The Next Generation of Nonprofit Executive Compensation: Providing a Competitive Advantage to Your Organization

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Purpose

- The purpose of today's session is to discuss how nonprofits can develop a higher level of sophistication surrounding executive pay and move beyond the basics of compliance to an approach that provides a real competitive advantage
- Topics
  - The current social and regulatory perception of executive compensation, including current IRS initiatives regarding tax-exempt executive compensation and the expanding role of state regulators
  - Using disclosure to help define your remuneration strategy
  - Identifying red flags
  - Assessing and mitigating your risks
  - Identifying goals and developing solutions to link business strategy and executive compensation
  - Using the reasonableness opinion as a way to educate your board and management team
  - Instituting policies and practices to protect your organization
  - Enhancing the role of the compensation committee and clearly delineating responsibilities between the committee, management, and the board

Current Social and Regulatory Perception of Executive Compensation

Current Social Regulatory Perception

- Who cares?
- What is the public’s perspective?
- Is anyone paying attention?
- What are the risks of excessive compensation?
- What are the risks of inadequate compensation?

Nonprofit Executive Compensation: Who Cares?

- **IRS** – Protects against tax abuse
- **State Regulators** – Consumer Protection
- **Donors** – Concerned that appropriate portion of contribution is used in accordance with donative intent
- **Members** – Concerned that dues are used in accordance with member intent
- **Media** – Excessive compensation makes great news in current economic environment
- **Competitor Organizations** – The pool of available member and donor funds is smaller than ever, creating competition for those funds
- **Competing Interests** – More than ever, Nonprofit entities are seen as tools of political and social reform, potential adversaries are looking at executive compensation as a means to tarnish public image
- Your **Employees**, **Executives**, and **Target Executives**!

Nonprofit Executive Compensation: What is the Public's Perspective?

- Regulators
  - Professionally educated with low income
  - Tend to believe that all non-profits (especially charities) should be run by people with altruistic purposes
- Donors/Members
  - Looking for greatest return on investment or donation
- Media
  - Looking for a story, reporting is inconsistent
- Employees
  - Comparing executive salary to their own
- Executives and Target Executives
  - Comparing the salaries with peers and other offers

Nonprofit Executive Compensation: Is Anyone Paying Attention?

- IRS
  - IRS Area Manager Peter Lorenzetti recently identified executive compensation as “far and away the most common risk area for nonprofits” and an issue that the IRS will “look at on every audit we do”
  - Executive compensation and intermediate sanctions were specifically included on the IRS TE/GE FY 2011 Workplan
  - Executive compensation was discussed as a significant issue in the Interim Report for the IRS College and University Compliance Project
  - We have seen the IRS assess more intermediate sanctions penalties in each of the last two years than in the previous six combined
  - During a recent conversation with an attorney from the IRS Office of Chief Counsel, we were told that the IRS would aggressively pursue these cases in court

Nonprofit Executive Compensation: Is Anyone Paying Attention?

- Competing Interests and Media
  - Exempt organizations are more frequently being used to obtain very specific goals and even to attack other exempt organizations
  - Playoff PAC v. the Bowl Championship Series
    - Playoff PAC is developing information off of publicly available IRS Forms
    - Executive compensation is a major issue in media reports about problems with BCS
    - Issue has been highlighted on: HBO, ESPN, Sports Illustrated, Nonprofit Times, etc.
  - Fiesta Bowl's CEO John Junker is the subject of media scrutiny
    - CEO Fired
    - Indicted by federal jury
    - State and federal regulators are investigating
    - IRS has not weighed in on the issue

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Nonprofit Executive Compensation: Is Anyone Paying Attention?

- Competitor Organizations
- Donors and Members
- Employees
- Executives and Target Executives

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Nonprofit Executive Compensation: Risk of Overcompensation?

- IRS
  - Revocation of tax-exempt status for private benefit or private inurement
  - Monetary penalties imposed on individual executives that receive excessive benefit (only Code sec. 501(c)(3) and 501(c)(4) organizations)
  - Monetary penalties imposed on board members and executives that approve the payment of an excessive benefit (only Code sec. 501(c)(3) and 501(c)(4) organizations)
  - Loss of goodwill
- Other Federal and State Regulators
  - Potential issues resulting from consumer fraud
  - Loss of goodwill

Nonprofit Executive Compensation: Risk of Overcompensation?

- Donors/Members/Competitors
  - Competitors that pay executives less compensation will use this information to attract your donors and members
- Media
  - Sensational articles get a lot of focus, and even when misleading, incorrect, or based on incomplete information, retractions are rare and rarely publicized
- Employees
  - Incongruent pay may lead to discontent and turnover
- Organization Executives
  - May be individually liable for IRS penalties
  - The organization may attract the wrong type of executive

Nonprofit Executive Compensation: Risk of Under-Compensation?

- Under-qualified candidates and executives
- Underpaid, unhappy executives
- High turnover
- Issues relating to executives needing substantial raises or bonuses in last years of employment to "make up for" many years of underpayment

Using Disclosure to Help Define Your Remuneration Strategy

Using Disclosure to Help Define Your Remuneration Strategy

- Understand what information can and will be viewed by the public
- Understand what similar organizations are reporting in information that they disclose
- Consult with experts to learn how the information that you disclose will be used by the public, the media, and the IRS
- Learn what policies you can put into place to demonstrate your efforts to pay no more than fair market value

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Using Disclosure to Help Define Your Remuneration Strategy

The executive remuneration strategy has typically been an afterthought for many organizations.

- An effective compensation program must closely align with a company's strategic business objectives, organizational culture, and drivers of value
- This may sound obvious and logical, but all too often the remuneration strategy is developed after-the-fact or has only a coincidental relationship to the business strategy/mission
- The most effective remuneration strategies are born from the business strategy/mission and are seen as a crucial method to help realize that mission
- The IRS Form 990 provides for an opportunity to define your remuneration strategy and comment on the rationale for its structure
- We find that when organizations specifically disclose their remuneration strategy, it presents an eye-opening look into the level of rigor really necessary to arrive at an effective policy
- Gone are the days of simply saying:

  "we target the median of the market for base salary and up to the 75th percentile for total cash compensation (performance warranted); benefits and retirement plans will be not be market leading but will be sufficient to be competitive…"

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Using Disclosure to Help Define Your Remuneration Strategy

When developing a remuneration strategy consider three important viewpoints:

Employer Perspective

- History of Pay
- Reward opportunities
- Degree of difficulty of performance goals
- Ability to impact results

Company Perspective

- Cost
- Attraction, retention, and motivation values
- Support of business and culture

Stakeholder Perspective

- Cost/benefit
- Competitiveness
- Best practice
- Program risk
- Governance

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Using Disclosure to Help Define Your Remuneration Strategy

Develop and manage a compensation philosophy with an eye to external factors, while considering its implications on pay.

Context/Inputs

Business Requirements

- How will the organization grow and how will it balance growth with profitability?
- What defines success – financial, operating, and strategic?
- What talent requirements are needed?

Competitive Requirements

- Pay opportunity
- Retention and attraction needs

External Requirements

- Regulations and stakeholder perception
- Industry standards and market practice
- Reasonableness of total remuneration

Basic Questions

What do we pay for?

- Performance measures
- Goals
- Linkage

How much do we pay?

- Comparable organizations
- Target Positioning

How do we pay?

- Differentiation
- Vehicles
- Risk vs. reward
- Time horizon

Red Flags

Red Flags

- Application for Tax-Exempt Status – IRS Form 1023 (501(c)(3) organizations), Part V:
  - Line 1: names and compensation of:
    - a) Officers and directors,
    - b) Highest compensated employees earning more than $50,000, and
    - c) Highest paid independent contractors earning more than $50,000
  - Line 3: names, qualifications, and average hours worked for people listed on Line 1
  - Line 4: description of compensation approval process
  - Line 5: conflict of interest policy
  - Lines 7 & 8: other transactions with executives

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Red Flags

- Application for Tax-Exempt Status – IRS Form 1024 (most other exempt organizations), Part II:
  - Line 3: names, titles, and compensation for officers and directors

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Red Flags

- Annual tax/information return – IRS Form 990
  - Part VI, Governance Management
    - Line 12: conflict of interest policy
    - Line 15: process for determining compensation for management

Red Flags

- Annual tax/information return – IRS Form 990
  - Part VII, Compensation of current and former officers, directors, key employees, highly compensated employees, and independent contractors
    - Section A, Line 1: list name, title, average hours worked, and amount of compensation for:
      - Current officers, directors, and key employees
      - Five highest compensated employees receiving more than $100,000
      - Former officers, key employees, and highest compensated employees receiving more than $100,000
      - Former directors receiving more than $10,000
    - Section B: name, compensation, and description of services provided by five highest compensated independent contractors receiving more than $100,000

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Red Flags

- Annual tax/information return – IRS Form 990
  - Part IX, Statement of Functional Expenses
    - Generally requests information about all expenditures and for 501(c)(3) and (c)(4) organizations; categorizes the expenses as:
      a) Program service expenses
      b) Management and general expenses
      c) Fundraising expenses
    - Line 5: “Compensation of current officers, directors, trustees, and key employees”

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Red Flags

- Annual tax/information return – IRS Form 990
  - Schedule J, Part I, Questions Regarding Compensation
    - Line 1: specific types of benefits
    - Line 2: expense reimbursement
    - Line 3: compensation approval process
      - Compensation committee?
      - Independent expert?
      - Board approval?
  - Schedule J, Part II, Breakdown of Officer, Director and Employee Compensation

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Red Flags

Ongoing regulator and press scrutiny of executive compensation at nonprofit organizations is certain.

- Potential “red flags” include:
  - Passive governance processes
  - Big numbers (i.e., upper quartile compensation, incentives, deferred compensation)
  - Vague or confusing explanations for pay decisions
  - Limited documentation
  - Inappropriate comparison group
  - Excessive benefits or perquisites
  - Misalignment between executive pay and organizational performance (or an inability to define the link)
  - Pay programs that encourage short-term actions
  - Management influence
  - Conflicts of interest

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Assessing and Mitigating Risks

Professional Resources Available

- When we see this issue raised by clients – *TOO LATE*

- Executive compensation is not an HR issue, it is not an accounting issue, and it is not a pure legal issue

- Do not rely solely on advice of your:
  - Legal counsel;
  - Tax accountant or independent auditor; or
  - HR director

Professional Resources Available

- When to seek expert advice – before entering into a contract with any officer, director, trustee, key employee, important donor, etc.
- Who to consult:
  - Your legal advisors;
  - A compensation/valuation expert; and
  - Your accountant

What Can You Do to Avoid Intermediate Sanctions?

- Use caution when entering into transactions with disqualified persons
- Develop, implement, and follow a conflict of interest policy that prevents board members and organization executives from participating in decisions that impact them financially
- Require board approval and documentation of transactions before any payments are made

What Can You Do to Avoid Intermediate Sanctions?

- Establish the rebuttable presumption of reasonableness

- Under section 53.4958-6 of the regulations, if the organization takes certain precautions in approving a transaction, there is a "rebuttable presumption" that the transaction is at fair market value

- To establish the rebuttable presumption:
    1. The transaction must be approved in advance by disinterested members of the organization's governing body;
    2. The governing body must obtain and rely on valid comparability data in approving the transaction; and
    3. The governing body must contemporaneously document its decision and the reason for its decision

Assessing and Mitigating Risk

A good first step to establishing reasonableness is to document everything related to executive compensation.

- Key items to document include:
  - The organization's compensation philosophy
  - The mix of pay for executives
  - Incentive plans, and especially their performance measurement components
  - Compensation Committee minutes
  - Executive employment agreements
  - Compensation reviews performed by independent advisors
- Documentation can demonstrate that compensation decisions are not arbitrary
- Performing an inventory of such items may reveal any areas of compensation administration where the organization may lack the internal resources with the requisite expertise to help the compensation committee achieve the necessary standards of good governance
- In these instances, it is critical for organizations to seek counsel for independent advisors who can fill these gaps and provide the necessary level of professional counsel

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Assessing and Mitigating Risk

Five key principles for an effective executive compensation governance framework

Executive Compensation Governance Pillars

Effective decision making

Properly constituted decision making body

Appropriate balance of Board, Committee and management decision making

Written policies

Compensation philosophy

Policies in key areas of activity (e.g., executive pay determination, reasonableness assessment, performance metrics)

Clear account-abilities

Clear definition of roles and responsibilities

Appropriate delegations and authorities

Approval processes for changes

Supervision and monitoring

Oversight procedures for Committees

Procedures for monitoring of plan and performance (e.g. funding status, investment, renewal status)

Effective information flow

Access to relevant and timely information

Clear lines of communication and reporting protocols

Set Direction → Implement → Monitor

Risk management

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Assessing and Mitigating Risk

What the compensation committee can do to enforce and/or enhance the governance framework

Effective decision making	Establish a structure and process for decision making so that it is clear who makes decisions on what and when
Written policies	Document compensation philosophy on issues like decision making, compensation strategy, incentive plan design, funding and investment, to provide guidance to the Committee and Board and ensure the desired consistency of approach
Clear accountabiliti-es	Define roles and responsibilities at the Board, Committee and management levels so that it is clear who is responsible to do what and nothing falls through a crack
Supervision and monitoring	Create a process for oversight of sites to help ensure that decisions are reasonable, services meet expectations, and costs are acceptable
Effective information flow	Establish the proper flow of information to help all parties in the structure fulfil their responsibilities efficiently and effectively

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Assessing and Mitigating Risk

The governance framework is a structured, consistent, and continuous process applied to all executive compensation decisions

Management of risk
Avoiding the downside

- Understanding of risks and opportunity to manage these proactively, avoiding losses or loss of value
- Mitigation of risk of loss due to inefficiency / gains from increased efficiencies
- Developing and deploying effective mitigation strategies
- Robust (and timely) decision making that can withstand scrutiny
- Assurance of regulatory compliance / avoidance of fines and other penalties
- Avoidance of surprises

Realization of reward
Capturing the upside

- Support business strategy and talent objectives
- Incorporate market best practices into compensation decisions
- Ability to move quickly to respond to change and take advantage of windows of opportunity
- Improved preparation for risk management
- Potential for streamlining of advisory structure, with associated efficiencies, consistency of advice and potential cost savings

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Linking Business Strategy and Executive Compensation

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Executive compensation management process

Business Strategy

Human Capital Strategy

Executive Compensation Strategy

Operating Model

Governance

Business and Mission

Infrastructure

Data	Technology
Talent	Management

Program Design

Performance

Ongoing review and alignment

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Using Reasonableness Opinion as a Way to Educate Your Board and Management Team

Using Reasonableness Opinion as a Way to Educate Your Board and Management Team

- A detailed and documented process is not only critical for good governance but is also a strong component of demonstrating reasonableness in order to obtain the “rebuttable presumption” associated with Intermediate Sanctions
- The Compensation Committee should provide education, report issues and progress of executive compensation program decisions to the full Board
- A increasingly critical vehicle for communicating these decisions is the reasonableness opinion
- The simple one-page opinion of the past has been replaced with a comprehensive document that clearly communicates the Committee’s intent for making executive pay decisions
  - Summary of findings
  - Organizational background
  - Compensation program details
  - Rationale for decisions (i.e., comparator organizations, data sources, financial performance)
  - Market analysis and methodology
  - Reasonableness Opinion

Five Key Considerations When Administering Executive Compensation in a Nonprofit Organization

- Use the governance of executive pay to clearly delineate the authority of the Board and Compensation Committee vis-a-vis the CEO
- Appropriately document compensation decision-making deliberations – not just conclusions or outcomes
- Clearly articulate the mix of pay and how that mix of pay should be structured to reinforce the business strategy and mission of the nonprofit organization
- Define the market from which you will recruit or lose talent and also understand what other stakeholders perceive your market to be (i.e., be aware of the actions of other local nonprofit organizations)
- Ensure the reasonableness opinion fully defines and explains the nuances of the facts and circumstances in nonprofit organizations – business strategy and mission, market for talent, comparator organizations competitive landscape – surrounding the complexity of executive pay decisions

Instituting Policies and Practices to Protect Your Organization

Instituting Policies and Practices to Protect Your Organization

- IRS focus on identifying inadequate policies and practices:
  - IRS Form 1023
  - IRS Form 990
  - College and University Compliance Project Interim Report
  - IRS Examinations
- Recommended policies:
  - Executive Compensation Policy
  - Conflict of interest Policy
- Timing
- Benefits of Policies

Enhancing the Role of the Compensation Committee and Clearly Delineating Responsibilities Between the Committee, Management, and the Board

Enhancing the Role of the Compensation Committee and Clearly Delineating Responsibilities Between the Committee, Management, and the Board

External Factors → **Compensation Philosophy** → **Pay Implications**

External Factors

- Strategic Plan
- Market Practice
- Governance & Compliance
- Stakeholder Perception

Attracting and retaining quality executives has become more challenging due to economic constraints and stakeholder perception

Compensation Philosophy

Key Considerations

- What are the values and reasoning behind the total compensation program and how it supports the organization's vision?
- How are the broad parameters of compensation administration and its components defined?
- What is the appropriate compensation strategy:
  - Target market for talent
  - Desired positioning against the market (e.g. median)
  - Frequency of assessing the program

Pay Implications

Executive Compensation

- **Pay levels**
- **Pay mix:** establish the appropriate mix between fixed and variable pay and between cash and non-cash rewards
- **Talent market:** identify whether a local, regional, or national market will be referenced for external comparison, and for which positions
- **Performance:** define reasonable and appropriate measures of performance

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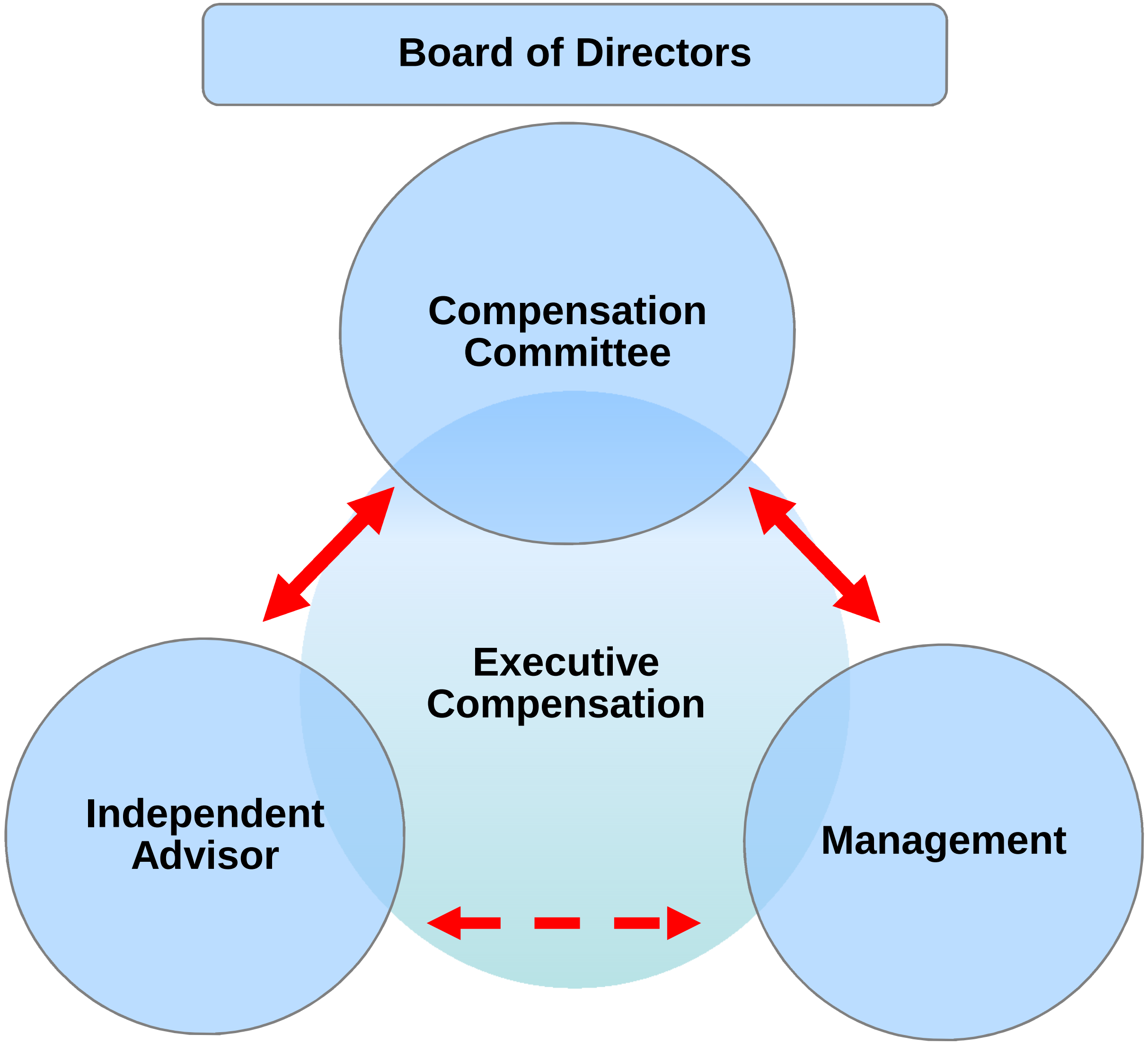
An Independent Advisor Typically Works **for** the Committee and **with M**anagement



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Questions and Discussion

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