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Compensation strategy motivates executives to achieve goals

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EMPLOYEE BENEFITS

A compensation strategy helps healthcare organizations motivate key executives to achieve business goals. Such a strategy has five elements: base salary, annual incentive plans, long-term incentive plans, perquisites, and benefits. In designing a compensation package, an organization should consider the managerial model of its executives plus the institution's culture and its position in the business life cycle.

Healthcare organizations should develop a total compensation strategy as part of an overall strategy for motivating and rewarding executives for achieving specific goals.

A total compensation strategy has five components.

Base salary. Base salary is a function of a hospital's competitive market, pay strategy in that market, and the individual executives' positions in their salary ranges. Salaries are strongly influenced by teaching status, bed size, years of experience, and years in the current job.[a]

Annual incentive plans. Incentive plans typically provide compensation based on a formula, on achievement of performance objectives, on a discretionary decision, or a combination of these. A healthcare organization or a department within it could be measured against its own performance or that of its peers.

Bonus plans are in this category, but they typically are discretionary and unrelated to a total compensation strategy.

a. KPMG Peat Marwick Main & Co., *1988 New England Hospital Industry Executive Compensation Report,* October 1988.

Long-term incentive plans. Such plans include stock-based plans, which offer stock options based on stock performance,or cash plans, which offer cash rewards tied to meeting objectives. The plans reward performance during a two-year to five-year period.

Perquisites. These benefits commonly include use of a car, supplemental executive retirement plans, annual physicals, and employment contracts.[b]

Benefits. These typically include a defined retirement benefit plan and a tax-sheltered annuity or Section 457 deferred compensation plan; medical and dental plans; short-term and long-term disability; life insurance; and tuition reimbursement. Flexible benefits and a variety of day care arrangements are becoming common.[c]

Each element plays an important role in an overall compensation strategy, but the elements and the total package should be analyzed from the point of view of the entire organization.

b. Ibid

c. Ibid

Business life cycle

The organization's culture and values influence who it hires and how it structures a compensation strategy.

All organizations proceed through five phases of a business life cycle—startup, growth, maturity, decline, and renewal. Because objectives are different in each phase, compensation elements also differ.

For example, a mature healthcare organization tends to be service oriented, conservative, and focused on maintaining the current level and quality of services. In contrast, an organization in the renewal phase may be more concerned with improving operating margins, implementing strategic planning, expanding services, and adopting aggressive management styles common in other industries.

To design a total compensation strategy, an organization must consider the managerial model of its executives, its position in the business life cycle, and its culture.

Questions that should be asked when judging the managerial model include:

- How important is teamwork among the executives?
- Can the organization accommodate actions with high risk and high potential payoffs?
- How should the managers balance dedication to mission and services with efficiency and profitability?

EXHIBIT 1: Community hospital

Organizational situation

This not-for-profit community hospital has declining market share, a new management team, and elderly attending physicians.

Managerial mode

Managers are service-oriented, aggressive, entrepreneurial, team builders, motivators, moderate-high risk takers, and have excellent relationship skills.

Compensation strategy and programs

Base pay is at the 75th percentile, and the hospital has a strong annual incentive plan linked to corporate performance.

Business strategy

Reorganize the hospital; achieve a surplus; attract and retain attending physicians in key areas.

- How can the hospital's physicians be reasonably incorporated into the model?

When determining the institution's position in the business life cycle, questions it should ask include:

- Is the organization in a period of growth or decline in market share and financial performance?
- Is the organization expanding into a variety of profit-making enterprises requiring entrepreneurial executives?
- How important is maximizing performance in the coming year versus in the coming three to five years?
- What other organizations compete for executive talent?

Regarding the organization's culture, questions to ask include:

- Does the organization have a culture of commitment to quality and mission balanced by efforts to increase efficiency?
- Has the organization accepted the need to modify or replace traditional managerial models?
- Is strategic planning carried out in a manner that accommodates a link between performance and rewards provided in the compensation plan?
- Will the organization reward the values held by employees?

Plan elements

The elements of the compensation plan should achieve the organization's objectives while supporting its values, culture, and business strategy. The elements should be designed so they do not provide overlapping rewards for completing one task.

The organization's position in the market may dictate elements of the plan. For example, a small hospital

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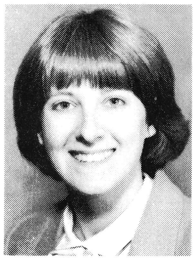

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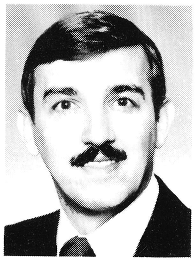

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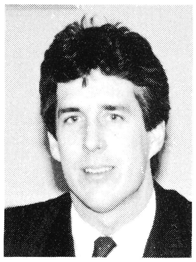

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EXHIBIT 2: Investor-owned system

Organizational situation

This investor-owned healthcare system has core hospitals with expanding nursing home, continuing care retirement community, and home health components. The system also has successful pediatric and obstetrics-gynecology practices.

Managerial mode

Managers have proven experience and technical ability and are strong, aggressive, results-driven, and willing to take a high degree of risk.

Compensation strategy and programs

Base pay is in the upper quartile, and divisional bonuses are offered on a discretionary basis. A stock option program is offered along with physician incentives. Perquisites and benefits are average.

Business strategy

The system is in an aggressive acquisition mode and is focusing on serving the elderly in a cost-effective manner.

EXHIBIT 3: Teaching hospital

Organizational situation

This established, not-for-profit teaching hospital has a severe cost-cutting environment, growing competition, and stable admissions.

Managerial mode

Managers have strong team spirit, dedication to the mission and service, and proven experience.

Compensation strategy and programs

Base pay is at the 60th percentile. Merit increases are offered, and chiefs of staff receive honoraria. Perquisites and benefits are above average.

Business strategy

Continue cost cutting, begin reorganizing, and alter business planning to begin to focus on market expansion.

might compensate its executives highly relative to other small hospitals because it expects its new ventures will enable it to compete with larger hospital systems.

An example of a community hospital that recently hired a new executive is shown in Exhibit 1. In this case, the compensation strategy, managerial model, and business strategy are appropriately linked.

Because of the immediate emphasis on achieving a short-term financial turnaround, a strong annual incentive is appropriate in this case. But to promote a longer view, a longer-term incentive plan focusing on performance in the coming three to five years would be helpful. This case also does not include a method for integrating physicians into the managerial model.

The investor-owned healthcare system in Exhibit 2 uses strategies similar to businesses in other industries.

Unless this organization has reached maturity in its business life cycle, base salary in the upper quartile is unnecessarily high and should be offset by variable compensation.

Instead of using discretionary bonuses, the system could better achieve targeted performance by outlining for executives in advance exactly what is expected of them. Executives should be able to evaluate their performance against expectations. Without this understanding, the discretionary awards may seem arbitrary and can be a source of friction among the executive team.

The system should also consider alternatives to its current stock option plan. Measures of performance other than the system's stock price might better reflect longer-term goals and prove more controllable by executives.

The teaching hospital in Exhibit 3 is ready for compensation changes linked to motivation and performance. To attain or retain a leadership position, base pay can be kept at the 60th percentile relative to similar-sized teaching hospitals.

An annual incentive plan for executives should be introduced if it can be supported by specific business planning. The most powerful influence on chief executive officer compensation is a hospital's emphasis on teaching, so comparison to the appropriate market of hospitals is crucial.[d]

Incentives

The use of short-term and long-term incentive plans is increasing. A recent survey found that 40 percent of hospitals in New England offer some form of incentive plan.[e] Another survey showed that 28.9 percent of healthcare facilities in the United States use incentive plans, and another 37.8 percent plan to install them.[f]

The advantages of a well designed incentive plan include the ability to:

- Vary compensation with hospital performance;
- Let executives know in advance what performance is expected;
- Link the hospital's strategic business plan to both executive performance and compensation; and
- Establish important, measurable goals that reduce the element of discretion.

d. Ibid

e. Ibid

f. ECS, a Wyatt Data Services Company, *The Report on Annual Incentive Plans in the Healthcare Industry*, November 1988.

The plan should clearly spell out its purpose; eligibility requirements; performance targets for individuals, departments, and the organization; and awards and how they will be paid.

These elements must be linked together and communicated to the executives.

Long-term incentive plans should be designed to supplement and support short-term plans. Although long-term and short-term objectives differ, they must work together to move the organization toward the same goals (see Exhibit 4).

EXHIBIT 4: Balancing incentives

Annual incentives

- Focus on short-term goals
- Short market cycles
- Modest capital investment
- Short strategic time frame

Long-term incentives

- Long investment and return cycles
- Long market cycles
- Substantial capital investments
- Long strategic time horizons
- Focus on long-term return

For example, a hospital might want to focus in the short-term plan on efficiency measures such as meeting targeted operating budgets. In the long-term, this efficient hospital must survive through growth. Growth objectives could be reflected in attainment of greater market share in three to five years.

Through the thoughtful use of the messages of compensation, healthcare organizations can increase the effectiveness of compensation dollars paid to executives. □

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