Determining Fair Compensation for Your Executive Director: What a Nonprofit Needs to Know

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Winter 2014

Abstract

This white paper will focus on the competitive edge that fair and reasonable executive director compensation provides for a nonprofit organization, as well as on how to define "fair" and how to calculate "reasonable" for a specific organization. It will also speak to the role of a compensation committee and, lastly, will review the penalties that may be incurred if the proper guidelines are not followed.

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1. Learning Why Executive Compensation Matters

Nonprofit organizations, like their for-profit corporate cousins, want to attract the best, brightest, and most effective leaders they can. With studies indicating that two-thirds of an organization's culture results from influence "at the top," the selection of the CEO or Executive Director is more critical than ever.

Today's economic landscape is defined in part by diminishing grants and shrinking contributions from corporate donors. With that in mind, nonprofits are competing with each other for dynamic, visionary leaders who can help them navigate the financial challenges, raise awareness, build strong connections and paint a compelling picture that attracts and engages the community. Nonprofit leaders, especially in smaller entities, are expected to have the experience necessary to cultivate high donors, articulate the organization's purpose in a meaningful way, manage the daily operations, produce successful events, inspire and direct the staff, interact positively with board members and, at the same time, advance the nonprofit's mission. This description covers a broad array of skills and only top talent can fill the bill.

The impact of a well-known and respected Executive Director on the organization's ability to achieve its mission is limitless. Passion for the cause is an important ingredient. Leaders want to work for, and with, organizations that they believe in, but passion is only one part of the formula. Great leaders have a price tag. And that is why compensation packages play a significant role in the success of many nonprofits.

Every nonprofit organization's Board of Directors faces the same dilemma: how to pay a fair salary that helps them get the attention of the best candidates as well as retain them once hired while, at the same time, not creating a burden on the budget. Some creativity may be necessary so that a group does not lose out on the chance to hire an extraordinary Executive Director. So before the door is slammed shut, talk to your Executive Committee, Board members, compensation committee members, loyal donors and CPA for ideas. A collaborative effort may deliver the best solution.

2. Defining Fair and Reasonable Compensation

Nonprofit executive compensation tops the list of the Internal Revenue Service's (IRS) hot buttons today. The resentment over the abuse of CEO salaries in Corporate America has spilled over to the nonprofit community, with volunteers, donors, the media and legislators calling for greater transparency and the application of reasonable standards on salaries for the Executive Director and other high-level leaders. Unfortunately for the nonprofit sector, where competition for talent is tough, the decision regarding how much they can pay their leadership is somewhat out of their hands.

Because the IRS is charged with enforcing the Federal Private Inurement Prohibition (FPIP), which strictly prevents the decision-makers of a tax-exempt organization from receiving unreasonable benefits from the nonprofit's income or assets, it has the authority to establish ground rules for fair and reasonable compensation calculations that are designed to encourage public trust and reduce risk.

In a nutshell, the IRS allows tax-exempt (nonprofit) organizations to pay their executives 'fair and reasonable' compensation. However, without a universally accepted standard for fair and reasonable, every nonprofit is left to its own devices to determine the appropriate salary for its executives. That said, there are common practices that must be taken into consideration which, if ignored, can result in severe penalties being imposed on the group.

- Use market rate as a standard for calculating pay. This rate is determined by conducting research regarding what someone in a similar position, in a similar size organization with a similar mission in a similar geographic locale is paid. Smaller organizations with less than $1 million in annual gross revenue may simply review the annual returns filed by a sample of their peers–perhaps looking at three or four similar organizations–to help them reach a conclusion. Larger organizations may obtain comparability data by taking into account external compensation surveys or studies. The more prestigious the study, the greater it's proven independence, the more confidence the group can have that it is developing a body of knowledge based on quality data that will stand up if challenged.

- Look outside the organization's sector. Compare their Executive Director's salary with that of a for-profit company when determining market rate, as long as the job description, size of the company and its mission are comparable to the nonprofit.

Looking inside and outside the nonprofit community for commonalities and standards enables the Board to arrive at a smart decision regarding their own situation.

3. Establishing the Executive Director's Salary Package

Although the IRS has been vague in its description of what fair and reasonable nonprofit executive compensation looks like, the punishment for not adhering to the rule is steep. However, there are steps the Board of Directors can take to comply with the intent of the IRS. It is important for the nonprofit leaders to establish a *process of compensation decision making*, taking into account these steps:

1. **Develop a written compensation policy.** Because the IRS Form 990 specifically asks about the process used to approve compensation of the ED/CEO, having a policy in writing provides guidance for the group and assurance to the IRS that the procedure followed is legitimate and fair.
2. **Conduct the necessary research.** Obtain comparable data from similar organizations in both the nonprofit and for-profit sectors; this data will help defend the decision and lay a foundation for fairness.
3. **Form a compensation committee.** The members will have responsibility for obtaining information about the market value of the Executive Director's role and providing the necessary benchmarks to help determine the best compensation package–including salary and any benefits and perks that the organization may offer.
4. **Approve the compensation package.** This should be done in conjunction with the Compensation Committee, the Executive Committee, and, ultimately, the Board of Directors, ensuring that no person voting has any conflict of interest.
5. **Document everything.** In today's litigious world, and with the IRS on high alert regarding excessive pay, the group should record the entire decision-making process. The documentation should include the comparability data obtained and relied on, the action of any members of the Board with a conflict of interest, the terms of the compensation package, the date of its approval, and the names of those who were present and voted on the transaction.

Once an organization has followed these steps, and has carefully and thoughtfully determined an appropriate salary, it can be comfortable that it has established a rebuttable presumption of reasonableness. This solid data, based on fact and founded on standards that are common to other similar organizations, should create credibility that the IRS cannot rebut or refute.

Still, the IRS leaves a door open by saying they may refute the presumption of reasonableness, but only if they themselves uncover sufficient contrary evidence that rebuts the probative value of the comparability data that the Board of Directors relied on to reach its decision. If the IRS can prove the data the Board amassed is not correct or is misleading, they can try to make their case and assess penalties. The more documentation the Board can provide, the more effectively it can defend itself because the burden to disprove the Board's actions under these circumstances will fall on the IRS.

The task of developing a nonprofit Executive Director's fair compensation is more than a list of IRS suggestions and rules. To determine fair pay, the organization must design a detailed job description and include a list of the qualities that it considers a priority, such as level of education or previously proven experience in similar circumstances. Next, the organization can decide what level of pay makes sense for the job it has described. Common sense, while occasionally ignored, can play a role in this process. But remember, it does not replace the importance of due diligence, which is conducted as described above for the purpose of gathering substantive comparability data. Lastly, the Board can loosely apply the rule of thumb that indicates that smaller organizations (under $1 million in revenue annually) may look to setting a salary at 10% of their budget while the larger organizations (in the tens of millions of dollars in revenue annually) may set a salary at 1%-2.5% of the budget. Of course these percentages of budget cannot be used without regard to all of the other key factors, but they can contribute to, or influence, the final decision.

Because of the relevance of the results of the October 2013 Charity Navigator's "Charity CEO Compensation Study" to this discussion on establishing the Executive Director's compensation, we include a brief synopsis of critical points with their permission.

The recent Charity Navigator study examined CEO compensation at 3,929 mid- to-large sized charities in America to help donors, policymakers, charity Boards and others understand how leadership pay varies by the charity's location, size and mission. Findings from the report include:

- **Modest raises are the norm since the recession**: Salaries for the CEOs in this study increased modestly since the recession: just 0.8% from 2008 to 2009, 1.5% from 2009 to 2010 and 2.5% from 2010 to 2011. These fairly small increases come after the 4.7% median increase charity CEOs received from 2007 to 2008.
- **Charity CEOs that aspire to have big salaries are more likely to succeed if they work at an educational charity:** The data shows that top pay at charities can vary greatly by mission with the heads of educational charities earning as much as $90,000 more than those running religious charities.
- **Geography influences the top executive's salary:** CEO salaries at nonprofits reflect the regional variation in the cost of living. For example, CEOs at charities in the Northeast ($149,523) and Mid-Atlantic ($147,474), which include Boston, Washington, D.C. and New York City, tend to earn higher salaries than those in the Mountain West ($108,893) and Midwest ($114,050), which include Milwaukee, Boise and Salt Lake City.
- **The bigger the charity's budget, the bigger the CEO's wallet:** Not surprisingly, the higher the charity's total expenses, the more likely it is that the CEO will earn higher compensation. Charities with over $500 million in total expenses report a median pay of $422,578 for their CEOs, whereas charities with $1 million to $3.5 million in total expenses report a median pay of just $95,661.
- **Mission, location and size also impact the CEO's raise:** Leaders at charities in the Northeast (2.7%), those focused on educational issues (3.1%) and those at larger organizations (3.6%) received the greatest median raises. In contrast, CEOs at charities in the Mountain West (1.8%), those working at religious charities (0%) and those running smaller organizations (1.7%) received the lowest increases in pay.
- **While most nonprofit leaders earn reasonable salaries, a handful of them earn excessive wages:** Nine of the charities in the study pay their CEO more than $1 million. That's up from calendar-year 2010 when six charities in the study had CEOs that were paid at least $1 million.
- **While location matters, so do categories:** For example, Education ($170,178), Arts, Culture and Humanities ($159,650), Public Benefit ($142,661) and Health ($137,919) led to higher-paid CEOs, while Religion ($82,746), Animals ($104,816), Human Services ($114,000) Environment ($117,644) and International ($120,000) led to lower-paid CEOs.
- **There are still some charities that report they essentially set their CEO's pay in a vacuum of information:** Nonprofit Boards should have a documented policy for establishing the CEO's pay. That objective process should include a review of CEO performance and benchmarking against comparable organizations. 244 charities in this study reported that they don't have a

policy in place for determining their CEO’s pay. The good news is that this is down from last year when 543 charities reported that they didn't have a policy for setting their CEO's salary.

“Given our research, which show that the typical charity CEO earns just $125,000, we do not believe that salaries approaching a million dollars or more are needed to attract bright, able, and committed candidates to positions of nonprofit leadership. As such, we agree that donors should continue to be skeptical of charities that pay salaries hovering near or above one million dollars, but that they not discount organizations where the leader's pay is in the low six figures,” said Charity Navigator, President & CEO, Ken Berger.

About Charity Navigator

Founded in 2001, Charity Navigator has become the nation's largest and most-utilized evaluator of charities. In their quest to help donors, their team of professional analysts has examined tens of thousands of non-profit financial documents. They've used this knowledge to develop an unbiased, objective, numbers-based rating system to assess over 7,000 of America's best known, and some lesser known but worthy charities.

Charity Navigator works to guide intelligent giving. Their goal is to help people give to charity with confidence. At the same time, they aim to help charities by shining lights on truly effective organizations. In doing so, they believe they can help ensure that charitable giving keeps pace with the growing need for charitable programs.

Their approach to rating charities is driven by those two objectives: helping givers and celebrating the work of charities.

4. The Role of the Compensation Committee

The compensation committee is charged with responsibility for reviewing all the competitive data and comparing the salaries of Executive Directors working under similar circumstances to their unique situation. They also are expected to review the accomplishments of the Executive Director, linking his or her measurable success, experience and performance to their compensation package decision.

They draw on all these pieces of information to create a practical picture of the situation and then calculate annual salary, benefits (which may include a wide range of options such as insurance, benefits or pension plan, vacation and sick pay and other perks (which can include automobile allowances and mileage reimbursement, conference attendance, travel and entertainment reimbursement, a retirement fund and other details that are of significant importance to the Executive Director and the group).

Based on the size of the Board, the “Comp Committee” can range from three to five Board members and usually includes the Board Chair, the Personnel Committee Chair and the Audit or Finance Chair. The organization needs to ensure there are enough people selected to represent diverse perspectives (some of the members may have corporate backgrounds, banking, finance or legal experience or are engaged in other professions) while still remaining small enough to be flexible and effective. Too many people can stall the discussion and too few can present a narrowly defined viewpoint. There should be some assurance that no one on the committee has any conflict of interest and that all will be open, fair and reasonable in their approach to their duties.

Once the committee is created, the real work begins. They come to a conclusion which then must have the benefit of Board oversight. Once voted on and agreed upon by the Board it can be presented to the Executive Director. Having relied on, and documented, carefully gathered comparable data as evidence to back up the organization’s calculations, there should be little argument at this stage.

Of course, in the real world, the negotiation process may include concessions by both sides. But, if the compensation committee offers objective facts and supporting data, and a reasonable explanation of their decision (taking into account the Executive Director’s expectations as voiced during regularly scheduled performance reviews and through other interactions with the Board) there should be no surprises for anyone involved.

5. Penalties Incurred for Not Applying the Standards

Recognizing that the IRS offers nonprofits neither a standard formula with which to calculate their Executive Director's compensation, such as a percentage of total revenues or expenses, nor any tables or standard definition of what is considered fair and reasonable, nonprofits need to be very careful as they prepare their compensation calculations. For those Board members who have ignored the IRS expectations, and who have no written policy, no back-up data and no documentation of the calculations process and vote, the outcome can be bleak if they are questioned.

If the IRS challenges the salary you are paying to your Executive Director, claiming it is excessive, and if you cannot provide appropriate documentation that supports the salary package (as described above), the penalties can range from fines to revocation of the organization's tax-exempt status.

Revocation is a last resort and is typically applied only in dire situations. Based on past experience, fines are the more likely consequence. These are known formally as "excessive benefit transaction excise taxes," but more informally they are referred to as "intermediate sanctions."

What should be of special concern is that the sanctions can be levied on the executive who received the overpayment *as well as* the board members who approved it or who knew about the excessive pay and did nothing to prevent it.

In previous years, the IRS has reported collecting as much as $21 million in excise taxes stemming from examinations involving excessive nonprofit executive compensation. As a result of this, the IRS now includes a compensation review in every examination it conducts of a tax-exempt organization. This greater scrutiny is not likely to diminish any time soon!

When conducting the compensation review, if it is determined that there is excessive executive compensation being paid, the IRS can:

- Require the Executive Director to repay the difference between reasonable pay and the excessive pay they received;
- If the Executive Director fails to repay this amount or only pays a portion of it, a 200% excise tax can be imposed on the amount that remains unpaid;
- The IRS may require the Executive Director to pay an excise tax equal to 25% of the amount of salary that they consider to be overpaid, or excessive; and
- The IRS may require each Board member who approved the excessive salary, or who knew about it and failed to act against it, to pay an excise tax equal to 10% of the overpayment–not to exceed $20,000 per transaction.

These harsh penalties highlight the seriousness of the situation and the commitment the IRS has made to ensuring tax-exempt organizations' compliance with the United States tax code.

Board members who do not take their fiduciary responsibility seriously and are using their seat on the Board to serve as a resume builder or to impress the community need to understand the reality of their responsibilities and take ownership of the decisions they make. The role of a Board member in protecting the organization is regarded by the IRS as an essential responsibility with grave implications across the community.

6. Conclusion

After all is said and done, the most effective and efficient manner for determining fair and reasonable compensation for a nonprofit Executive Director takes into consideration all factors, acknowledges the financial limitations of the group, holds up under IRS scrutiny as well as under the questioning eyes of donors, volunteers and the community at-large. This comprehensive approach will enable the organization to attract a great leader by approaching the decision from several angles using multiple benchmarks and key performance indicators. The Board that begins with a representative compensation committee and a written plan, then examines the compensation packages of others in their ‘space,’ maintains meticulous records and applies good judgment and common sense should be able to attract and retain a quality leader today and into the future.

7. Research Citations

Some of the information presented here was obtained by conducting research using the following websites:

www.guidestar.org. “What You Need to Know About Nonprofit Executive Compensation.”

www.forbes.com. “Five Must-haves in an Executive Director’s Employment Agreement.” Evangeline Gomez.

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www.501c3.org/blog/nonprofit-executive-compensation. “Nonprofit Executive Compensation.” 2013 Charity CEO Compensation Study. Charity Navigator. October 2013.

www.jlittleford.com/Articles/process_pitfalls. “Executive Compensation: The Process, the Pitfalls and Opportunities.”

www.councilofnonprofits.org/nonprofit-executive-compensation. “Executive Compensation Policies.”

“Compensation Committees: Does Your Organization Need a Compensation Committee?” Eileen Morgan Johnson. Whiteford, Taylor & Preston, LLP.

8. About the Authors

Bridget Hartnett, CPA, PSA

Bridget Hartnett, CPA and PSA, is a Member of the firm at Sobel & Co., with a depth of experience in nonprofit accounting which she draws on to provide high-level services for clients.

Experience in the Nonprofit Niche

Bridget spends most of her time working closely with clients in the social services and nonprofit areas, including educational institutions. She supervises the audit engagements conducted by Sobel & Co. for the Cerebral Palsy Association of Middlesex County, the Youth Development Clinic of Newark and Catholic Charities of the Trenton, Metuchen and Newark dioceses, Freedom House, and C.J. Foundation. In addition, she handles all of the firm's education audits and holds a New Jersey Public School Auditor's (PSA) license. Bridget is also responsible for reviewing and overseeing the preparation of nonprofit tax returns.

Philanthropic and Social Service Commitment

Bridget carries her commitment to social services beyond the work place to include her personal involvement in several areas, such as St. Benedict's school in Holmdel where she volunteers for projects and special events as needed, as well as gives her resources and time to various children's charities, such as the New Jersey Chapter of Make-A-Wish and others. She is also a volunteer with professional business groups in the New Jersey community, including Monmouth Ocean County Nonprofit Committee and the Western Monmouth Chamber of Commerce where she is Treasurer and helped to found the successful Young Professionals' Group and currently serves as Co-Chair and founder of their newly formed Nonprofit Committee.

Professional Credentials

As a licensed Certified Public Accountant in New Jersey, Bridget is a member of both the American Institute of Certified Public Accountants (AICPA) and the New Jersey Society of Certified Public Accountants (NJSCPA). Bridget is an active member of the New Jersey CPA Society's Nonprofit Interest Group.

Educational Background

Bridget graduated with her Bachelor of Science degree from Montclair State University.

Ron Matan, CPA, CGMA, PSA

Ron Matan is the Member in Charge of Sobel & Co.'s Nonprofit and Social Services Group. In this role he brings a unique blend of public accounting and business acumen to every client engagement. A key member of Sobel & Co.'s Leadership Team since joining the firm in 1997, Ron works primarily with nonprofit organizations, including United States Department of Housing and Urban Development (HUD) projects, A-133 engagements, and low-income housing tax credit programs (LIHTC).

Experience in the Nonprofit Niche

Ron is responsible for the firm-wide quality of this practice area and is the firm liaison for the AICPA's Government (Nonprofit) Audit Quality Center. With over 35 years of experience in public and private industry and accounting experience with all types of nonprofit and social service organizations, Ron offers a unique blend of knowledge and insight to these specialized engagements. Ron is a Certified Tax Credit Compliance Professional and is listed in the Guide that is circulated to all State Agencies Allocating Tax Credits, as well as the Internal Revenue Service. He has taken courses in advanced training for peer reviews and performs peer reviews of other accounting firms. Ron also holds a New Jersey Public School Auditor's (PSA) license.

Philanthropic and Social Service Commitment

Ron is a member of the Board of Directors of the Neighborhood Health Services Corporation, headquartered in Plainfield, New Jersey, where he serves as Treasurer and Chairman of both the Finance and Audit Committees. Ron also serves on the Union County Educational Services Foundation Board. Ron is a former Treasurer and Board Member of Kids Peace Treatment Centers for emotionally disturbed children, located in Bethlehem, Pennsylvania.

Professional Credentials

Ron is a Certified Public Accountant licensed to practice in New Jersey, New York and Pennsylvania. He is a member of the American Institute of Certified Public Accountants and the New Jersey Society of Certified Public Accountants (NJSCPA). Ron has been elected to PKF North America's Nonprofit Committee, and in June 2004, he was appointed to the New Jersey Society of Certified Public Accountants' Peer Review Executive Committee. Ron is also a member of the NJSCPA's Nonprofit Interest Group.

Educational Background

Ron is a graduate of Kings College in Wilkes-Barre, Pennsylvania, where he received a Bachelor of Science Degree in Accounting.

9. About Sobel & Co.

Sobel & Co. is a regional accounting and consulting firm located in Livingston, New Jersey, that has been providing nonprofit and social service organizations in the New Jersey/New York metropolitan area with audit, accounting, tax and advisory services since its inception in 1956.

The firm is distinctive in its approach to the nonprofit community because of its sincere passion for serving this sector. As it says on the Sobel & Co. website, "We work with the nonprofit sector because we feel good helping those who do good; we have a passion for helping nonprofit organizations achieve their mission of helping the world's most vulnerable."

The firm currently works with more than 190 nonprofit organizations with revenues ranging from $100,000 to over $75,000,000. Based on this depth of experience, the professionals in the nonprofit group are keenly familiar with the issues facing nonprofits and they apply this knowledge to bring added value to every engagement.

As a further demonstration of the firm's commitment to the nonprofit community, several complimentary programs are offered throughout the year. These include quarterly webinars, roundtable discussions and an annual symposium on timely and relevant topics.

We also encourage you to visit our website at www.sobel-cpa.com and click on the nonprofit niche page. Once there, please browse our resource library where you will find published white papers along with a variety of articles. We provide a Desk Reference Manual for Nonprofits, a Survey of Nonprofit Organizations that contains interesting insights on nonprofits, a wide range of tools and benchmarking data, a monthly e-mail newsletter that offers relevant information to organizations and links to other key sites that are valuable for the nonprofit community.

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