

Can Your Incentive Program Withstand Today's Scrutiny?

The uncertain economic environment, coupled with recent IRS, Congressional, and media scrutiny of executive compensation, is giving healthcare organizations reasons to pause and review their incentive programs.

The new IRS Form 990 mandates greater transparency of executive compensation and governance practices. Form 990 will require disclosure of incentive payments, severance payments and deferred compensation, as well as the governance procedures used to ensure reasonable compensation.

Board members in tax-exempt healthcare organizations should redouble their efforts and exercise proper oversight to ensure that all aspects of the total compensation received by their executives are appropriate in light of the economic environment, community standards and the need to attract and retain qualified executive talent.

Given the increased attention to compensation, incentive programs require particular attention.

Here are six suggestions related to the incentive program for board and compensation committee members:

1 Reassess the Compensation Philosophy and Determine the Appropriate Level of Risk

Now is the time to review the organization's compensation philosophy and affirm or modify the level of risk associated with incentive programs. Risk, in this case, may be associated with damage to mission, loss of not-for-profit status, declines in community health, and loss of long-term financial viability. Board members should ask whether the level of risk in the incentive program is appropriate, or whether it fosters undesired behaviors.

2 Review the Incentive Measures

The board or compensation committee should carefully review the measures contained in the incentive program to ensure they appropriately address the organization's financial and charitable-purpose objectives. Overreliance on one or the other type of measure is likely to have negative consequences.

Financial performance and capital investment are critically important to organizations. However, if only financial measures are used or are heavily weighted in the incentive program, the organization leaves itself open to criticism that the mission and tax-exempt purpose of the organization are being ignored. The IRS clearly requires all compensation-related programs to be supportive of the tax-exempt purpose of the organization. Therefore, a thorough review of the types of performance measures being used, and the emphasis placed on these measures in the incentive program, needs to be carefully considered.

3 Ensure There is a "Circuit Breaker" Measure

Very often, organizations use "triggers" or "circuit breakers" in incentive programs that preclude or severely reduce incentive payments if performance does not meet a minimum threshold.

A common trigger measure in healthcare organizations relates to operating margin. The thinking behind this is if there is no

margin, there is no money to pay incentives, regardless of overall hospital performance. Other triggers may include patient safety, community benefit and debt-service covenants.

Some hospitals are also addressing negative operating margins, especially in these difficult economic times. Board members should apply a common-sense approach to the specific facts and circumstances because incentive payments made under these conditions will receive extra scrutiny.

4 Review the Maximum Incentive Payment Amounts

Boards and compensation committee members have a fiduciary obligation to ensure the assets of the tax-exempt organization are appropriately used and that none of these assets inure to the benefit of any individual. Boards and committees always have the opportunity to exercise their discretion to alter or change the incentive programs of the organizations they oversee. An appropriate safeguard is to ensure there is a maximum incentive payment—that incentives are not "uncapped"—and that the maximum is reasonable and aligned with market practices. This includes assessing all elements of compensation, including pay, benefits and any special executive benefits and perquisites.

5 Receive Regular Performance Updates

Throughout the year the uncertain economy necessitates that boards and compensation

committee members be kept aware of the performance measures. Annual evaluations in today's environment are not sufficient. Such discussions ensure there are no surprises at the end of the incentive measurement period.

At the outset of the performance period, committee members should discuss the parameters for potentially revising incentive plan measures during the year.

While many plans allow for board or committee discretion regarding changes to the incentive plan, it is advisable to carefully review the facts and circumstances associated with any changes during a plan cycle. Since retroactive changes are generally inadvisable, any modifications should be carefully reviewed and approved by the board or committee, and sound business judgment should prevail in these circumstances.

6 Review/Implement a "Clawback" Provision

Boards and committees should also review the annual incentive plan document to ensure it contains appropriate "clawback" provisions. While clawbacks typically allow an organization to recover incentive payments awarded on the basis of fraudulently or inappropriately prepared financial statements, organizations are beginning to expand the definition of clawbacks to include significant operational errors or performance-related failures in its tax-exempt mission.

Below is an example of "clawback" language that can be included in an incentive plan.

"If for any reason XYZ's financial statements must be restated as a result of material noncompliance with accounting requirements due to misconduct on the part of an executive(s), then the incentive awards for senior executives made on the basis of these statements will be forfeited, and any monies owed XYZ repaid."

It is also a good idea to make incentive payments only after the receipt of the audited financial statements. This helps ensure incentives are based on independently verified financial data.

Conclusion

Now is an opportune time for an organization to review its compensation programs. In particular, the prudent tax-exempt healthcare organization will make the most of this time to carefully review its incentive plans and adjust plan designs as appropriate given the new economic, legislative and regulatory challenges.

About Sullivan, Cotter and Associates, Inc.

Sullivan, Cotter and Associates, Inc. is an independent consulting firm specializing in the assessment and development of strategic total compensation programs for not-for-profit healthcare clients.

Since 1992, SullivanCotter has worked closely with not-for-profit healthcare organization boards, compensation committees and management to devise innovative compensation solutions that attract and retain leadership and physician talent and that comply with regulatory standards and best corporate governance practices. A leader in compensation consulting and benchmarking, SullivanCotter annually conducts the most widely recognized healthcare executive and physician compensation surveys in the United States.

SullivanCotter has offices in Atlanta, Boston, Chicago, Dallas, Denver, Detroit, New York, Parsippany, San Francisco and Westport.

For more information, visit www.sullivancotter.com or call 888-739-7039 toll-free.

sullivancotter
AND ASSOCIATES, INC.

www.sullivancotter.com | 888.739.7039

INTEGRITY. INDEPENDENCE. INSIGHT.

© 2009 Sullivan, Cotter and Associates, Inc. The material in this publication may not be reproduced, in whole or part, without acknowledgment of its source and copyright. This material is intended to provide information of general interest in a summary manner and should not be construed as individual legal advice. Readers should consult with their Sullivan, Cotter and Associates, Inc. professional and their legal counsel before acting on the information contained in this publication.