Red Flags: When to Probe Deeper on Executive Compensation

What are the red flags that should alert a board or compensation committee to pay closer attention?

We asked three compensation consultants:

Jim Rohan, Vice President and Managing Director, Sullivan, Cotter and Associates, Chicago, IL; David Bjork, PhD, Managing Director at Clark Consulting, Minneapolis, MN; and Lindalee Lawrence, President of Lawrence Associates, Wellesley, MA.

Big Numbers

Executive compensation must be reasonable in relation to market data from appropriate peer groups. “Most organizations carefully manage total compensation to ensure it does not exceed the 75th percentile of market comparability data,” says Rohan. “In some cases hospitals may need to pay above the 75th percentile for a particular business reason, and that's fine as long as the decision is approved by an independent compensation committee and the rationale is well documented.”

“If they’re paying above the median, then it becomes even more important to state why this is needed for their particular organization and is consistent with their charitable mission,” says Bjork. “Often it comes down to an argument that you need first rate talent to carry out your mission, and top people have many other opportunities elsewhere.”

The higher the compensation, the more a board must be prepared to document its reasonableness. “Boards should be sure they have satisfied the IRS intermediate sanctions safe harbor, so that the IRS must prove its case, rather than vice versa,” Lawrence says. “An inquisitive press and a state attorney general with strong oversight increase the odds that an organization will be looked at. Behavior that flaunts pay, benefits or perks can prompt outside scrutiny. Substantial year-to-year changes in compensation can also trigger questions.”

Executive pay in healthcare is increasing only four or five percent per year, Bjork points out, not much faster than general inflation in the cost of living. Everyone strives to pay enough to attract talented executives, he says. "A good third of the universe wants to pay at the 75th percentile. More than half want to pay at median, so everyone is chasing the middle of the market. That contributes to continued growth in compensation levels."

Rural hospitals and small community hospitals don't necessarily need to pay at the median to attract executive talent, he says. Surveys show that small rural hospitals tend to pay well below national norms, though they are competitive on a regional basis. “If you can recruit and retain, you are paying enough, even if you are 10 percent below the national median,” Bjork says. But if good CEOs are leaving every few years for greener pastures, or if a hospital can’t recruit top notch chief financial and chief nursing officers because of sub-par pay, a higher percentile may be justified.

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>
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Vague or Confusing Explanations

Boards should expect straightforward explanations and clear answers to their questions. Vague or confusing explanations are signs that there is something the board ought to dig into. An incentive plan should be so clear that a board member who sees it once a year can understand it on its face, says Bjork. "If you ever sense that management or your consultant is treating you like an amateur and not giving the board enough information, that would make me suspicious – they could be hiding something."

If a board isn't being educated about current developments in regulation of executive compensation, that itself is a "red flag" for the board, adds Lawrence.

Inappropriate Comparison Group

Make sure you are getting data from comparable organizations. The IRS expects boards to insist on getting data on like jobs, from like organizations, in like circumstances. If you're a children's hospital, define whether your peer group is other children's hospitals, or is a combination of community hospitals and children's hospitals, and explain why.

State explicitly whether you are looking at a national, regional or local peer roup, and why. The IRS is beginning to suggest hospitals should use regional or local data. This makes no sense, says Bjork, since the labor market for executive talent isn't local or regional. At present almost all hospitals use national data (with the exception of California and certain large east coast cities) so they should explain why in their compensation philosophy, says Bjork.

Lawrence says looking at regional or local comparisons can be relevant. Although an organization may recruit nationally, the CEO lives locally, and regional or local patterns of compensation differ depending on cost of living and other factors.

Over-reliance on Financial Incentives

Incentive plans should include a balanced set of measures including financial performance, community benefits, strategic growth, patient access, patient satisfaction, and quality of care. The IRS has expressed reservations about too large a share of total incentives being based strictly on financial performance, says Rohan. The incentive plan should set reasonable limits in terms of incentives as well as potential impact on total compensation.

Extras Not Included

Boards should insist on getting full disclosure on all elements of executive compensation, including all perquisites and the ultimate liability for retirement benefits and severance. When determining executive compensation, boards should look at each element in the context of total compensation.

For example, Rohan says, "Let's assume an organization pays its executives total cash compensation at the upper end of the market (i.e., above the 75th percentile). Then based on current market practice, it adds a rather aggressive supplemental executive retirement plan (SERP). This organization would need to determine if its current cash compensation plus the new SERP results in total compensation that is reasonable."

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The IRS can fine executives for being paid too much, and require repayment of any amount over fair market value or any amount not disclosed as compensation. Boards should protect executives and themselves by approving total compensation and

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seeing that it is accurately disclosed on form 990. "Make sure you have full disclosure on perquisites and all contractual terms," says Bjork. "If you are paying for country clubs or an automobile, that should be disclosed to the board every year."

It is essential that the IRS form 990 capture all forms of compensation, including perks such as executive expense accounts, personal use of employer-owned cars, cell phones, or home computers. Compensation committee and board decisions about total compensation levels need to match the actual payments reported on the 990. The IRS is looking closely at these forms, and underreporting compensation is a serious violation.

"If you inadvertently pay two bonuses in the same fiscal year, or if severance pay shows up on the form, that can create a problem," says Lawrence. "Historically there have been a number of cases where the board was not aware of total compensation levels, because an executive was compensated through various subsidiaries, and this has led to regulatory problems."

Passive Process

"We see executive compensation committees becoming much more careful and deliberate as they carry out their governance responsibilities. They're asking senior management much tougher questions," Rohan says.

If board members aren't asking questions about executive compensation, or if they let the CEO dominate the discussions, be wary, says Bjork. If they don't "quiz consultants on the reliability of their data, watch out."

At a minimum, the compensation committee should meet twice a year, says Bjork. First, it reviews and approves incentive plan goals and measures. At the close of the fiscal year, the committee meets again to review performance against goals and determine actual incentive award levels.

Management Influence

The board or compensation committee should choose its executive compensation consultant and directly supervise his or her work. Any evidence that management is excessively involved undermines the credibility of the external advisor, our experts agree.

Management may identify a list of potential firms and draft a request for proposals, but the committee itself needs to listen to presentations, choose the consultant and direct his or her work. Management also may assist with data collection. "The IRS has also said that compensation consultants are supposed to collect all our data through the committee members, but that is almost impossible – it is not an effective use of their time," says Bjork. "Compensation consultants need direct access to management to gather detailed information about the hospital's past compensation practices."

Outside advisors should be vetted for other business they do with the organization. "If the committee advisor also has a book of business that senior management controls (e.g. an outsourcing contract), the question has to be asked – which master is the advisor serving? Is it the board/committee or senior management?" Rohan says. "Can the advisor be accused of making recommendations to the committee that he/she might not otherwise make to protect the other business?"

Board Conflicts of Interest

Ideally, members of the compensation committee should have no conflicts of interest. At a minimum, they should meet the organization's definition of an "independent director."

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"It is often assumed that members of the committee don't have conflicts, but when you go through a formal review process, you do discover potential conflicts," says Rohan. "This committee must be free of conflicts if the organization is to qualify for the "rebuttable presumption" available under intermediate sanctions." That will generally rule out physician board members who serve on the medical staff.

Skimpy Documentation

The compensation committee should keep detailed minutes and records. Several years ago, those minutes might be one or two pages at most; today they tend to be eight or nine pages long. "They should contain enough detail so that a reader can follow the thread of the committee's conversation and decision-making process," says Rohan.

The executive compensation committee also should receive needed data well ahead of decisions. "Getting materials at the last minute on significant issues is a definitely red flag," Rohan says.

Paying too little

Paying too little can be a problem, too. In small communities where the hospital is the largest, most complex enterprise around, the CEO may be paid more than anyone else in the board room. The local farmer, store owner, or teacher may react from a personal viewpoint and question why anyone is worth so much, experts say. On public hospital boards that are appointed or elected, executive pay may acquire political overtones. "Some boards are reluctant to pay competitively, and don't think executives could get better paying jobs. They find out," says Bjork, "when an executive leaves that they generally have to pay more to recruit a replacement."

Education and open discussion can help the board act objectively, not emotionally. Does the hospital seek an executive from the local community, or does it recruit regionally or nationally for healthcare management professionals? If a hospital wants the best talent, it needs to establish compensation based on regional or national benchmarks.

"This can be a difficult discussion," Rohan says. "It probably takes one or two meetings for the board to come to terms with the compensation levels it needs to pay to attract top talent to its community. After appropriate education and discussion, board members generally reach consensus on appropriate pay levels. This consensus opinion requires a sensitivity to community perceptions and a public communications plan to describe how compensation is set and why executive pay is merited.