INTRODUCTION

Hiring and retaining the chief executive are among the most important functions of a nonprofit organization's board. While the board is ultimately responsible for the organization's mission and strategy, the chief executive is the executor — and very often the main architect — of that strategy.

Recruiting and retaining the best possible chief executive often depends on offering the right compensation plan. An effective compensation plan enables a board to hire the best candidate for the job. The plan then provides feedback on performance and helps retain a good chief executive by rewarding effective leadership of the organization.

In developing the chief executive compensation plan, the board must execute a careful balancing act. On the one hand, it must offer a strong salary and benefits package in order to attract the best possible candidates for the chief executive position, and to keep that person in office. On the other hand, it must not offer a compensation package that is out of line with the organization's mission or with the overall culture of the nonprofit sector, whose work is regarded, both within and outside the sector, as properly being driven by mission rather than profit.

INCREASED PUBLIC AND IRS SCRUTINY

To complicate matters, the environment in which boards must make decisions about chief executive compensation has become more difficult. Outside scrutiny of nonprofit salaries has increased; both the media and the Internal Revenue Service (IRS) are paying much closer attention than they have in the past to nonprofit, and especially chief executive, compensation. In June 2004, the IRS announced that it was stepping up scrutiny of nonprofit salaries and hiring 73 new auditors to review compensation for executives at nonprofit organizations for compliance with IRS regulations.1 In March 2007, the IRS reported on the initial results of its investigation. While it did not find major compliance problems, 30 percent of the more than 1,200 organizations examined had to amend their IRS Form 990 tax returns, and the IRS assessed more than $21 million in proposed excise taxes.2 In April 2009, the IRS director of tax-exempt organizations “warned nonprofits to be mindful of executive compensation practices” and again announced additions to IRS

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audit staff. The IRS continues to face pressure from Congress to review nonprofit compensation some lawmakers view as “excessive.”

In addition, changes to the information that must be reported on the IRS Form 990, effective beginning in the 2008 tax year, are likely to increase scrutiny of nonprofit compensation practices. The new 990 will mandate much more detailed disclosure of chief executive compensation, as well as the compensation for other senior and highly compensated nonprofit executives.

IRS FORM 990

Most nonprofit organizations with annual budgets over $25,000 are required to file an IRS Form 990 or 990-EZ every year (see the instructions to the most recent IRS Form 990 for exceptions; private foundations file a 990-PF form). Form 990 data are available to the public; the Form 990s from the past three years must be made available to anyone who visits a nonprofit and asks for them, and nonprofits have 30 days to send out a photocopy if one is requested in writing. If an organization posts its Form 990 on the Internet, however, it is exempt from the other disclosure requirements. The nonprofit organization GuideStar (www.guidestar.org), posts approximately 4.6 million Form 990s on the Web. Other organizations, including the Chronicle of Philanthropy, also publish selected Form 990 data from time to time.

As of the 2008 tax year, the IRS Form 990 (but not the 990-PF) will require nonprofits to report compensation for all officers, directors, trustees and “key employees” (persons making over $150,000 a year in taxable compensation, having substantial influence over the organization, and among the top 20 highest paid employees). Organizations must break out compensation in more detail than in the past, report on perquisites, and describe their process for establishing the compensation of the chief executive.

See Appendix I for more on the new IRS Form 990.

State regulators, too, are cracking down on potentially excessive chief executive compensation; state attorneys general are bringing lawsuits that result in judgments ordering chief executives to repay millions of dollars in excess compensation. California’s adoption of the California Nonprofit Integrity Act of 2004, which took effect in January 2005, requires the boards of charitable organizations with revenues of at least $2 million to review and approve the chief executive’s compensation package to ensure its reasonableness. More and more state legislatures are on the road to tightening regulation of the internal practices of nonprofits — with compensation becoming increasingly important. State attorneys general — in


California, New York, Texas and elsewhere — are aggressively pursuing nonprofits perceived as overcompensating their chief executives (and other senior staff).

A series of high-profile cases have attracted press scrutiny that has seriously affected the reputation of leading nonprofit organizations, including arts organizations, foundations, and universities — and destroying, in some cases, the careers of their chief executives. One recent example involved the Museum of Modern Art. The New York Times reported in 2007 that a trust created by several of the Museum’s board members had been covering the director’s housing costs. This was not reported to the IRS as compensation. In other cases, the former president of American University and the former secretary of the Smithsonian came under scrutiny for charging allegedly lavish and unnecessary business expenses, and were forced to resign.6

As a consequence of this scrutiny, many nonprofits have made commendable progress in changing their compensation plans and increasing the transparency of their processes for setting compensation and reviewing chief executive performance on a regular basis. Sound practices are not, however, universal. Many boards still do not take full steps to monitor chief executive compensation. BoardSource, for example, found that only 67 percent of full boards approve the chief executive’s compensation.7 While, as we discuss in more detail later (see pages 12–13), there is no federal legal requirement that the full board formally approve chief executive compensation, the full board needs to know what it is paying, and therefore we strongly recommend that the full board in fact review and approve chief executive compensation. The new IRS Form 990 asks if the board has received and understood the form, with its detailed compensation information, before the form is finalized and filed.8 This is an unsubtle hint in favor of full board review.

**TRENDS IN CHIEF EXECUTIVE COMPENSATION**

Perhaps not coincidentally, the increased scrutiny from the government, the press, and the public comes at a time when compensation practices at many nonprofits are coming to resemble, at least to some degree, those in the for-profit sector. Salaries at many nonprofits have been rising, and salaries at some large nonprofits have reached levels formerly associated only with parts of the for-profit marketplace.9 In addition, some nonprofits have introduced compensation features such as bonuses, incentives, and deferred compensation that were formerly seen almost exclusively among for-profit corporations. Some nonprofits have found that these compensation features can offer distinct advantages in encouraging focused performance while controlling


compensation costs — although, as we discuss in more detail later in the book, they are not for everyone. The IRS has recognized that untraditional forms of compensation, such as bonuses and incentives, can contribute to stronger and more successful nonprofit organizations. Estimates of the percentage of nonprofits with chief executive bonus or incentive programs vary: A 2008 Quatt Associates survey of large nonprofit organizations showed that 62.5 percent offered such programs. The same survey found that 20 percent of chief executives of major foundations received incentives (a 2007 survey by the Council on Foundations found that 24 percent of foundations offered incentive pay to chief executives). A Quatt survey of academic institutions found that 23 percent of chief executives received incentives, while a 2008–2009 survey by the College and University Personnel Association found that bonuses were paid to 11.8 percent of chief executives of single institutions and 2.6 percent of chief executives of multiple-institution systems.\(^\text{10}\)

Of course, few nonprofit organizations have the luxury of offering excessive compensation to any of their staff members; the challenge that many smaller organizations face is not to control unreasonably high salaries, but to find enough money to pay reasonable salaries at all. This all-too-common financial challenge is one of the reasons that chief executive compensation in the nonprofit sector, like sector salaries in general, remains below the levels found in the for-profit world. In addition, nonprofits cannot offer some of the more lucrative features found in for-profit compensation, such as equity, and deferred compensation in the nonprofit sector is subject to stricter rules than it is in the for-profit world.

What are the trends toward making nonprofit salaries competitive?

Nonprofit salaries rose steadily through 2008, and at least among larger and more complex nonprofits, the gap in salary compensation between for-profits and nonprofits narrowed. Moreover, some pay practices, such as bonus and deferred compensation, formerly seen only in for-profit organizations, have become increasingly common in nonprofit organizations.

That said, nonprofit total compensation still lags behind for-profit pay for positions of the same impact and complexity, and probably always will. In part this is because nonprofits cannot offer equity or other lucrative forms of long-term compensation. The larger reason, however, is that external scrutiny, federal and state oversight, and the internal culture of nonprofits generally discourage the payment of very high levels of compensation. For many nonprofits, financial considerations are also significant limits on executive pay.

The bottom line: Many nonprofits are now appropriately competitive — paying enough to ensure they can hire the talent they need, but not so much that they risk violating the public trust that expects them to focus on their main responsibility, their mission.

PUBLIC EXPECTATIONS

Perhaps the most significant factor differentiating compensation for chief executives in the nonprofit sector from that of their counterparts in for-profit businesses is public expectation. The public rightly believes that a nonprofit organization has a responsibility to channel as much of its donor money as possible toward the fulfillment of its mission. Many members of the public also believe that staff at nonprofits should be willing to receive lower salaries than staff members in comparable positions in for-profit businesses, because the nonprofit staff person is dedicated to the organization’s mission. These expectations create a value system in which an apparently generous, and perhaps appropriate, salary is seen to imply a lack of dedication to the organization and its mission. Compensation practices that are universal in the for-profit sector, and increasingly common among nonprofits, such as pay for performance and bonuses, are sometimes perceived as inappropriate.

Nonprofit boards must be prepared to work within the constraints imposed by this publicly held value system. They must also recognize that the same value system may be an integral part of their organization’s internal culture as well. When this is the case, board members and staff alike may object to the use of market-based comparisons for making salary determinations and to the provision of benefits and perquisites for the chief executive. They may even resist giving the chief executive more than a token annual salary increase.

Q Are chief executive pay records public information? What about the pay of other employees?

A Chief executive pay, including cash pay and benefits, must be reported on the annual IRS Form 990 that almost all tax-exempt organizations must file. Organizations must also report on their 990s compensation for: a) officers, directors, and trustees; b) “key employees” (the top 20 employees who receive at least $150,000 in reportable income and have fiscal or program management responsibility for at least 10 percent of the organization’s financial resources); and c) the top five employees not included in (a) or (b) who receive at least $100,000 in reportable compensation. IRS Form 990s must be made available to the public upon request.

BALANCING PUBLIC EXPECTATIONS WITH THE NEED TO COMPETE FOR STRONG LEADERSHIP

On the other hand, boards need to be aware that unrealistically low expectations about executive compensation can be detrimental to a nonprofit organization. The chief executive is a nonprofit’s single-most-important employee. Failure to pay a competitive salary, however noble the motivation for doing so, can cause a nonprofit

11 Sarah Z. Sleeper, “Sizing Up San Diego’s Nonprofit CEO Pay,” San Diego Metropolitan, June 2004; Negative public perception may lead to a loss of funding sources — in May of 2009, a Maryland county withdrew $55,000 in grants to a public charity to protest what it believed was excessive pay for the charity’s CEO, “MontCo Withholds Money to Charity Because of High Executive Pay,” Washington Examiner, May 12, 2009.
to lose a strong chief executive or find it almost impossible to recruit an effective one, harming the organization’s success and its ability to fulfill its mission. Below-market chief executive compensation can also act as a cap on the pay of other senior staff, leading to further losses in effectiveness as key employees are recruited away by other organizations.

Board members should therefore consider very carefully the potential costs of underpaying their organization’s chief executive. Competitive salaries, based on the nonprofit marketplace, and innovative compensation practices — for organizations that can afford them and are prepared to justify them — can help recruit and retain skilled and experienced leaders. For organizations that are facing budget constraints, it may make sense to economize in other areas rather than risk the loss of an effective organizational leader. Of course, each nonprofit must decide for itself what mix of compensation features makes the most sense for its circumstances.

A nonprofit organization’s board can most effectively meet public expectations and justify its decisions regarding chief executive compensation when it approaches compensation as a strategic decision. The board’s principal duty in setting chief executive pay, in addition to meeting legal norms and stakeholder expectations, is to ensure that the compensation package supports organizational success. The compensation package must be an integral part of overall organizational strategy and planning. By ensuring that the chief executive’s compensation will contribute to the realization of the organization’s mission and objectives, the board provides a rationale for its decisions that will stand up to public scrutiny.

As we were completing the second edition of this book, a severe economic downturn was affecting nonprofit and for-profit compensation alike. After a long run of good years, nonprofits face falling budgets, hiring freezes or layoffs, and even the prospect of having to sharply cut back or cease their operations. The long-term effect on nonprofit compensation is unpredictable, although a slowdown in rising compensation levels seems likely. However, difficult economic times may also make it even more important to recruit and retain the best possible talent in a way that respects public concerns and perceptions.

WHAT YOU WILL FIND IN THIS BOOK

This book is intended as a practical guide for nonprofit boards to use in setting chief executive compensation — both when hiring a new leader and when reviewing the pay of a sitting chief executive. It is designed to serve as a reference tool and as a step-by-step guide that a board can use to establish an effective compensation structure within the context of the organization’s mission, history, goals, and marketplace. It seeks to provide information and guidelines that will be useful to nonprofits of all sizes, while recognizing that small, medium-sized, and large nonprofits have differing needs and circumstances. Above all, it aims to help nonprofits of all types increase the transparency and integrity of their chief executive compensation practices as part of their stewardship of the public trust.
Chapter 1 discusses the board’s role in setting chief executive compensation. It places the issue in the larger context of the board’s responsibilities to the organization, and outlines procedures for the board to follow in setting chief executive compensation. Chapter 2 covers the role of organizational culture, mission, and strategy in setting chief executive compensation. Chapter 3 explains how to develop a profile of the specific qualities desired in the chief executive. A formal profile helps a board target its recruitment to the correct marketplace and set compensation in light of the marketplace and desired skills; it is also helpful in determining how to reward those skills. Chapter 4 discusses the compensation philosophy: the set of values and mechanisms used to set compensation. Chapter 5 describes how to define the chief executive’s marketplace and obtain data from the marketplace for use in setting compensation. Chapter 6 focuses on the legal requirements surrounding chief executive compensation, and how the board should act to protect itself, and the organization’s executives, from liability. Chapter 7 discusses disclosure and explanation of chief executive compensation to the organization’s various stakeholders, including staff, donors, and the public. Chapter 8 discusses the elements of the compensation package and their implementation. Chapter 9 covers chief executive employment agreements.

Readers familiar with the previous edition will find the following updates and additions:

- Impact of the new 990, and how to use the new data it will provide
- Additional guidance on how to use survey data in market pricing
- Sample compensation committee charter
- Expanded section on legal standards
- Sample chief executive job description
- Guidance on setting and adjusting compensation in difficult economic times
- The board’s role in reviewing compensation for other senior executives beyond the chief executive

**USING THIS BOOK**

This book is organized to provide a logical, step-by-step method for boards to follow in thinking about chief executive compensation. We understand, however, that concepts referenced in one section may raise questions that are answered in detail only in subsequent sections. We have therefore included answers to frequently asked questions (FAQs) throughout the text. A full list of these FAQs is also included as Appendix II. We have also included boxes on major subjects and concepts for ease of reference.