Executive Compensation

Rewarding Excellence and Ensuring Governance

By Patricia K. Zingheim, Jay R. Schuster, & David A. Thomsen

It's the law — and the best way to create a high-performance organization.

It's the board's job to set executive compensation that's reasonable, competitive, and based on actual performance. The IRS, believing that many boards aren't fulfilling this duty, has begun scrutinizing the way nonprofits compensate their executives.

States are also getting involved. State regulations, such as California's Nonprofit Integrity Act of 2004 and New York's Not-for-Profit Corporation Law, require that nonprofit boards take the review and approval of executive compensation seriously.

Where does your executive compensation program stand compared to objective measures of reasonableness? If state or federal regulators challenge your compensation program, what will they find? It's crucial to ask these questions now and diagnose your board's and organization's liability relative to how you reward executive performance. It may be too late when regulators are at the door asking questions you're unable to answer.

And even if you aren't examined by the IRS or regulated by your state attorney general, good governance demands that you reward people based on clearly established performance measures. These measures should reflect organizational outcomes and be consistent with what other organizations pay for the same roles.

What Does the Law Demand?

The IRS's intermediate sanctions law imposes potential personal board member liability for charitable and social-welfare organizations that don't set reasonable compensation for their executives. (See "Glossary" on this page for definitions of "reasonable compensation" and other terms.) Each board, or committee charged with determining compensation, should seek to measure compensation reasonableness as follows:

- **Define the job's market value** using a source that is completely independent and doesn't create a conflict of interest for the organization's managers or auditors.
- **Use compensation data** to determine the competitive worth of the executive jobs in question. Make compensation decisions based on unbiased data that you can defend to state or federal regulators if they question your compensation arrangements.
- **Hire a compensation professional** as a consultant.

Glossary

Intermediate sanctions: excise-tax penalties, imposed on disqualified persons and organization managers within applicable tax-exempt organizations, as noted in Section 4958 of the Internal Revenue Code.

Disqualified person: any person in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization. Certain officers, including presidents, CEOs, COOs, and treasurers, are always deemed capable of exercising substantial influence.

Excess benefit transaction: an economic benefit provided directly or indirectly to any disqualified person that exceeds the value received (including the performance of services) from the disqualified person.

Reasonable compensation: value of services provided to an organization based on what would ordinarily be paid for services by like enterprises (including taxable corporations) under like circumstances.

Ask the consultant to recommend compensation levels, and follow these recommendations. Have the consultant compare each facet of executive compensation to the competitive market. Review total compensation, cash compensation, deferred compensation, benefits, perquisites, allowances, and all other forms of cash and non-cash compensation to be paid now or in the future. Require the consultant to provide data that includes at least the following:

- compensation levels paid by organizations of similar size for functionally comparable positions within analogous industries
- availability of similar services in your organization's geographic area
- current compensation surveys compiled by independent firms.

Many board members don't understand the breadth and seriousness of potential personal liability associated with intermediate sanctions. For example:

- **The nonprofit board faces a liability** of up to $10,000 if it participates in an excess-benefit transaction.
- **The person receiving the excess benefit** and the organizational managers involved both face potential personal liability.
- **An automatic excess-benefit transaction** occurs each time money or property passes to a disqualified person without written substantiation. This is true even if the total compensation conferred is reasonable.

One way to analyze reasonable executive compensation is to use the same software used by the IRS — ERI's Executive Compensation Assessor® (www.eri-nonprofit-salaries.com). This survey product allows tax-exempt organizations to analyze reasonableness by using compensation data from Form 990s and Form 990PFs as well as from for-profit companies.

Why Pay for Performance?

Many nonprofit organizations compensate executives based on

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A Road Map to Good Compensation Decisions

- With the aid of a qualified professional, compare executive compensation at your organization to that at organizations similar to yours in industry, geographic location, and size. Use this information to establish compensation arrangements that take into account your executives' performance and the current labor market. Refer to this process in your board minutes to document that you have conducted a thorough review of executive compensation.

- Be sure board members possess enough knowledge and expertise to interpret the compensation comparability data. Form a board committee to be in charge of compensation decisions.

- Create performance measures based on your organization's mission, vision, and goals. Develop a combination of qualitative and quantitative measures. Make sure all performance measures are documented and measurable.

- Adjust compensation based on the market, provided that the executive demonstrates competency, meets performance expectations, and lives the organization's values. Reward performance through a variable pay plan that provides reasonable compensation if all goals are achieved. Stick to the variable pay plan, and avoid (1) awarding compensation increases when goals aren't achieved, and (2) awarding compensation in excess of the variable pay arrangement that was bargained for (to avoid a "material modification" to the compensation arrangement).

- Make certain that your board evaluates the CEO annually, based on goal achievement, and approves new goals on an annual basis.

Is the Compensation Data Reliable?

When deciding whether to use compensation data, always ask:

- Is the data provided by a reputable firm?
- Is this firm independent of the organization and the executives whose compensation is in question?
- Did the firm conduct a survey to compare the organization's compensation to organizations in similar industries and geographic areas? Were enough organizations included in the survey to make the results meaningful?
- Is the survey current so as to eliminate any question of outdated or irrelevant data?

Executives should earn more when the organization meets goals and less when it doesn't.

length of service rather than how well they perform. That's a mistake, not only because it potentially violates the IRS's intermediate sanctions law but because organizations that pay for performance outperform those that don't. Here are some other reasons why it makes sense to pay for performance:

• **High-performance organizations recognize and reward success.** As the organization achieves goals, the executive team should be rewarded. Executives should be paid more when the organization meets or exceeds goals than when goals are missed. Paying for performance gives credibility to the goal-setting process and attracts executives who believe that their success depends on the organization's success.

• **Executives who are willing to have their performance evaluated by the board** will seek organizations that reward performance. Boards that reward performance will hire executives who help sustain a high-performance culture. Executives who are role models of paying for performance will establish similar programs for all employees. Thus, achieving the organization's goals becomes the job of everyone in the organization.

• **When the organization pays for performance, the board's role is to coach and facilitate** executive performance through performance reviews. Performance management thus becomes a key tool of communications, as the board makes sure that goals are consistently achieved and performance is rewarded accordingly.

• **Paying for performance reinforces the organization's mission.** The test of the mission's viability is the board's ability to define it in terms that can be used to develop

Example of Intermediate Sanctions: Don't Make These Mistakes

In a recently published tax advisory memo, the IRS imposed intermediate sanction penalties on a tax-exempt organization despite the fact that the organization had retained an executive compensation firm to analyze compensation comparability data and the relevant marketplace. The IRS concluded that the foundation for determining compensation wasn't strong enough to form a basis for compensation reasonableness. The IRS cited the following problems:

- The board failed to establish that the Personnel Committee involved had knowledge or expertise in determining reasonable compensation.
- The board minutes failed to refer to the compensation data provided by the executive compensation survey.
- The report from the executive compensation firm wasn't current.

The IRS determined that intermediate sanctions applied and thereby brought governance by the board into question.

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If the IRS challenges your compensation program, what will they find?

performance measures. Good governance comes from a mission statement that can be measured in terms of accomplishment.

How Do You Pay for Performance?

To assure that you tie executive compensation to the organization's achievements, and that you comply with the law, follow these steps:

• **Choose performance measures** that reflect the executive team's responsibilities for the organization's success. Base compensation on these measures. Executives should earn more when the organization meets goals and less when it doesn't. Be sure the board sticks to these predetermined guidelines.

Organizations that pay for performance outperform those that don't.

• **Examine compensation arrangements regularly** to avoid issues relating to excess-benefit transactions.

• **Examine contracts** to be sure executives have fulfilled their obligations.

• **Carefully review the compensation arrangements** of all executives. Board members, including those outside the committee charged with forming the compensation arrangements, should be brought up to speed regarding how and why executives are being paid what they're being paid.

• **Be sure all board members understand** the basis for executive pay.

• **Ensure compensation reasonableness** by using data sources that the IRS will accept as appropriate. Use unbiased measures of competitive compensation. ■

Where to Find More

For more information on setting compensation, see these *Nonprofit World* articles at www.snpo.org/ members:

- New Penalties Proposed for Nonprofits (Vol. 14, No. 1)
- Avoiding the Snares of Intermediate Sanctions (Vol. 14, No. 6)
- How to Be Sure Compensation Is Reasonable (Vol. 17, No. 1)
- New Regs Unravel Intermediate Sanctions Snares (Vol. 19, No. 4)
- Expectations for Board Members Are Changing (Vol. 19, No. 3)
- Use Employee Ownership to Motivate People and Gain Revenue (Vol. 22, No. 4)
- How Much Are You Really Worth? Latest Salary Survey Results (Vol. 23, No. 1)

Patricia K. Zingheim and Jay R. Schuster are partners with Schuster-Zingheim and Associates, Inc., a pay and rewards consulting firm located in Los Angeles, and authors of the book Pay People Right! *(www.paypeopleright.com). David A. Thomsen, Esq., CCP, is an employee of ERI Economic Research Institute, Inc. ERI provides compensation survey products, including the Executive Compensation Assessor for tax-exempt entities (www.eri-nonprofit-salaries.com) and SalaryExpert's Intermediate Sanctions Compensation and Comparables Report (http://www.salaryexpert.com/index.cfm?FuseAction=PCSReports.Main&ItemID=20). ERI's products are used to determine reasonable compensation paid by nonprofit and for-profit organizations.*