Measures

- Financial performance and specified financial ratios
- Operating indicators, including length-of-stay, average daily census, admissions, outpatient visits, etc.
- Achievement of hospital strategies and objectives
- Market share growth
- Physician satisfaction
- Employee satisfaction
- Patient satisfaction

Qualitative Measures

- Medical staff relations
- Internal operations
- The CEO's success in accomplishing specific strategic and personal objectives defined by the board at the beginning of the evaluation period
- Leadership and strategic development
- Financial development
- Community relations
- Board relations and development
- Independence and development
- Communication
- Problem solving
- Ethics

Evaluating CEO Compensation

Trustees should clearly understand the organization's culture and leadership requirements when evaluating the CEO and/or establishing performance measurement requirements. The board should also invite key stakeholders, such as medical staff leaders and members of the senior management team, to appropriately and meaningfully participate in the evaluation process.

The *Hay Group's Hospital Compensation Report*, the most comprehensive and widely used compensation benchmarking resource in health care, is an excellent resource for evaluating CEO compensation and comparing it to the CEO's peer group. In addition, compensation may be compared to data derived from other reliable hospital CEO salary surveys.

The degree of success of the CEO in achieving organizational objectives should also be a major factor in determining CEO salary and incentive compensation. Trends in various financial and operating indicator areas, and the organization's financial and operating success over the previous year should be considered. These operating and financial indicators may be

compared to other hospitals in the organization's peer group (e.g. by revenue, number of beds, geographic location, etc.), using resources such as the Ingenix *Almanac of Hospital Financial and Operating Indicators*.

CEO Leadership Responsibilities Assessment

A CEO Leadership Responsibilities Assessment is a way to assess board, physician and senior management viewpoints about the importance of various CEO functions and leadership qualities in ensuring the hospital's future success. It is *not* an evaluation of the CEO's performance in these areas, but rather an assessment of the importance of various factors in CEO success. The assessment should ideally consist of two areas: essential functions and personal attributes of the CEO.

Essential Functions of the CEO

- Medical staff relations;
- Internal operations;
- Leadership development;
- Strategic development;
- Financial development;
- Community relations;
- Board relations and development;
- Teambuilding; and
- Regulatory compliance.

Personal Attributes of the CEO

- Independence and creativity;
- Communication;
- Problem solving; and
- Ethics.

The assessors should also define other leadership skills and assets they believe the CEO should possess, and include the CEO's personal goals and objectives. The combined results of the Leadership Responsibilities Assessment can be used to develop a prioritized list of criteria with which to rate CEO performance. Success in achieving the pre-determined criteria should be directly related to the CEO's compensation. Paying special attention to conducting an effective and meaningful CEO performance and compensation evaluation will go a long way toward building better board and CEO relationships.

Sources and Additional Information

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