

METRO
**Metropolitan Exposition-Recreation
Commission**

***MERC's Accountability Processes
Need to Be Strengthened***

October 2003

A Report by the Office of the Auditor



METRO

PEOPLE PLACES
OPEN SPACES

Alexis Dow, CPA
Metro Auditor



METRO

Office of the Auditor

October 31, 2003

To the Metro Council and citizens of the Metro region:

Consistent with Metro Council President David Bragdon's inaugural promise of "transformation of this government into a more accountable and efficient organization" and our own work plan, we reviewed MERC's Pay for Performance or PFP program to determine if opportunities exist to improve program operations, to assess accountability mechanisms and to evaluate the program's potential applicability elsewhere within Metro.

We found the PFP program to be a compensation program that is operating without the controls necessary to demonstrate that it is being managed fairly, consistently and in the best public interest.

We recommend instituting processes to assure that the PFP program is administered in an equitable, transparent and consistent manner and that process be established to provide accurate and well-founded information about what the program is accomplishing.

MERC instituted the performance oriented compensation system, or PFP program, in January 1999 for about 90 full-time, non-represented employees. The program reflects growing governmental movement toward pay approaches that attempt to relate employee pay more directly to their performance – a very worthy goal.

Salaries for program employees totaled \$4.8 million in FY 2003.

The written responses of the Metro Chief Operating Officer and MERC are at the end of the report.

Very truly yours,

A handwritten signature in black ink that reads "Alexis Dow".

Alexis Dow, CPA
Metro Auditor

Auditor: Joe Gibbons

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Executive Summary

The Metropolitan Exposition-Recreation Commission (MERC), a unit of Metro, initiated a Pay for Performance (PFP) compensation program for about 90 employees in January 1999. Salaries for program employees totaled \$4.8 million for fiscal year 2003.

PFP programs have been used to improve performance in private industry and in government agencies. While they can be difficult to implement, a key element of achieving success is to provide for appropriate oversight, measurement and reporting of program performance. This establishes the basis for holding management accountable and for ensuring that program results are made visible to employees and policy makers.

Our findings point to the need for greater accountability over MERC's PFP program. The program is operating without a formal system to measure and report on its performance and to assure that appropriate policies and procedures are being followed. As a result:

- MERC has made pay decisions inconsistent with PFP principles and its own representations. For example, MERC made pay increases approximating \$300,000 over two years that were not performance based. In another example, MERC asserts that its pay decisions are linked to the organization's financial performance, but this linkage does not appear to be in place. MERC's operating losses have been increasing since the PFP program was started – in 1998 the losses were \$2.4 million and by 2003 they were \$7.1 million – while PFP payouts and salaries have been increasing. In addition, MERC management was unable to provide convincing evidence that their PFP program has improved organizational performance.
- MERC management has made decisions inconsistent with MERC policies. For example, management guaranteed an employee an automatic performance-based pay increase in a job offer and provided some employees with better vacation benefits than MERC policy allowed.
- The Commission and Metro Council lack appropriate information to fulfill their oversight responsibilities. Information is not available to tell these policy makers and the public what the program has accomplished and some information provided has resulted in misconceptions about employee satisfaction, program costs and program administration. For example, surveys show a high level of employee dissatisfaction with the program and the results of these surveys were not conveyed to the Commission. Management has stated that the program costs 10 to 20 percent less than Metro's merit/cost-of-living based compensation system, but it was unable to provide credible evidence to support this assertion.

To provide a basis of accountability, a system is needed for measuring and reporting on the program and providing a basis for reporting on its activities and accomplishments. We believe the MERC Commission should exercise stronger oversight than it has in the past to assure that these controls are put in place.

Our recommendations are on the following pages.

Recommendations

The following recommendations are intended to provide more effective accountability over MERC's pay for performance compensation program by strengthening Metro Council and MERC Commission oversight and requiring management actions to be more transparent and consistent with prudent compensation and accountability practices.

Recommendations to the MERC Commission

We recommend that the MERC Commission strengthen its oversight of MERC's compensation program by:

1. **Directing MERC management to establish and report on specific program goals and performance measures to provide a basis for evaluating program accomplishments.**

MERC established the program without first defining what the organization expected to get in return (i.e. the compelling business need) for the considerable effort and investment required to establish its performance-oriented compensation program. We recommend that the Commission direct MERC's General Manager to clearly define the purpose of the compensation program, why it is critical for MERC's success, what its specific measurable goals and objectives should be, how its effectiveness will be measured and reported, and where measurement data are available or how it can be created. The performance or measurement indicators should go back several years before the program's inception, so that they can serve as a baseline on which to gauge current and future achievements.

2. **Assuring that compensation policies are prudent, equitable, transparent and consistently applied.**

- Stop the practice of immediately adjusting individual employee pay based on compensation studies¹ rather than performance. Linking study results to immediate or direct pay increases is not consistent with the program's objectives and results in paying employees more in the near term than is necessary to retain them.
- Require management to document all existing policies and procedures, apply them consistently and report all exceptions to the Commission for review. This includes (1) developing policies as needed (2) modifying existing policies that are inconsistent or unclear, (3) specifying within the policies the conditions under which exceptions are appropriate, (4) justifying and documenting exceptions and notifying the Commission about them, and (5) making certain these policies are evident by documenting them in an operating manual.

¹ Classification and compensation studies are surveys of other employers to determine comparability of compensation paid for particular positions, usually conducted about every five years. For simplicity, we refer to these studies in this report as compensation studies.

- Address the inconsistent application of benefits and decide whether those employees with benefits that are inconsistent with existing MERC policies should have those benefits continued or modified. For example, some employees have received more generous vacation benefits than allowed under MERC's policy.
3. **Directing MERC management to establish clear linkage between employee pay and MERC's operational and financial performance.**
- MERC's PFP compensation program does not follow MERC's stated policy of clearly relating salary increases to the organization's financial performance. This is an issue because MERC's salary increases have grown although its financial situation has worsened.

Recommendations to Metro

We recommend that the Metro Council:²

1. **Establish specific guidelines and requirements for the Commission to follow in exercising its responsibilities in an accountable manner.**

Such guidelines would provide direction to the Commission and clarify what the Council expects the Commission to do to assure that MERC operates in an accountable manner, as envisioned in Metro Council Ordinance 97-677B. Guidelines should address the need for the Commission to assure that MERC has:

- appropriate program goals, objectives, policies and procedures, and performance measures
- established processes for monitoring program performance
- established reporting requirements to help monitor program performance.

2. **Establish a formal process for considering and reconciling unresolved issues of mutual interest to Metro and the MERC Commission.**

Important questions raised by the Metro Council and Metro staff relating to MERC's administration of its compensation system have gone unresolved, allowing questionable pay adjustments to be implemented and violations of program policy to proceed unchecked. Metro should establish a joint Metro/MERC Committee to resolve these and other issues, such as the reasonableness of MERC making significant pay increases while concurrently experiencing financial shortfalls. A joint Metro/MERC Committee could be composed of a few Council and Commission members, similar to the joint Senate-House Committees that resolve differences between the two houses of the U.S. Congress.

² At the October 23, 2003, Metro Council meeting there was a first reading of proposed Ordinance No. 03-1023, for the purpose of amending provisions of Metro Code Chapter 6.01 relating to the Metropolitan Exposition-Recreation Commission. This proposed ordinance makes changes that significantly enhance MERC operational accountability. Depending on the outcome of this Ordinance, these recommendations may no longer apply as presented.

Introduction

We conducted a series of reviews of a performance-oriented compensation program for about 90 non-union employees within the Metropolitan Exposition-Recreation Commission (MERC),³ a unit of Metro. Salaries for program employees totaled \$4.8 million in FY 2003. This pay program reflects a growing governmental experimentation with pay approaches that base pay increases more heavily on achieving specific organizational results. Our reviews were conducted for several purposes: to evaluate the program's potential applicability elsewhere within Metro;⁴ to determine if opportunities exist to improve program operations, such as employee performance agreements;⁵ and to help assess accountability mechanisms over MERC activities, the focus of this report.

Overview of MERC's pay program

MERC's compensation program differs substantially from the conventional approach used in most governmental settings, including the rest of MERC and Metro. Under more "traditional" public sector compensation approaches, pay for each job or classes of jobs may carry series of "step" increases or a salary range in some form tied to a minimum and maximum amount of pay. Both of these approaches typically lead to consistent salary increases over a given time, either through the form of annual step increases based on tenure or through increases in pay based on established merit review criteria.

Under MERC's program, employee pay increases and/or bonuses can vary substantially and are based at least in part on management's judgment of employee job performance plus other factors. MERC's program bases employee pay on three primary factors:

- The results of classification and compensation studies and salary trending studies.⁶ These studies determine the salary range and amount of increase, if any, for which an employee may be eligible.
- MERC facilities' performance as measured by condition, customer service, operating revenues/expenses and ending fund balance.

³ MERC is both a seven-member citizen commission and the organization that operates the facilities under the Commission's direction. MERC provides stewardship and management of the Oregon Convention Center, the Portland Center for the Performing Arts and the Portland Metropolitan Exposition Center. In this report, we use the acronym "MERC" to refer to the organization that operates the facilities and the term "Commission" to refer to the governing board.

⁴ *MERC'S PFP Program Implementation Is Not a Model For Metro*, October 2003

⁵ *MERC Employee Performance Agreements Need Improvement*, October 2003

⁶ Trend analysis is a statistical method used to adjust salary ranges to keep pace with the local labor market, usually conducted every year. Classification and compensation studies are surveys of other employers to determine comparability of compensation paid for particular positions, usually conducted about every five years as an accepted practice of helping assure competitiveness in the labor market. For simplicity, we refer to these studies in this report as compensation studies.

- How well an employee is performing in his or her job.

In FY 2002, MERC's PFP program covered 88 employees, whose salaries ranged from \$26,400 to \$116,600, excluding the General Manager. PFP employee pay (including salary increases and bonuses) totaled nearly \$4,358,000.⁷ These amounts do not include benefits, such as employer-paid retirement contributions or employer-paid health insurance contributions.

MERC's pay program is described more fully in the Background section of this report.

Management controls and accountability

Public officials entrusted with public resources are accountable for the use of those resources. To provide accountability, public bodies have become more involved in transforming their management frameworks and processes by defining appropriate goals and objectives and setting up systems to measure and report on how well their objectives are met. These frameworks and processes are collectively called management or internal controls.

While management controls vary from organization to organization, a useful framework for evaluating them is the management control standards developed for the Committee of Sponsoring Organizations (COSO) of the Treadway Commission⁸ in 1994. A COSO report titled *Internal Control – Integrated Framework*⁹ establishes a definitive framework against which public and private organizations can assess and improve their internal control systems. In the COSO framework, internal control consists of five interrelated components:

- Control environment – must include integrity, ethical values and competence; attention and direction provided by the policy makers; and management's philosophy and operating style.
- Risk assessment – identifies and analyzes relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed.

⁷ This figure includes the salary of the MERC General Manager. We included his salary in our figures because his and PFP employees' salary were adjusted based on the same compensation study.

⁸ COSO is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls and corporate governance. COSO was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private sector initiative that studied the causal factors that can lead to fraudulent financial reporting and developed recommendations for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions.

⁹ Internal Control – Integrated Framework Executive Summary can be viewed at: http://www.coso.org/Publications/executive_summary_integrated_framework.htm

- Control activities – are policies and procedures that help ensure management directives are carried out.
- Information and communication – Must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Effective communication also must occur in a broader sense, flowing down, across and up the organization.
- Monitoring – Assesses the quality of the system's performance over time, through ongoing management and supervisory oversight activities and other evaluations.

Poor Accountability Processes Permit Deviations from Organizational Policies and Goals

MERC's compensation program is operating without the controls necessary to demonstrate that it is being managed fairly, consistently and in the best public interest. Significant management control weaknesses identified include:

- lack of a system to measure, monitor and report on PFP program performance
- pay and benefit decisions that are inconsistent with stated PFP program intent and policies and procedures
- lack of transparent and complete reporting of PFP program activities and management concerns
- insufficient oversight by the MERC Commission.

Improvements are needed to enable MERC to better demonstrate what the program is accomplishing, to assure consistency and appropriateness of pay decisions and to lead to greater openness of program performance and employee acceptance of MERC's compensation system.

MERC lacks a system to measure, monitor and report on program performance

Performance measurement is an important part of management controls because it provides a way to report on whether a program is operating as intended. It typically assesses program activities, such as conformance to statutory and regulatory requirements, program design, professional standards or customer expectations.

Because of its ongoing nature, performance measurement can serve as an early warning system to management and as a vehicle for improving accountability to the public. Metro recognizes the importance of measuring program performance and has established such measures for its various programs. For example, a recent Metro report on the results of Metro's urban growth management policies quotes Osbourne and Gaebler's *Reinventing Government* management truism as follows:¹⁰

- If you don't measure results, you can't tell success from failure.
- If you can't see success, you can't reward it.
- If you can't see failure, you can't correct it.

¹⁰ Excerpt from Metro's March 2003 report: *The Portland region: How are we doing?* Metro's urban growth management policies were condensed into eight fundamental values to focus the scope of performance effort and reporting. This report is a snapshot of how the Portland region is doing in relation to Metro's growth management goals.

Our findings with regard to MERC's compensation program point to probable organizational and managerial weaknesses in this internal control area. Four and one-half years after program implementation, MERC policy makers and management still do not have a way to measure the performance of MERC's overhauled compensation program. This inability relates to two major deficiencies: lack of clear program objectives and lack of a system for measuring progress on these objectives.

Program objectives not defined MERC did not clearly identify a compelling business need for creating its new compensation program. MERC's General Manager stated that there was no reason to establish a compelling reason for creating the program because he and the Commission determined that having the program was essentially a policy decision. As a result, MERC management did not establish the program with a clear tie to organizational objectives, such as increased profit per customer, improved revenue to expense ratio, or increased customer satisfaction. Employees have individual goals against which they are evaluated, but the program has no clear accountability link to MERC's broader purposes and organizational performance.

Compensation programs that are based on similar PFP principles establish a clear tie between the goals and objectives on which work performance is evaluated and the mission of the organization. In this way, the organization can determine employee effectiveness in achieving specific short- and long-term objectives, and oversight bodies (such as the Metro Council or the MERC Commission) can evaluate how effective the program is in helping to achieve organizational objectives. According to PFP experts, establishing such links to organizational missions is also important in that it helps establish a clear reason for adopting such a program, and thus for obtaining greater acceptance within the organization.

The significance of MERC's omission in this area will be apparent later in this report, when we describe the inconsistency between many pay increases and these organizational objectives, as well as the overall employee dissatisfaction with the program.

Measurement system is not in place MERC has not established the types of program performance indicators that were recommended before program implementation. When MERC's PFP program was developed, Metro's Human Resources (HR) Director helped design the program and proposed a set of measurable performance indicators, such as increased profit per customer, cost savings at facilities, increased customer satisfaction and improved revenue to expense ratio. Although some employees have similar goals in their performance agreements, MERC management did not adopt such performance measures to determine if the program is having intended organizational

success. Thus, while MERC has established a compensation program that is innovative relative to Metro's traditional system, MERC cannot demonstrate that the program has directly enhanced organizational performance.

MERC management dismissed the need for establishing program performance indicators, using reasons that are invalid. The General Manager said that since Metro does not have such indicators for its traditional pay program, he did not believe it necessary for MERC's PFP program to have them. The lack of performance indicators in Metro's traditional program is not a valid justification for ignoring the need for them in this program. The General Manager has made MERC's PFP compensation program a highly visible one with a stated need to enhance employee and organizational performance. Indicators would help show the extent to which the program is meeting that need.

The lack of measures also hinders the MERC Commission in assessing how well the program is functioning and determining what MERC has gained from the experience. For accountability purposes, both the Commission and the Metro Council need a way to monitor program outcomes to assure the program is working as intended and to identify necessary changes and adjustments. A performance measurement system is essential to developing and reporting the kinds of information needed.

Compensation decisions not consistent with policies

A sound management control system would help ensure that compensation decisions are consistent with basic policies. Management controls recognize the importance of establishing sound policies and adhering to them. The standards stress such criteria as the following with regard to policies:

- Policies need to be **consistent**, so that management directions can be appropriately administered and communicated.
- In an organization of MERC's size, policies need to be **clearly documented**, so that they can be readily understood and complied with. Policy documentation should appear in management directives, administrative policies and operating manuals.
- Policies need to be consistently carried out **and adhered to**. Lack of compliance with policies can frustrate the efficient accomplishment of organizational goals. Lack of compliance can also increase the potential for fraud, waste, or abuse and employees' legitimately questioning the credibility of management actions.

Many of the compensation decisions made under MERC's PFP program, however, are not consistent with MERC policies or with principles and practices for similar PFP programs. We also found it difficult to

determine the basis for some compensation decisions, because MERC does not have written policies and procedures relating to key elements of its program. Reasons for deviating from existing policy are not documented, as they should be in a public entity of MERC's size.

Some compensation decisions were contrary to existing policies

We identified various instances in which undocumented reasons for decisions about pay or other aspects of compensation appeared contrary to, or at least inconsistent with, established MERC or Metro policies. They involve making pay adjustments during probationary periods, granting an existing employee a higher salary than the program supposedly allowed and providing more generous vacation benefits than MERC policy allows.

Pay adjustments during probationary periods. MERC had a policy in place in the first years of the program that new employees would not be eligible for the PFP program until they successfully completed their six-month probation period. However, on at least three occasions MERC management made PFP awards to probationary employees. MERC's policy has since been revised to allow for such increases, but the decisions at the time violated an existing policy that the MERC management announced on various occasions, and they were also contrary to the advice of Metro's Human Resources Department. We found no documentation in employees' files indicating that the Commission knew about or authorized the exceptions or other documentation that explained these exceptions to policy.

- A series of emails in March 2000 showed that the Metro HR department contacted MERC management regarding a decision to make a PFP award to a probationary employee who was ineligible for an increase. The PFP increase would also exceed the 12 percent ceiling for the program. Metro HR noted that this and other similar situations were out of the ordinary administration of MERC's PFP program, cautioning that if MERC wanted to keep its PFP program "clean" such deviations from policy make it more difficult and future problems would arise. Nevertheless, MERC decided to make a \$3,082 salary adjustment for the employee.
- In late March 2000 MERC hired a manager in the Administration Division, and at the end of FY 2000 or about three months into the probationary period, the manager's PFP awards included a \$2,032 salary increase and a \$3,047 bonus. Metro HR advised MERC about potential problems related to the employee's ineligibility for such pay awards.
- In early 2000 MERC management made an employment offer for a position within its Administration Division. The offer, which was accepted, stated that the (probationary) employee would "receive a

guaranteed PFP percentage bonus in July/August 2000 of 5 percent. The percentage can be exceeded based on performance. This guarantee is for one year.” Again, Metro’s HR department cautioned MERC to keep its PFP program “clean” by not violating its policy of no PFP salary increases or bonuses during probationary periods.

Reasons for salary increase higher than policy allowed not

documented. In another case, an employee was hired in September 2000 at a salary of \$70,990, the mid point of the position’s salary range. In July 2001 he was given a PFP salary increase to \$73,190. In October 2001 the General Manager placed the employee into an “out of classification” position at a salary of \$76,850. The General Manager noted in the file that one reason he made this decision was his anticipation of the results of a compensation study (to be completed in July 2002) that would provide for a higher salary for the position. MERC personnel policy in place at time of these events noted that individual pay changes will be based solely on performance and if there is a reclassification, paperwork and documentation is required. The decision to raise the salary is questionable because:

- The file did not show that the employee was performing a different job.
- The salary adjustment was contrary to MERC’s PFP standards that state all salary increases must be earned within the bounds of the program and the adjusted base salary was beyond the market midpoint for the position. PFP-related factors, such as facility and individual performance, were not part of the decision process.
- The compensation study was not complete, and in fact the contract for this study was signed in late November, well after this decision was made. Compensation decisions that deviate from policy should be clearly documented and reported upward.

Vacation allowances awarded in excess of MERC’s policies. MERC’s policy on vacation benefits is straightforward, stating that vacation leave with pay for MERC full-time employees shall accrue at specific rates each pay period. The policy does not allow for deviation. However, in three instances MERC granted select PFP employees more generous vacation allowances than those given to other MERC employees and allowed under MERC’s personnel policies. These employees were given vacation benefits that mirrored the Metro vacation benefit. MERC and Metro have different vacation plans that do not contain the same accrual rates or apply the same years of service criteria. For example, new Metro employees accrue 10 hours of vacation per month, compared with new MERC employees who accrue 6.68 hours per month, a 50 percent difference. For reasons that are not documented in employee files, three

MERC PFP program employees accrue vacation time at the rates established under Metro's plan. In one case, the employee involved was a former Metro employee who was allowed to continue to accrue vacation at the same rate as Metro's plan. However, the five other current MERC employees who previously worked at Metro accrue vacation days at the MERC rate and only the one received the more generous Metro-like vacation plan.

In addition to employee equity issues, MERC may be absorbing more costs than needed on this matter. For example, in the above-cited case of the former Metro employee who now works at MERC, the employee worked at Metro for about one year before being hired at MERC. In this instance, the difference between Metro and MERC vacation plans for the employee's time at MERC, as of July 1, 2003, is an additional 138 hours of vacation, or an added benefit of about \$5,500.

Many pay adjustments are inconsistent with PFP principles

One of the most common reasons given to change from a so-called "traditional government entitlement pay program" to some form of a PFP program is to emphasize that employees must earn their salaries and bonuses through individual and organizational performance. MERC's PFP program has been publicized as entrepreneurial and performance-driven, concepts consistent with PFP principles.

The design of MERC's PFP program includes a process for changing salary ranges based upon compensation studies, even though such changes are linked to employment market factors rather than being performance-driven. MERC, however, promulgated the policy that pay adjustments would not be made as the result of a salary range change but through the normal employee performance assessment process. In other words and consistent with original program design, direct salary increases would be based solely on performance. MERC went outside this policy when it made two direct pay adjustments that resulted from a 2002 compensation study that was based on statistics of salary for similar positions in other organizations, rather than actual employee performance. In fact, a sizable portion of MERC's salary increases (37 percent) in 2002 and 2003 was the result of this study.

MERC's first stage of these salary hikes for PFP employees were delivered in mid-2002 after a round of lay-offs in response to financial challenges then facing MERC. The increases went to 49 of the 88 employees in MERC's PFP program. The adjustments were made retroactively and paid out over a 2-year period, totaling \$164,911 for FY 2002 and \$138,474 for FY 2003, exclusive of fringe increases tied to salary (such as Social Security, retirement, and medical benefits that would add about 40 percent to those dollars).

The second stage of these salary increases in late July 2003 came at a time when the organization was again in financial difficulty. In August 2003, MERC formally announced a projected 6.5 percent reduction in operating revenue and a similar reduction in other revenues, amounting to a \$2.1 million financial shortfall for the current fiscal year. In response, MERC is in the process of laying off about 25¹¹ employees, reducing payments to the Portland Oregon Visitors Association¹² by \$250,000 and also reducing various budgets.

MERC established and publicizes its compensation system as being based solely on performance, wherein salary increases are based on performance rather than being in a job position. However, MERC's General Manager maintains that compensation study-related salary increases are not really part of the PFP compensation program. We disagree because their compensation study-related salary increases are unique to MERC PFP employees and are inconsistent with other MERC and Metro compensation policies and practices. For example, MERC does not automatically adjust the pay of employees in union- or association-represented positions based on compensation studies, although COLA-type adjustments may be part of a negotiated contract with a union. Similarly, Metro does not adjust the pay of either represented or non-represented employees based on compensation studies. This practice limits the ability to manage or otherwise address the overall costs associated with the typical results of such studies which would otherwise occur over a period of time through pay adjustments based on performance decisions or tenure.

Accountability issues remain From an accountability standpoint, there are additional concerns about the salary increases, because a significant amount of money was involved and because the salary increases raised issues at the Metro Council level that were not resolved. In reviewing MERC's proposal at the time, the Metro Council in August 2002 raised a number of concerns. Metro Councilors, through the then-Metro Executive Officer, asked for an independent evaluation of the compensation study and for responses on specific Council concerns. Metro officials were caught off guard by MERC's rapid implementation of the compensation study.

The Metro Council's concerns about the immediate salary increases in mid 2002 included:

¹¹ Estimated number of employees laid off based on preliminary reports. Final numbers will be determined after MERC represented employees complete a layoff "bumping" process.

¹² MERC obtains national marketing and sales assistance for the Oregon Convention Center by contracting with the Portland Oregon Visitors Association (POVA). POVA is a private, non-profit marketing organization that promotes convention business and tourism for the area. In FY 2003, MERC's contract with POVA was for about \$2.5 million.

- Immediate implementation of the increases was contrary to Metro Resolution 97-677B, which required MERC to be more accountable by providing advance notice to the Council on important issues well in advance of action. Metro Councilors learned of the increases after the fact, despite having asked MERC earlier in the year to present the results of the compensation study for analysis prior to making the salary increases.
- The compensation study recommended substantially higher pay for some positions without providing detailed data or rationale such as describing the study's methodology or the job market comparables used to determine the recommended increases in the salary ranges.
- Increased salary ranges for some MERC positions raised them well over positions at Metro that are classified at a higher level of responsibility. The Council felt that this would cause equity issues within Metro.
- The employees receiving the greatest benefit of the study were primarily at upper management levels, where increases were as high as 30 percent. The Council was concerned that MERC's action was not prudent in a depressed economy and with both Metro and MERC facing rising health, retirement and other increased costs.
- The Council noted that the salary increases appeared particularly questionable because six months earlier MERC laid off about 25 employees, citing budget constraints and lack of projected revenues. The Council did not see how the additional financial resources needed for the increase could so easily become available.

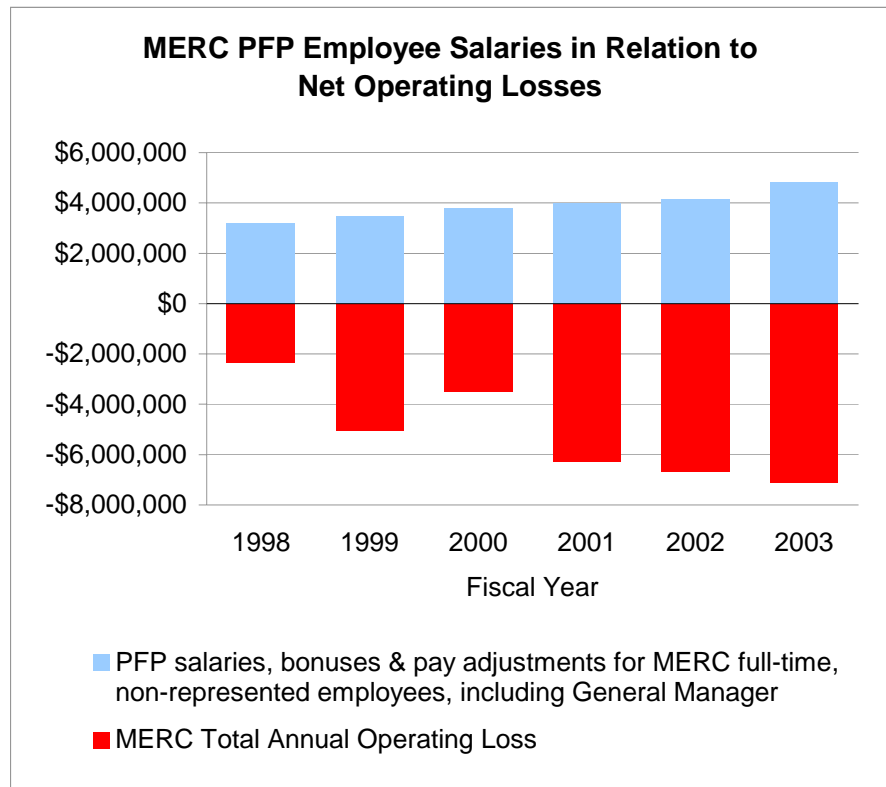
MERC did not fully address the Council's concerns. Without better communication and compliance with existing agreements on such matters, the issue may be repeated when MERC completes its next compensation study, which is typically performed on a 5-year cycle.

Salary increases are not related to policy linking increases to financial performance

Although MERC's stated policy is to relate the amount of PFP awards to financial and other performance factors for its facilities, the actual relationship has been the opposite: as MERC's overall financial performance has worsened, PFP program employee awards have risen. Chart 1 shows that since FY 1998, MERC's operating losses have increased from \$2.4 million to \$7.1 million. During that same period, total awards (salaries, bonuses and compensation study-related increases) for full-time employees placed in the new program increased from \$3.2 million to \$4.8 million. Between 2002 and 2003, total awards to employees increased, while operating losses deepened. These trends also appear inconsistent with MERC's:

- Statement in the FY 2004 budget that it would focus on expenditure management, as well as MERC administration's objectives to facilitate the achievement of financial stability.
- Policy that states that pay decisions will be based on MERC's ability to pay.
- Presentation to the Commission in September 1999 that the benefits of MERC's PFP program are founded on the premises that organizational results and success determine pay adjustments. In good financial years, rewards can be outstanding. When the organization does poorly, employees' pay is proportionately reduced to reflect the organization's decreased ability to pay.
- Original policy statement on the program that all "individual pay changes will be based solely on performance."

Chart 1



The apparent gap between MERC's continuing operational net losses and annual salary, bonus and compensation study-related increases is not in accordance with MERC's entrepreneurial philosophy or sound financial management. We asked MERC management why MERC has continued to increase its PFP awards since program inception, even though operational financial performance has been poor. They told us that

financial performance is only one of the factors to be considered and that other factors such as customer satisfaction are also considered in making PFP awards.

Customer satisfaction and other factors may be important performance indicators that demonstrate PFP impacts. However, MERC's continued salary increases are inconsistent with its policy of making PFP awards based on financial performance. Such actions do not appear consistent with the entrepreneurial, cost-effective concept on which the move to PFP was based. Further, an analysis of data on customer satisfaction and other indicators did not show any clear link between these indicators and compensation levels.

Reporting about costs and employee acceptance has not been accurate

MERC managers have relayed inaccurate and misleading information about the program. An effective management control system is based in part on the concept of open reporting. For controls to work effectively, important information related to organizational performance should be available to managers and oversight bodies, so that they can make informed decisions about developments in the organization. We have already noted that MERC does not have a system in place to monitor and report on the implementation of the compensation program. As a result, it is even more critical that any other available information about the program, such as employee attitudes about it, be available. This openness is not evident in MERC's program.

Part of the problem stems from what was discussed above – the difficulty in clearly establishing the basis for some of the compensation decisions made in the program. Another indication of control weaknesses in this area, however, is that some information presented to the MERC Commission or the Metro Council is incomplete or inaccurate.

Employee problems with PFP not conveyed

We found a substantial difference between the MERC Commission's perception of employee attitudes about the compensation program and what MERC's research was actually showing about employee support for the program. Our interviews of three Commissioners disclosed that they believed MERC employees to be generally satisfied with the program. One Commissioner said that, based on what he had been told and observed, at least two-thirds of MERC's PFP employees were satisfied with the program. Their perceptions, however, are inconsistent with three separate employee surveys that found a significant level of employee dissatisfaction with the program. MERC management did not divulge these results to the Commission.

According to the three surveys MERC consultants conducted, most employees agree with the PFP concept but few like the way the program

has been implemented. Employees' opinions about the program have not changed appreciably over time. For example:

- In September 1999 a MERC consultant found that 31 percent of employees under the program were dissatisfied or very dissatisfied with MERC's PFP program for various reasons (18 percent were satisfied or very satisfied and the remaining 51 percent were neutral). About 90 percent of the general comments about the program were negative.
- In August 2001 a MERC consultant found that 73 percent of participants were not satisfied with MERC's PFP program and believed they were no more motivated under the new program.
- In March 2002 a MERC consultant interviewed 85 MERC PFP program employees and found as follows: "Only 6 to 8 staff members [7 - 9 percent] considered the plan OK as is, and all others [91 - 93 percent] expressed strong criticism of several elements of the plan as currently structured". Concerns raised included perceptions that MERC's program:
 - o was unfair to middle and lower level positions
 - o was not rewarding staff for positive performance
 - o was producing inconsistent and unfair employee ratings and rewards.

At the request of MERC management we did not personally interview MERC PFP employees. However, we interviewed the MERC consultants who had conducted these studies and our consultant who advised us on this work. They said that for PFP program success, the level of employee acceptance should be higher after a few years of implementation, although such programs are always works in progress. The need for such acceptance is critical because the success of PFP programs highly depends on a "culture of cooperation."

The disconnect between employees' actual views about the program and commissioners' sense of what the employees thought rests in part with not sharing the information from these surveys, as well as communications provided in briefings such as the one we observed in July 2002. At this briefing, MERC's Human Resources Director and a MERC consultant told the Commission that while some relatively minor issues existed with the program, these issues were being addressed and overall the program was well accepted and working as expected.

When we discussed employee views of PFP with MERC's General Manager, he said the issue was one that management, rather than the Commission, should deal with and that he hoped we would not tell the Commission about the matter. He also said the program was not designed

with the basic intention of making employees happy. We agree, but we also believe that, based on a preponderance of PFP literature and the views of consultants, employee acceptance is paramount for program credibility and success. Moreover, PFP programs should be transparent at all levels. MERC management has a responsibility to accurately inform the Commission about program issues, such as the extent to which employees accept the program. The low acceptance of MERC's program after more than four years of implementation indicates that there are issues associated with the program that the Commission might want to address.

Costs of the program incorrectly described

Another incorrect view that MERC commissioners may have, based on MERC management's communications to the Commission, Metro Council and others, is that the PFP program is resulting in a cost savings. MERC management has repeatedly stated that its PFP program costs 10 to 20 percent less than Metro's merit pay/cost-of-living system. If true, this could be a reason for the Metro Council to consider establishing a MERC-like PFP program throughout Metro, although the literature notes that cost savings are usually not associated with PFP programs. When we asked MERC management for data supporting their conclusion that their program was less costly than Metro's, we found that MERC did not provide a sound basis for the assertion that the program saves money.

- MERC management cited a study by Metro's Financial Planning Division that supposedly compared the costs of the two systems. In fact, the study compared two different pay structures, PFP and COLA/merit, with a common set of assumptions. The study's author told us that the analysis did not compare MERC's PFP program to Metro's COLA/merit system. The study showed that, given the specific set of assumptions over a five-year period, the PFP structure was less expensive than the COLA/merit structure. However, over the longer term, PFP costs tended to be more than the costs of the COLA/merit system. Further, the study assumptions do not directly compare to Metro or MERC actual experience.
- MERC management provided two further analyses of its own to support its position on this matter. We found that both analyses contain flawed assumptions and other weaknesses. For example, they did not include bonuses and did not consider the long-term impact of the two approaches.
- The Commission Chair concurred that neither the MERC PFP program nor the "traditional" merit/COLA approach is absolutely cheaper and the cost of each is based on policy decisions that will cause each to vary significantly.

- Finally, the MERC General Manager's more recent assertions contradict what he told the Commission in September 1999, nine months after program implementation. At that time, the General manager told the Commission that after comparing MERC's PFP costs to a Metro compensation plan, MERC's PFP program would be about 5 percent more expensive than Metro's plan. He did not mention this event to us during conversations about program costs.

As a related matter, MERC's program may be substantially more costly than the salary increases and bonus dollars would indicate. MERC does not track indirect program costs and these costs may be significant. For example, some employees interviewed during the three surveys cited above noted that they spend an inordinate amount of their time, about 20 percent, involved in PFP-related activities, such as working on appraisals and documenting what subordinates do in order to achieve good ratings. Also, MERC's HR Director convenes a group of about 6 managers and employees every two weeks for two-hour sessions to address PFP-related problems and decide such issues. These administrative costs should be tracked and considered not only as the basis for claiming program costs savings but also as a way to demonstrate the cost-effectiveness standard that is part of MERC's directive from Metro.

Basis for salary adjustments not fully communicated

One further example of the lack of transparency about the compensation program involves communication between MERC management and the Metro Council on the basis for salary adjustments. At a recent Council meeting where MERC briefed the Council on the program, a Councilor asked the MERC representatives if compensation studies led to direct pay adjustments of MERC employees. MERC's Human Resources Director replied that all such increases must be earned through performance. Because this response seemed inconsistent with the data we had gathered, we asked the Councilor more specifically about his understanding of the response. He stated that the response was somewhat vague but he understood the response to be that MERC does not make direct salary adjustments as a result of compensation studies. He was surprised to learn that the MERC response to his question contradicted what MERC actually did in applying the results of the 2002 pay compensation study. Similarly, MERC's HR Director previously made the same statement to us that "All adjustments to the pay of full-time, non represented employees are made through performance awards" – a statement contrary to MERC actions.

MERC Commission has not played a strong role in

The MERC Commission is responsible for providing governance, guidance and oversight of MERC management. We believe these responsibilities have not been adequately carried out as evidenced by the

overseeing the program

fact that, as discussed earlier, MERC lacks a system to measure, monitor and report on program performance. In authorizing the program, the Commission did not require management to define the program's compelling need and related goals and objectives. Also, the Commission did not establish provisions to assure that the program would operate in an accountable manner as envisioned in Metro Ordinance 97-677B, which states, "MERC is authorized to operate in the most flexible, entrepreneurial and efficient manner possible to best meet the goal of cost effective, efficient, and accountable management of the MERC facilities." The ordinance does not provide specific guidance, but to achieve this goal MERC has to have an effective management control system, including ways to measure program progress and achievements and compliance with Metro directives.

Further, accountability standards stress the importance of oversight bodies being knowledgeable of and involved in the entity's activities. Because MERC lacks a performance measurement system, appropriate information is not available to properly assess and evaluate the PFP program or to enable Commissioners to exercise appropriate oversight. For example, our discussions with three Commissioners indicated that they had limited knowledge of the PFP program. They could not tell us whether the program had goals, objectives and performance measures, and they told us that it would be helpful to the Commission if our audit work showed how well the PFP program was working. In addition, they erroneously viewed the program as being widely accepted and supported by employees and less costly than Metro's merit pay system, apparently because this is what MERC management told them.

MERC's PFP program represents the first time such a program has been tried at MERC or Metro. It is therefore considered a high-risk venture,¹³ requiring strong accountability controls. Such controls are needed to provide the basis for holding management accountable, ensuring that the program is working as intended and reporting results to policy makers, employees and other stakeholders. If these controls were in place, the Metro Council would now have better information as it considers alternative forms of employee compensation programs.

Although MERC's PFP program is only one aspect of MERC's operations, from an accountability standpoint the problems we have discussed in this report indicate a need for stronger oversight of MERC activities.

¹³ We discussed the issue of PFP and risk with Metro's outside financial auditors. The firm's partner in charge of the work stated that as a standard part of their audits where pay is linked to financial performance, the firm considers this as a potential fraud/abuse environment and therefore pays attention to the matter as a risk factor. They typically assign their more experienced auditors to look at such issues and the MERC PFP Program was viewed as a potential risk in this regard, although the auditors did not identify any problems on this regard.

Background

Overview of MERC's compensation program

MERC manages three regional facilities – the Oregon Convention Center, the Portland Metropolitan Exposition Center and the Portland Center for the Performing Arts. Together, these three facilities and MERC's Administration Department have about 180 full-time equivalent employees, ranging from managers and events coordinators to custodial and security staffs. The Metro Council in 1997 empowered the Commission to operate these facilities in a cost-effective, independent, entrepreneurial and accountable manner. This empowerment included authority for MERC to adopt its own personnel rules, including compensation policies. Under this authority, MERC established a new compensation program for about 90 employees in January 1999. Employees covered by this program were in full-time positions that were not represented by unions or other associations. Their job titles included facility director, ticketing/parking manager, event coordinator and administrative secretary, among others.

MERC's PFP program differs substantially from the traditional approach used in most governmental settings. Under the traditional approach, pay for each job carries a series of "step" increases. Employees receive a "step" or "merit" increase after completing a period of time on the job, usually one to three years, and reach the "top step" of their position after satisfactorily performing on the job for some years, depending on the organization. In this way, their pay goes up as they acquire seniority in their positions. In most years, all of the "step" levels are also adjusted upward to reflect cost-of-living (COLA) increases that are roughly equivalent to the change in the Consumer Price Index. Thus, the "traditional" Merit/COLA government approach tends to provide predictable, relatively fixed increases that are tied heavily to the length of time an employee has been in the position and continuing performance at a given level. MERC's program has neither the traditional "merit" increases nor traditional COLA increases. Under the MERC program, employee pay increases can vary substantially and are based on management's judgment of employee job performance, facility performance and compensation studies.

Evolution of MERC's program

MERC hired an HR/PFP consultant to design the program. MERC's General Manager did not like the consultant's design because it was viewed as "one size fits all", although it is the design that was initially implemented and is to some degree still in effect. Some of the problems with the original plan were that:

- individual performance measures were too broad
- performance rankings for MERC as a whole needed to be more consistent

- more meaningful goals and objectives were needed
- more training for managers and supervisors was needed.

MERC has attempted to improve the program. According to MERC documents and our discussions with Metro and MERC HR officials, MERC has:

- streamlined the evaluation process by changing the six-month review from written to verbal
- redesigned some forms to be more user-friendly
- formed a PFP Advisory Committee comprised of representatives from all facilities and worked with the Committee to develop new performance measures for each job
- developed a comprehensive PFP Manual.

Pay is based on three main factors

MERC's program, which has been in effect for more than 4 years, bases employees' pay on management's judgment of three primary factors:

- **Salary ranges for comparable jobs in other organizations.** Pay systems, including MERC's, usually make these determinations through two approaches: (1) trend analyses – a statistical method used to adjust salary ranges to keep pace with the local labor market, usually conducted every one or two years; and (2) classification and compensation studies – surveys of other employers to determine comparability of compensation paid for particular positions, usually conducted about every five years. Such adjustments affect the salary ranges within which pay levels are set. MERC's policy is to have a compensation system that is fair, equitable, dependable and one that can easily be maintained through routine trending and classification and comparability studies.
- **The facility's overall performance.** This factor reflects management's judgment of how well each facility has met goals related to such factors as facility condition, customer service and financial performance.
- **How well an employee is doing his or her job.** This factor is the "bottom line" for a PFP program. Unlike "step" increases, which are fixed in amount for everyone with a particular job classification, the size of increases under this factor is determined on an individual basis. Two persons with the same job classification and experience levels might receive markedly different pay adjustments, depending on how management views their performance. Also unlike merit increases, which are awarded at fixed intervals, these increases are typically made at the end of the fiscal year when employee performance is fully evaluated.

The factors are intertwined, in that the salary ranges established for comparable jobs can have a direct bearing on the amount and type of performance-related pay. In overview, the factors are related as follows:

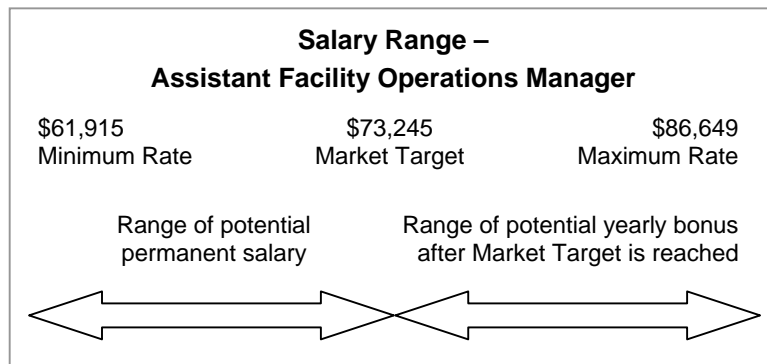
- **Compensation studies establish salary ranges and a “market target” for maximum permanent pay.** Using trend analyses and compensation studies, MERC assigns each job classification a minimum and maximum salary range that MERC management adjusts, as it deems necessary, to remain competitive with the labor market. The approximate midpoint of the range is known as the “market target.” Employees are able to earn permanent increases to their base pay up to this market target. Employees whose base pay is already at the market target remain eligible for permanent increases in future years as trending and comparability adjustments move the “market target” higher. Based on a 2002 compensation study, employees were placed in the same relationship within the new salary range as in the previous range (e.g.: if an employee was at 80 percent of market target before the study, he/she was placed at 80 percent of the revised market target). Moving employees’ compensation upward in this manner is essentially a “COLA-Plus” and quasi-Step Increase approach to compensation, contrary to PFP principles because such increases are not performance based.
- **Overall facility performance sets range of employees’ performance pay increases.** Facilities are rated on condition, customer service and financial success. Facilities condition is rated on a four-point scale, evaluating the general physical condition of the facilities, equipment, general maintenance, patron and tenant accommodations, safety and other factors. MERC evaluators rate such items as parking accommodations, exterior lighting and cleanliness, condition of lobbies and restrooms, medical aid areas, and public address systems. The facility score determines the range and upper limit of PFP awards for all of the facility’s employees in a year. Each employee has a stake in the facility’s overall success because the higher the facility score, the higher the range of potential PFP awards that year.¹⁴
- **Individual performance increases are permanent pay adjustments for employees below the “market target” of their range and bonuses for those already at the “market target.”** Once a facility’s score is determined, the size and nature of individual performance adjustments can be determined. For employees not yet at the “market target,” such adjustments can take the form of an increase to that level. Employees whose salary is at the “market target” are not

¹⁴ MERC’s Administration Division has 14 PFP employees whose PFP awards are based the combined average performance of the three facilities as well as on individual performance.

eligible to receive permanent pay increases, but they are eligible for an annual bonus not to exceed 12 percent of base pay in any performance year, up to the maximum of the salary range. The yearly bonus is not added to base pay and must be re-earned each year.

Pay program structure The workings of the system can perhaps be better understood through an example for a specific MERC job position. The following chart exemplifies the pay-related components of the program for a facility operations manager in 2002. In this example, the salary range minimum is \$61,915 and the “market target” (on average, the amount that the job is paid in the labor market) is \$73,245. MERC’s program does not provide base pay above the market target but it offers the potential of a lump sum bonus in an amount between market target and maximum rate.

Chart 2



The amount and type of the facility operations manager’s performance pay increase or performance bonus is based on the facility’s performance rating and the manager’s individual performance score. An employee’s individual score is determined by how well he or she meets the expectations established in individual performance agreements. The following table shows the minimum and maximum increases that can be earned. For example, a manager whose facility received a score 4 (the highest) and who was rated as consistently exceeding goals and objectives would be eligible for an amount equal to 12 percent of base pay. To the extent the manager’s pay was below the “market target,” he or she could receive this amount as a permanent pay adjustment. Any amount that would have the effect of raising permanent pay above the “market target” would be awarded as a one-time bonus.

Table 1
MERC PFP Formula

Employee's Performance Rating	Range of performance pay or bonus (% of base pay)
Consistently exceeds goals and objectives	8 – 12%
Meets and occasionally exceeds goals and objectives	4 – 7%
Meets some key goals and objectives but improvement is required to attain expected level of performance	2 – 3%
Consistently fails to meet goals and objectives, and improvement is required to attain expected levels of performance	0 – 1%

MERC's program uses employee agreements to define performance expectations and foster better communications between employees and supervisors. Under these agreements, employees and supervisors jointly establish a written set of goals and objectives at the start of an appraisal period. Employee performance and progress is measured against these agreements at least twice each year – mid-year and year-end, at which time PFP decisions are made. MERC's standards call for establishing employee goals and objectives that are clear, specific, measurable, achievable, time certain, organizationally aligned and limited in number. These agreements also serve as basic documentation for performance-based rewards. We discuss our assessment of MERC's employee performance agreements in a separate report.¹⁵

In FY 2002, MERC's PFP program covered 88 employees, whose salaries ranged from \$26,400 to \$116,600, excluding the General Manager. PFP awards (including salaries and bonuses) totaled nearly \$4,358,000.¹⁶ These amounts do not include benefits, such as employer-paid retirement contributions or employer-paid health insurance contributions. That same year, MERC's total budget (excluding ending fund balance and contingency) was about \$81 million. Program awards thus accounted for about 5.4 percent of MERC's expenditures. The total pay for PFP program employees in 2002 was an increase of about 11.32 percent from the previous year, an increase that combines the results of comparability adjustments and pay for performance increases.

¹⁵ *MERC Employee Performance Agreements Need Improvement*, October 2003

¹⁶ This figure includes the salary of the MERC General Manager. We included his salary in our figures because his and PFP employees' salary was adjusted in based on the same compensation study.

The Commission designated MERC's General Manager as the administrator of the program. MERC's Human Resources Director acts for the General Manager in providing day-to-day administration of the program. MERC management also has a review committee that meets regularly to discuss PFP program issues. In addition, Metro's Human Resources Department is responsible for performing human relations-related functions for MERC, such as preparing job announcements, posting and advertising open positions, maintaining and developing salary range data, maintaining personnel files and processing personnel action approvals (e.g. cost of living increases, classification and/or compensation actions, promotions, new hires, etc.).

**Audit objective,
scope and
methodology**

The objective of this report is to present to the Metro Council and the MERC Commission for their consideration what we believe to be a need for greater public accountability over MERC's employee compensation program and potentially over other MERC affairs as well. The information and conclusions presented here are based on our assessment of:

- the adequacy of MERC's management control system for measuring, reporting and monitoring its compensation program
- the reasonableness of MERC's administration of its policies and procedures for the program.

Our work centered on issues related primarily to MERC's PFP compensation program and therefore covered only a portion of MERC's activities, whereas management controls encompass the entire range of an organization's activities. Even so, the concerns we identified were substantial enough to rise to the MERC Commission and the Metro Council in this separate report.

The standards and criteria we used during this analysis consisted primarily of the following:

- Metro and MERC resolutions, ordinances and policy statements and other standards regarding accountability, cost-effective operations, performance-related compensation and personnel management
- COSO internal control standards, as discussed above
- Government Auditing Standards,¹⁷ promulgated by the Comptroller General of the United States, U.S. General Accounting Office and required by Metro Code to be followed by the Metro Auditor.

We began our in-depth work for this review in August 2002. At the request of MERC management in January 2003, we agreed to postpone

¹⁷ Summarized at: <http://www.gao.gov/govaud/ybk01.htm#ybintr>

the issuance of our report regarding MERC employee performance agreements until drafts of the other reports had also been completed. We performed additional work on MERC's overall pay system between March and June 2003. We performed our work in accordance with generally accepted government auditing standards.

Responses to the Report

Metro Response

Auditor comments on use of Audit Response forms

We are pleased to introduce the use of *Audit Response* forms.

These forms allow readers to focus more easily on the recommended actions. This benefit contributes to their use as a widely accepted standard practice.

In addition, Metro Code 2.15.070 states in part, “The response must specify agreement with the audit findings and recommendations, or reasons for disagreement, as well as proposed plans for implementing solutions to identified problems and a proposed timetable to complete such activities.”

We provided MERC and the Metro Chief Operating Officer with an *Audit Response* form for each audit recommendation addressing these items to facilitate their response and to improve the process for monitoring progress.

The formal narrative responses from MERC or Metro Chief Operating Officer follow the *Audit Response* forms.

Audit Response forms will continue to be used on future audits.

Audit: MERC's Accountability Processes Need to Be Strengthened

Date: October 2003

AUDIT RESPONSE

Recommendation 1 (Metro Council)

Establish specific guidelines and requirements for the Commission to follow in exercising its responsibilities in an accountable manner.

Agree

Yes _____

No _____ (specify reasons for disagreement)

Note: At the October 23, 2003, Metro Council meeting there was a first reading of proposed Ordinance No. 03-1023, for the purpose of amending provisions of Metro Code Chapter 6.01 relating to the Metropolitan Exposition-Recreation Commission. This proposed ordinance makes changes that significantly enhance MERC operational accountability.

What action will be taken (if any)?

Who will take action?

When will action be accomplished?

Ordinance No. 03-1023 will be effective 90 days after adoption.

Follow-up necessary to correct or prevent reoccurrence.

Not applicable at this time

Audit: MERC's Accountability Processes Need to Be Strengthened

Date: October 2003

AUDIT RESPONSE

Recommendation 2 (Metro Council)

Establish a process for considering and reconciling unresolved issues of mutual interest to the Council and MERC Commission.

Agree

Yes _____

No _____ (specify reasons for disagreement)

Note: At the October 23, 2003, Metro Council meeting there was a first reading of proposed Ordinance No. 03-1023, for the purpose of amending provisions of Metro Code Chapter 6.01 relating to the Metropolitan Exposition-Recreation Commission. This proposed ordinance makes changes that significantly enhance MERC operational accountability.

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When will action be accomplished?

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Follow-up necessary to correct or prevent reoccurrence.

Not applicable at this time

**METRO**

October 14, 2003

Alexis Dow, Metro Auditor
600 NE Grand Avenue
Portland, OR 97232

Dear Auditor Dow:

This letter is the Chief Operating Officer's response to the September 30, 2003 draft audit of the MERC Pay for Performance program. The draft audit has been published in three parts titled: 1) MERC Employee Performance Agreements Need Improvement, 2) MERC's PFP Program Implementation is not a Model For Metro and 3) MERC's Accountability Processes Need to be Strengthened. It is my understanding that the MERC Chair will comment on the first part and your expectation is that the Chief Operating Officer (COO) of Metro comment on the second and third parts as listed above.

This is the first significant audit report that this COO has commented on so let me begin by saying how important I believe the Metro Auditor is to the efficient and effective operations of Metro. Metro is a relatively new experiment in governance and to have a well functioning auditing office and a productive relationship between the Metro Auditor and the management of the agency can only lend credibility to all aspects of what we do here at Metro.

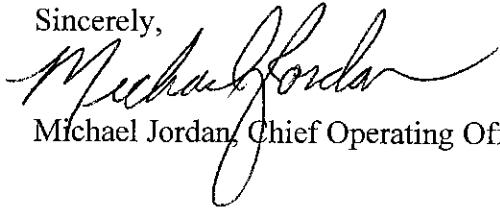
While Metro is operating under a new structure that only this year created the office of COO, it is not without a policy and legislative history that has created relationships and delegated authority in a manner that represents the desires of elected policy makers. Therefore, I feel it is inappropriate for me to comment on the properly delegated authority to the MERC and its management by the Metro Council. Further, the two parts of the audit draft that appear to be advice to the Metro Council on pay for performance are difficult for me to comment on at this time because the discussion of linking compensation to performance for Metro is in such a preliminary phase that it is impossible to determine how valuable such advice is to that discussion.

Linking compensation to performance for individuals or work groups in the public sector for general government type services is a difficult exercise, at best. I am certain that as the Metro Council proceeds with its discussion and study of this issue that it will draw on many sources for advice and comparison, including the experiences at MERC and the recommendations of your audit. Specifically, I am certain that the Council will find that

the data on Pay-for-Performance you have gathered and organized to be extremely valuable. Further, your recommendations suggest thought processes that I am sure the Council will go through when Metro considers how we will more closely link compensation to performance.

Let me reiterate my statement about how important the auditing function is here at Metro and state my commitment to work with you to enhance Metro's current reputation as a world-class organization.

Sincerely,

A handwritten signature in cursive script, appearing to read "Michael Jordan". The signature is fluid and extends across the line of the name below it.

Michael Jordan, Chief Operating Officer

MERC Response

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Audit: MERC's Accountability Processes Need to Be Strengthened

Date: October 2003

AUDIT RESPONSE

Recommendation 1 (MERC Commission)

The MERC Commission should strengthen its oversight of MERC's compensation program by:

Directing MERC management to establish and report on specific program goals and performance measures.

Agree

Yes ____

No X (specify reasons for disagreement)

The commission has been kept well informed on the PFP program involved in decisions about continuous improvements to the program. MERC Commissioner Judy Rice was appointed as liaison to management on the PFP program. Commissioner Rice has extensive private sector experience in human resource systems, including PFP. Commissioner Rice worked directly with MERC's Human Resources Director and senior staff, monitoring the program and overseeing proposed changes and improvements.

Continuous program improvement is an ongoing activity. We commissioned an employee survey to determine areas where the program could be strengthened. Subsequently, an employee review committee was created to advise management and the commission on possible areas of improvement. The committee has been capably staffed by human resources managers from MERC and Metro. The review committee worked with a qualified human resources consultant to recommend changes in the program.

What action will be taken (if any)?

Not addressed

Who will take action?

Not addressed

When will action be accomplished?

Not addressed

Follow-up necessary to correct or prevent reoccurrence.

Not addressed

Audit: MERC's Accountability Processes Need to Be Strengthened

Date: October 2003

AUDIT RESPONSE

Recommendation 2 (MERC Commission)

The MERC Commission should strengthen its oversight of MERC's compensation program by:

Assuring that compensation policies are prudent, equitable, transparent and consistently applied.

Agree

Yes ____

No (specify reasons for disagreement)

MERC's compensation policies are prudent, equitable, transparent, and consistently applied.

The audit recommends that MERC not perform further compensation comparability studies and adjust employee wages in response to labor market standards. The audit purports that where an employer has a performance-based compensation system, no salary changes should be implemented as result of a market comparability study. This is an invalid theory that does not reflect standard practice. There is no data nor any generally accepted "best practice" that justifies this recommendation.

Market competitiveness is essential to a successful PFP program. If it is ignored, the plan will fail. Implementing market-based adjustments to salaries on a periodic basis is also critical. The intent from the beginning was to move people through the salary range to the market based mid-point based on their performance. If the market based mid-point doesn't reflect the changes in the market it would make the entire program suspect. Individual employees become discouraged when they feel they are losing ground while market rates increase even if they are getting frequent pay increases .

All responsible employers periodically test their compensation systems against the market and make adjustments. MERC's policies require a study at least every five years. MERC retained a qualified compensation consultant who worked closely with its management staff, the employee review committee, and Metro Human Resources to compare MERC's salary ranges to the relevant market, including Metro. The results called for adjustments in specified ranges and recommended implementing all of those changes effective July 1, 2002.

Noteworthy, the commission elected not to implement this recommendation fully. In order to mitigate personnel wage adjustments, the commission decided to phase in full implementation of the study over a two-year period. Staff followed that direction and budgeted accordingly. The budget was approved in public hearings by the MERC budget committee, the full commission, the Metro Council, and the Tax Supervising and Conservation Commission.

What action will be taken (if any)?

Not addressed

Who will take action?

Not addressed

When will action be accomplished?

Not addressed

Follow-up necessary to correct or prevent reoccurrence.

Not addressed

Audit: MERC's Accountability Processes Need to Be Strengthened

Date: October 2003

AUDIT RESPONSE

Recommendation 3 (MERC Commission)

The MERC Commission should strengthen its oversight of MERC's compensation program by:

Directing MERC management to establish clear linkage between employee pay and MERC's operational and financial performance.

Agree

Yes ____

No X (specify reasons for disagreement)

The PFP program has a demonstrably clear linkage between employee pay and MERC's operational and financial performance, especially when compared with traditional plans.

Each MERC facility has four goals that reflect MERC's business and strategic plan objectives and together determine the facility's PFP score. No one goal is determinative—they are all calculated together as a weighted average. Employees' goals, in turn, contribute to the attainment of one or more of the overall facility goals. The facility goals include:

1. The ratio of operating revenues to operating expenditures.
2. Customer service.
3. Building condition.
4. A variable goal chosen by agreement between the General Manger and the facility director.

What action will be taken (if any)?

Not addressed

Who will take action?

Not addressed

When will action be accomplished?

Not addressed

Follow-up necessary to correct or prevent reoccurrence.

Not addressed

Auditor comments on MERC response

Four years ago, MERC embarked upon an innovative and entrepreneurial approach to employee compensation when it introduced its Pay for Performance (PFP) program.

In keeping with my responsibility to protect the interests of the citizens of the Metro region, my staff and I recently studied MERC's PFP program to gauge its effectiveness, identify areas for improvement, and determine if it could be applied to other areas of Metro.

The Office of the Auditor shares the Metro Council's goal of efficiency and accountability in government. Consequently, we were disappointed by the response to our reports provided by the MERC Commission.

The response does not address many of the reports' substantive issues, such as the need for accountability processes and adherence to established policies. In addition, the Commission's response contains inaccuracies, including incorrect statements about the reports' contents or conclusions, that distract from the reports' primary findings. For example:

- Contrary to MERC's position, the Metro Auditor does have the authority to question management decisions, particularly when those decisions result in actions in direct violation of MERC's own policies.
- Contrary to MERC's assertion, MERC could not prove its pay program had made any difference to organizational performance. Further, after three years, as many as 9 out of 10 employees continue to have significant misgivings about the PFP program, as implemented by MERC management.
- Contrary to MERC's position, the Auditor's benchmarks for the PFP program are clear and reasonable. Simply put, the fact that the PFP program is a good idea is not enough. To realize its potential benefit for MERC employees, managers and the taxpayers, the PFP program must be properly implemented and able to show objective, measurable results.
- Contrary to MERC's statement, PFP is not less costly over time than traditional "step" based compensation programs. Any projection to decide which program is less costly is *based on assumptions, many of which are policy driven*. In fact, then-MERC Chair Rice concurred with this conclusion during an April 2003 meeting with the Auditor.
- Contrary to MERC's presentation, the Auditor pursued a cooperative and constructive approach to MERC's response to the audit by meeting with MERC Commission Chair Conkling two weeks before issuing the draft audit reports, followed by a telephone consultation a few days later.
- Contrary to MERC's contention, the human resources consultant utilized by the Auditor is an acknowledged expert, with more than 20 years experience designing, implementing, and/or analyzing public- and private-sector compensation programs. In fact, a Metro human resources professional called this consultant "one of the best."

MERC can better realize the potential benefits offered by a PFP program by making the recommended improvements outlined in the audit reports.

In addition, by measuring the accomplishments of its own performance program, MERC can better manage its PFP program and provide the fairness and accountability it owes to its employees and the taxpayers.



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METROPOLITAN EXPOSITION-RECREATION COMMISSION

October 14, 2003

Metro Auditor Alexis Dow
 600 NE Grand Avenue
 Portland, OR 97232

Dear Auditor Dow:

This is MERC's response to the September 30, 2003 draft audit of our Pay for Performance program.¹

Executive Summary

MERC's Pay for Performance (PFP) system is an innovative approach to public employee compensation that links pay to measurable performance. Traditional public employee compensation systems typically have no annual goals, no meaningful evaluations, and salary increases based on seniority. The public has grown concerned about the gulf between public and private sector approaches to compensation and wants government to be more accountable for levels of service, cost efficiency and productivity.

We sought to change that four years ago, with a commissioner-led initiative to strengthen the entrepreneurial culture of our staff in line with our mission of professionally managing publicly owned exposition and spectator facilities. We are proud of the results. At the highest level, it shows that we are serious about being accountable for public service standards by tying compensation to measurable performance. Employees and managers meet regularly, enhancing communication. Managers have a mechanism to allocate resources to the best performers rather than giving the same pay increases to everyone.

PFP is a fiscally responsible business management process. Even if it cost the same as a "civil service" program, the message that "performance matters" would still have value. However, it costs *less over time than* "civil service" programs because payouts are not automatic: lower payouts result when performance goals are not achieved. *Average salaries at MERC have increased less than salaries in traditional "step" programs—even when market based adjustments are included.*

The recommendations in the first section of the audit on "performance agreements" are largely helpful. We have already implemented many of them. The remainder of the audit, however, tends toward sweeping judgments, often based on inaccurate conclusions. Equally troubling is the inclusion of extraneous commentary that at best tangentially touches on the PFP program. These errors and inaccurate conclusions, along with the adversarial tone and content of the audit, detract from a useful and professional discussion. Here is a quick summary of some of the more egregious errors and inaccurate conclusions in the audit:

- The audit consistently mixes up the impacts of MERC's PFP system with the implementation of a compensation market study that was conducted. No compensation system exists in a vacuum from market conditions. That's why Metro is undertaking a similar compensation market study for its pay

¹ Due to the length and complexity of this audit and concerns about its methodology, Commissioner Sheryl Manning, a Certified Public Accountant with auditing experience, and Commissioner Judy Rice, a former corporate human resources director, have co-authored this response. We note that we were asked to respond only to the audit recommendations, using a form supplied by the Auditor's Office. To do so would imply that we accept the conclusions made about the program—many of which we consider ill-founded, subjective, or inaccurate. The Metro Code does not require this form and no previous audit has employed it.



system. Differentiating the impacts of separate undertakings is essential to a constructive evaluation of the PFP system.

- Overall salary increase statistics cited in the reports fail to take into account the addition of new employees at the expanded Oregon Convention Center. Failing to exclude new employee salaries skews the statistics to make the program look more costly.
- Program costs are actually very reasonable. The average plan salary increased by only approximately 5% annually during the audit study period—including all salary, bonus, and compensation market study adjustments.² Over the same time frame, several Metro departments had higher average annual salary increases under a traditional “step” plan. Average annual salaries of MERC staff under the PFP program also are lower than in many Metro departments.
- The analysis (especially the bar charts “MERC PFP Employee Salaries and Net Operating Losses”) lumps together all MERC facilities, though our system is tied to specific facility performance. Each facility has different kinds of operations and community missions therefore different performance targets. The audit also does not recognize planned business losses at the Oregon Convention Center during expansion construction. Failure to analyze the facilities separately and take into account OCC construction distorts the conclusions.
- The reports assert that newly recruited MERC personnel were hired with terms that violate MERC and Metro employment policies. This isn’t true. Not one employee’s salary has been set above the mid-point range. Once hired, they became subject to the PFP system and were treated like all other employees.
- The audit claims that Metro was unaware of key MERC compensation decisions. That’s not true. In the case of the compensation market study implementation, there was close communication between MERC commissioners and Metro officials, resulting in a decision to phase-in pay raises.
- The audit asserts that commissioners were uninformed about the program and concludes that MERC staff misrepresented program performance. That’s not true. The commission assigned Commissioner Judy Rice as its liaison to MERC staff for both the PFP program and the compensation study. Commissioner Rice and MERC staff kept us well informed.
- The audit inappropriately uses a single hired consultant’s views on “best practices” to criticize MERC’s system. Many of these conclusions are simply disagreements with the consultants MERC retained. Conflicting consultant opinions are an inadequate basis for audit findings.
- Many audit conclusions are based on supposition, rather than objective evidence.
- The audit states that trying something new such as Pay for Performance must be supported by an analysis approaching mathematical certainty. We disagree. Choosing performance over seniority is a *policy* decision. Further, this requirement would only discourage innovation.
- The audit inaccurately represents MERC as having inadequate or inconsistent PFP policies.
- The audit’s intemperate language, misleading statistics, and personal attacks on MERC staff are not constructive. The overall approach lacks the objectivity and impartiality required by government auditing standards.

² While we reject mixing up PFP with compensation study adjustments, we do so here in response to the audit’s erroneous insistence on this approach, and to illustrate the overall economy of our compensation strategy.

I. Faulty Process, Timelines and Methodology

A. Faulty Process and Timelines

This audit began 18 months ago, in March, 2002, when the PFP program was only 2 1/2 years old. The audit contains nearly 100 pages of recommendations and discussion. The Auditor's office has always given Metro and MERC staff advance copies of audits for review and discussion well in advance of release of the "final draft," which triggers the formal response deadline. Here, no advance notice was given. The MERC Chair's request for additional time to respond was denied. MERC Chair Conkling and Commissioner Manning also tried to identify problems with the audit and requested a more constructive approach in a meeting with the Auditor, before submitting this response.

It is unfair and unwise to require a response to an 18-month audit project in such a short time frame, especially when volunteer commissioners are involved in the response. The public interest is best served by an audit report that has been vetted to meet the highest standards of accuracy. This unprecedented approach contributes to the audit's errors.

B. Inappropriate and Invalid Methodology

(1) Differences of Opinion Among Consultants are an Invalid Basis for Audit Findings

The most valuable audit findings are based on objective evidence—not mere differences of opinion. Much of the audit is an essay detailing differences of opinion between the human resource consultant hired by the Auditor's office and those that were employed by MERC. This difference of opinion between "dueling consultants" is not a legitimate basis for audit findings.

(2) Conclusions Should be Based On Real Evidence, Not Supposition

The audit makes many unjustified suppositions. For example, the audit concludes the MERC PFP program is not working very well. After this conclusion was reached, several unnamed MERC Commissioners were interviewed, who apparently stated their opinions that the program was working well. Based on that evidence, the audit concludes that MERC staff misrepresented the program's effectiveness—without any evidence of misrepresentation. Suppositions of this sort are unfair to our staff and inappropriate.

(3) Disincentive for Innovation and Use of Inappropriate Standards

A major theme is that MERC should have made a series of findings approaching mathematical certainty prior to adopting a PFP system. However, no similar justification is required for continuing traditional systems. This is not a legitimate basis for audit findings. First, the decision to link employee compensation to performance instead of seniority is a *policy* decision not subject to audit review. Second, requiring this sort of empirical justification *only for innovation* would create a powerful disincentive at Metro for change of any kind—a climate we doubt the public or the Metro Council would endorse.

The audit compares MERC's PFP program to a theoretically perfect PFP program based on the concept of "best practices." "Best practices" analysis can be a legitimate benchmark for analyzing programs, *but only where such standards are generally accepted and agreed upon*. Pay for performance is an innovative program and increasingly popular compensation choice, but there is no standard design—each workplace application is developed based on the specific business objectives. The "best practices" presented in the audit are merely the subjective opinions of the auditor's consultant, not a universal comparison for audit findings.

(4) *Failure to Interview Appropriate Staff*

MERC repeatedly requested during the 18 months of the audit that the individual assigned by Metro's Human Resource Department to work with MERC on both PFP and the compensation study be interviewed. Despite these many requests, this individual was not contacted until after the Auditor's office informed the Metro Council that the audit had already been written. This failure has contributed to the many factual errors in the audit.

C. Violations of Government Auditing Standards

Government Accounting Standards (references are to Government Auditing Standards – 2003 Revision) require auditors to be “objective and free of conflicts of interest.” Additionally, auditors must be “impartial, intellectually honest,” and free of relationships “that may in fact or appearance impair [an] auditor's objectivity in performing the audit...” (Section 1.24).

The “accountability” and “not a model” parts of the audit violate the requirement that auditors be objective, impartial, and free of conflicts. The use of intemperate language, erroneous statistics, supposition, and personal attacks on MERC staff shows an unprofessional level of personal involvement inconsistent with objectivity and impartiality.

Sections 3.03, 3.04, and 3.05 of Government Auditing Standards require auditors to be free in both fact and appearance from any personal impairments to “independence.” (Section 3.03). This means that auditors should “avoid situations that could lead reasonable third parties with knowledge of the relevant facts and circumstances to conclude that the auditors are not able to maintain independence and, thus, are not capable of exercising objective and impartial judgment on all issues associated with conducting and reporting on the work.” (Section 3.04).

No knowledgeable third party could read the inflammatory language and unwarranted suppositions in this audit and conclude that the auditor is “exercising objective and impartial judgment on all issues associated with conducting and reporting on the work.” In this situation, applicable standards require that an auditor either decline the work, or report those personal impairments in the scope section of the audit. By failing to do either, the audit violates these important requirements.

II. **Serious Errors of Fact**

The audit contains many factual errors. That may be partially due to the insufficient time that has been allowed for MERC to point out problems prior to issuance of the final draft. Another factor may have been the Auditor's use of a consultant with little in the way of experience with PFP programs. We will attempt to point out these errors as we respond.

III. **“Performance Agreement” Recommendations**

A major section of the audit deals with recommendations for improving what are termed “Performance Agreements,” a term MERC does not use in its PFP program. We will assume that it applies to the “Goals and Objectives” used as the basis for setting performance expectations with MERC staff.

Recommendation Number 1:

“Establish further training on employee performance agreements. Performance management training for managers, supervisors and employees should be different. Training for each group should be done in conjunction with further emphasizing and communicating organizational goals for the upcoming year and stating how those translate to each work group within MERC.”

Response to Recommendation Number 1:

We agree with this recommendation and are already implementing it. A great deal of training has been conducted since the program was implemented just four years ago. As we gain experience, we have recognized that ongoing training is needed, especially on developing and measuring employee goals and objectives. We also recognize that training needs are different for managers, supervisors, and general employees.

We have made a commitment to review goals for each of MERC's 68 job classifications and develop model goals and measurements that can be adapted for individuals in accordance with facility needs. This is a two-year project led by MERC's Human Resources Director in conjunction with its Employee Review Committee, which assists management in improving the program. Another issue being addressed is identifying positions that would be better served by "position standards" rather than the goals and objectives.

Recommendation Number 2:

"Simplify and focus employee performance agreements' goal statements. Continue to use 4 (or even 3) goal statements and limit them to 35 words or less. Use several behavioral factors (e.g. customer service, initiative, flexibility, planning) to rate performance against a three or four-point generic scale."

Response to Recommendation Number 2:

We agree in part with this recommendation. We agree employee goals should be simple and focused. This is a major emphasis of our ongoing enhancements to the program. This will be achieved by creating the "model goals" referred to earlier, as well as by continued training. We already use the four-point scale that is recommended.

We disagree that we must use a limit of 3 or 4 goal statements. That is a management decision dictated by our strategic plan and business needs.

Recommendation Number 3:

"Have an independent human resources consultant review employee performance agreements at the beginning of the next evaluation cycle. Require that the consultant be well versed on the MERC's widely accepted standards that agreements need to be specific, measurable, etc. To enhance program credibility and lessen potential for employee/supervisor misunderstanding, have the consultant look for and resolve issues where agreements are not consistent with the criteria."

Response to Recommendation Number 3:

We disagree with this recommendation, which has been made without a cost-benefit assessment. Based on our experience using consultants, we believe the cost would be very high and outweigh any potential benefits. We believe Metro and MERC have sufficient internal expertise to accomplish these tasks. We now have more experience in *managing* this type of program than outside consultants, who typically are in the business of helping to *create* them. Moreover, this recommendation would serve to undermine one of the fundamental tenets of PFP and its application, which is the trust and accountability built between supervisor and employee that results from collaborative goal setting and regular performance reviews.

IV. “Accountability” Recommendations

Introduction

The “accountability” section of the audit is not really an “audit” in any generally accepted use of that term. In essence, it is an essay of the auditor’s personal views.

Inappropriate “Audit Objective, Scope, and Methodology”

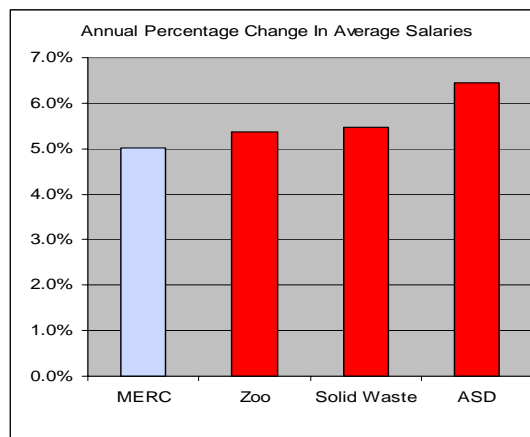
This section of the audit purports to set forth the “Audit Objective, Scope, and Methodology.” However, there is no defined objective, no governing scope, and no discernable methodology. This section of the audit begins with a conclusion and follows with an essay seeking to justify that conclusion. This does not conform to generally accepted governmental auditing standards.

Response to Executive Summary

The audit inaccurately claims that salaries for program employees increased by 14% over two budget years. This is not true. The summary uses an inaccurate and misleading basis for assessing the rate of increase in MERC’s personal service costs, in part by including the cost of adding additional staff for the expanded Oregon Convention Center. The result falsely implies these increases are due to MERC’s PFP program and skews the entire result.

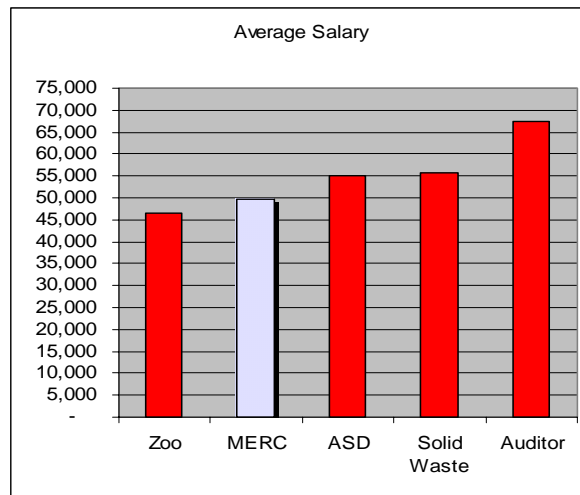
On the contrary, the costs of the program are actually quite reasonable. During the four-year period from 2000-2003 (the time period analyzed by the audit), the average salary paid to an employee in our PFP program has increased from \$43,844 to \$49,569. This amounts to an average annual increase of approximately 5%, *including all base salary increases, all bonuses, and all compensation study adjustments.*³

By contrast, during the same time period, traditional civil service type plans resulted in slightly larger increases in salaries at Metro. For example, the average pay of Oregon Zoo employees increased from \$39,671 to \$46,426, an annual increase of 5.4%. Solid Waste salaries increased from \$47,580 to \$55,812, an average of 5.5%. In Metro’s Administrative Services Division, the average salary increased 6.4% annually, from \$45,707 to \$55,120. The following chart illustrates the situation:



³ Our analysis compares actual annual percentage changes in average salaries for MERC employees in the PFP plan with budgeted salaries for full-time regular Metro employees. Again, while we reject combining PFP with compensation study adjustments, we do so here in response to the audit’s erroneous insistence on this approach.

Moreover, the average salary for MERC employees in the PFP program was low by comparison, at \$49,569. Metro's Administrative Services Department's average salary was \$55,120, Solid Waste was at \$55,812, and the Office of the Auditor was highest of this group at \$67,518. These comparisons are illustrated graphically below:



There is no legitimate basis for concluding that MERC's PFP program is overly generous.

The summary also repeats and emphasizes two flaws common to the entire audit:

(1) It fails to distinguish between MERC's implementation of a compensation study to address inequities with the market place and the PFP program. Like most organizations, MERC and Metro periodically perform compensation studies in order to test their salary ranges against the marketplace. Compensation studies are *necessary regardless of what kind of compensation system an organization has*. In fact, periodic market reviews are even more critical under a performance-based compensation program. When salaries are not automatically adjusted for inflation (as under a standard COLA), the risk of deviation from the market is even greater. The audit's erroneous insistence that MERC's compensation study undermined the PFP program has led to serious mistakes and faulty conclusions.

(2) The audit falsely claims that decisions about pay and benefits have run counter to unspecified "MERC or Metro policies." In its rush to judgment, the audit takes three entirely appropriate recruiting decisions and jumps to the unjustified conclusion that this makes the entire PFP program invalid. On three separate occasions over four years, MERC hiring managers found it necessary to negotiate first-year compensation with potential employees. This is a common practice in both the public and private sectors. None of these employees received base salary above the mid-point and, once hired, they became subject to the PFP plan and were treated like all other staff. There is nothing improper about these decisions.

Given these serious analytical problems, the specific recommendations that follow are of marginal value.

Recommendation Number 1:

"The MERC Commission should strengthen its oversight of MERC's compensation program by directing MERC management to establish and report on specific program goals and performance measures."

Response to Recommendation Number 1:

The commission has been kept well informed on the PFP program involved in decisions about continuous improvements to the program. MERC Commissioner Judy Rice was appointed as liaison to management on the PFP program. Commissioner Rice has extensive private sector experience in human resource systems, including PFP. Commissioner Rice worked directly with MERC's Human Resources Director and senior staff, monitoring the program and overseeing proposed changes and improvements.

Continuous program improvement is an ongoing activity. We commissioned an employee survey to determine areas where the program could be strengthened. Subsequently, an employee review committee was created to advise management and the commission on possible areas of improvement. The committee has been capably staffed by human resources managers from MERC and Metro. The review committee worked with a qualified human resources consultant to recommend changes in the program.

Recommendation Number 2:

“The MERC Commission should strengthen its oversight of MERC’s compensation program by assuring that compensation policies are prudent, equitable, transparent and consistently applied.”

Response to Recommendation Number 2:

MERC’s compensation policies are prudent, equitable, transparent, and consistently applied.

The audit recommends that MERC not perform further compensation comparability studies and adjust employee wages in response to labor market standards. The audit purports that where an employer has a performance-based compensation system, no salary changes should be implemented as result of a market comparability study. This is an invalid theory that does not reflect standard practice. There is no data nor any generally accepted “best practice” that justifies this recommendation.

Market competitiveness is essential to a successful PFP program. If it is ignored, the plan will fail. Implementing market-based adjustments to salaries on a periodic basis is also critical. The intent from the beginning was to move people through the salary range to the market based mid-point based on their performance. If the market based mid-point doesn’t reflect the changes in the market it would make the entire program suspect. Individual employees become discouraged when they feel they are losing ground while market rates increase even if they are getting frequent pay increases⁴.

All responsible employers periodically test their compensation systems against the market and make adjustments. MERC’s policies require a study at least every five years. MERC retained a qualified compensation consultant who worked closely with its management staff, the employee review committee, and Metro Human Resources to compare MERC’s salary ranges to the relevant market, including Metro. The results called for adjustments in specified ranges and recommended implementing all of those changes effective July 1, 2002.

Noteworthy, the commission elected not to implement this recommendation fully. In order to mitigate personnel wage adjustments, the commission decided to phase in full implementation of the study over a two-year period. Staff followed that direction and budgeted accordingly. The budget was approved in public hearings by the MERC budget committee, the full commission, the Metro Council, and the Tax Supervising and Conservation Commission.

⁴ Metro is currently considering a similar system.

The remainder of this section of the audit is difficult to understand. It includes a recommendation to develop policies “as needed” and modify supposedly “unclear” policies, but does not identify any policies that are missing or unclear. It also recommends MERC create an operating manual, which it already has in place.

Recommendation Number 3:

“The MERC Commission should strengthen its oversight of MERC’s compensation program by directing MERC management to establish clear linkage between employee pay and MERC’s operational and financial performance.”

Response to Recommendation Number 3:

The PFP program has a demonstrably clear linkage between employee pay and MERC’s operational and financial performance, especially when compared with traditional plans.

Each MERC facility has four goals that reflect MERC’s business and strategic plan objectives and together determine the facility’s PFP score. No one goal is determinative—they are all calculated together as a weighted average. Employees’ goals, in turn, contribute to the attainment of one or more of the overall facility goals. The facility goals include:

1. The ratio of operating revenues to operating expenditures.
2. Customer service.
3. Building condition.
4. A variable goal chosen by agreement between the General Manger and the facility director.

This section of the audit causes us several concerns regarding accuracy, inappropriate recommendations, and misleading statistics.

First, the audit declares that tying employee compensation to a factor such as increasing the ratio of operating revenues to operating expenditures is inappropriate. We disagree. We believe our facility management staff is responsible for exactly that type of accomplishment. That is a management decision as to what we believe the job is, not a subject for audit review.

Second, after concluding that employee compensation should not reflect net operating revenues, the audit then criticizes our program because it supposedly lacks a direct link between financial performance and PFP. This is illogical at best. It also misconstrues the program, which never has been based solely on financial performance, but includes other important factors such as building maintenance and customer service. PFP was designed to place our pay program in alignment with MERC’s organizational objectives. We are confident that we have done just that, but organizational performance is impacted by many factors that are more significant than the PFP program.

The statistics used to attempt to prove this point are misleading. The audit employs a chart that purports to show the relationship between PFP payouts and MERC operating results. This chart suffers from several serious flaws:

- It falsely characterizes the entire annual salaries of all employees in the PFP program as “PFP Payout,” when the actual amount is far smaller.
- It compares PFP payouts exclusively to financial performance, which never has been the sole and exclusive goal of the program.
- It inaccurately includes one time only compensation study implementation costs as “PFP Payouts.”

- It includes years in which the Oregon Convention Center was under construction, with expected and planned decreases in operating revenues.
- It lumps all MERC facilities together, even though each facility has a different mission, subsidy level, and operating results.

Third, the audit errs when it discusses supposed failures in communication between MERC management staff, the commission, and the Metro Council. For example, a member of the Metro Human Resources staff was assigned to work with the employee review committee and relayed this information back to the Metro Human Resources Director. MERC staff also made sure MERC's PFP liaison commissioner had full knowledge of all issues concerning the plan.

The auditor mistakenly criticized MERC's communication with the Metro Council about the compensation study and its implementation. When the consultant's recommendations were presented, the MERC and Metro Council leadership discussed the study's implementation plan and reached consensus that it should be phased in during a two-year time period. The phase-in was adopted by the commission, a reflection that advice from the Metro Council was considered and acted upon positively.

Finally, the audit claims that the Metro Council requested that MERC retain a second consultant to review its compensation study implementation and that MERC refused to do so. That is incorrect. The former Metro Executive Officer assigned the Metro Budget Coordinator to perform this task. She determined that MERC's system actually cost less than a traditional "step" program. After these results were obtained, the Executive saw no need for retaining additional consultants. The audit dismisses the analysis done by Metro's Budget Coordinator. Additionally, MERC staff provided the Auditor's office with several alternative financial evaluations that all yielded similar results, which the Auditor's office also dismissed.

V. Conclusion

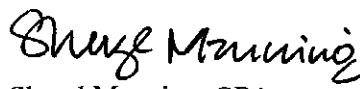
Part of the "accountability" section and the entire "not a model" report are directed to the Metro Council and Chief Operating Officer as opposed to MERC. We will not presume to respond on their behalf. We do note that these sections suffer from the same faulty analysis and factual errors detailed above. These reports are essentially essays of the Auditor's personal opinions, not audits.

We have not yet sent copies of this response to the Metro Council, as is our usual practice. It is our hope that further dialogue with the Auditor's office could produce a more mutually beneficial and constructive approach. Please feel free to contact us or our staff if you believe this would be productive.

Sincerely,



Gary Conkling
MERC Chair



Sheryl Manning, CPA
MERC Commissioner



Judy Rice
MERC Commissioner



Metro Auditor Report Evaluation Form

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Our mission at the Office of the Metro Auditor is to assist and advise Metro in achieving honest, efficient management and full accountability to the public. We strive to provide Metro with accurate information, unbiased analysis and objective recommendations on how best to use public resources in support of the region's well-being.

Your feedback helps us do a better job. If you would please take a few minutes to fill out the following information for us, it will help us assess and improve our work.



Name of Audit Report: MERC's Accountability Processes
Need to Be Strengthened

Please rate the following elements of this report by checking the appropriate box.

	Too Little	Just Right	Too Much
Background Information	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Details	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Length of Report	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Clarity of Writing	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Potential Impact	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Suggestions for our report format: _____

Suggestions for future studies: _____

Other comments, ideas, thoughts: _____

Name (optional): _____

Thanks for taking the time to help us.

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Mail: Metro Auditor, 600 NE Grand Avenue, Portland, OR 97232-2736
Call: Alexis Dow, CPA, Metro Auditor, 503.797.1891
Email: dowa@metro.dst.or.us

Suggestion Hotline: 503.230.0600, MetroAuditor@metro.dst.or.us

Metro

People places • open spaces

Clean air and clean water do not stop at city limits or county lines. Neither does the need for jobs, a thriving economy and good transportation choices for people and businesses in our region. Voters have asked Metro to help with the challenges that cross those lines and affect the 24 cities and three counties in the Portland metropolitan area.

A regional approach simply makes sense when it comes to protecting open space, caring for parks, planning for the best use of land, managing garbage disposal and increasing recycling. Metro oversees world-class facilities such as the Oregon Zoo, which contributes to conservation and education, and the Oregon Convention Center, which benefits the region's economy.

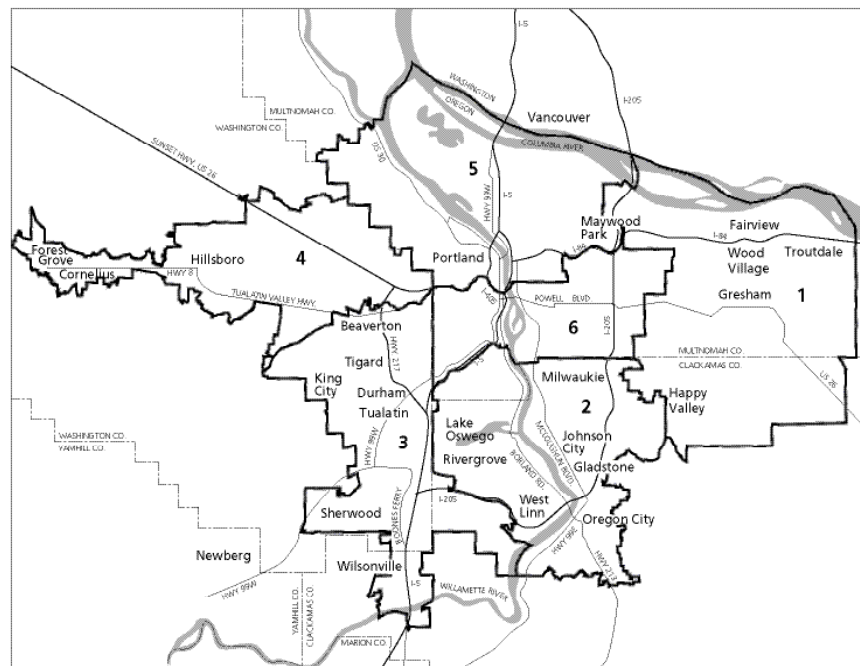
Your Metro representatives

Metro Council President – David Bragdon

Metro Councilors – Rod Park, deputy council president, District 1; Brian Newman, District 2; Carl Hosticka, District 3; Susan McLain, District 4; Rex Burkholder, District 5; Rod Monroe, District 6.

Auditor – Alexis Dow, CPA

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Council districts

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