Determining Executive Compensation

Two of the principal responsibilities of a nonprofit board are to hire and to evaluate the performance of the chief executive. Every member of the board should participate in this process. Generally speaking, the fewer board members involved in approving final decisions about executive compensation and the fewer board members who know the full details of the compensation package, the greater the potential for abuse—inadvertent or otherwise.

The board chair, executive committee, or compensation committee alone may conduct preliminary negotiations with the chief executive. Regardless of who conducts these preliminary negotiations, however, the ultimate responsibility for setting executive compensation falls to the entire board. All board members must know the full details of the chief executive's compensation package and have the opportunity to discuss and approve it.
Before embarking on this process, the board should get its bearings. The following checklist should help.

- **Conduct extensive research.** In addition to reviewing national and regional survey information about compensation levels in the nonprofit sector, seek help from peer organizations. A few strategic telephone calls to peers or an examination of the Form 990s filed by peer organizations within your community should yield relevant information about whether your chief executive's salary reflects equivalent compensation in similar organizations. When comparing your organization's compensation level to those of other nonprofit organizations, consider the similarities and differences between the organizations. For example: the organization's mission; the community in which the organization operates; the size and scope of the organization; the requirements for the job; and the total compensation package, including benefits and perquisites.

- **Consider the nature of your organization, and how that affects appropriate compensation levels for the chief executive.** A larger and more complex organization which is competing directly with the for-profit sector for its executive may have to pay a higher salary than an organization whose activities are simpler or more narrowly focused. The minimum salary acceptable to an already-employed candidate will usually be what he or she is currently making, but the right salary will be what is necessary to attract and keep someone who can meet the

leadership challenges of the job. Make certain that the compensation level you set is in line with job requirements and with your organization's ability to pay.

- **Consider equity and the perception of equity.** Consider the implications of paying your chief executive at a disproportionately higher (or lower) level than the rest of the staff. If your organization's activities are carried out primarily by unpaid volunteers, will morale be affected adversely if your chief executive is handsomely compensated? Be aware of the full salary practices of your organization. And keep the big picture in mind when considering salary adjustments. For example, as E.B. Knauft writes in Financial Compensation in Nonprofit Organizations, when a drop in income or rise in fixed expenses negatively affects the organization's bottom line, requiring a salary freeze, "it seems appropriate that this also apply to the chief executive so that the entire staff receives the same message."

- **Protect the board's decision from undue influence by the chief executive and his or her close associates.** Abuse can take many forms. The chief executive should not recommend his or her own salary increase; if a compensation consultant is hired, he or she should be retained by the board and not by the executive. If a small group is charged with making a recommendation to the board, that group must carry out its work free of undue influence by the chief executive.

- **Be aware of IRS criteria for excessive compensation.** Excessive compensation may be a factor in revoking an organization's tax-exempt status, although neither the IRS nor anyone else has developed absolute criteria for determining when executive compensation is in fact excessive. In arguing cases of excessive compensation, the IRS generally uses two criteria: the amount of compensation compared to compensation of executives at similar organizations and the manner in which the compensation was determined.

Other factors the IRS considers relevant in determining "reasonable compensation" include: nature and scope of the individual's duties; the individual's background and expertise; the size of the organization; the amount of time devoted to performing duties; local and national economic conditions; the amount paid by organizations of similar size and type in the same area to equally qualified employees for similar services; and whether the compensation negotiation was conducted at arm's length"—in other

words, whether the chief executive had undue influence over the negotiation process and outcome.

- **Follow a process that holds each board member responsible for understanding and approving the entire executive compensation package.** While the initial recommendation for compensation may come from a smaller committee, the entire board should discuss and approve the salary in executive session, without the chief executive being present.

- **Remember that the compensation package is likely to become common knowledge.** Beyond the board's responsibility for effective fiscal oversight, the public nature of executive compensation and the growing public interest in compensation levels within the sector make it even more important that each board member fully understand the compensation package. Each board member should be prepared to explain and defend the salary figure to many different constituencies. Donors, other employees, beneficiaries of the organization's services, and the media may all have reactions and opinions when the chief executive's salary is discussed publicly. Board members should anticipate these reactions and be prepared to respond; otherwise, controversy over executive compensation can make it difficult for the organization to operate effectively.

- **Understand that a compensation package includes more than money.** In addition to base salary, many nonprofit organizations offer their chief executives fringe benefits, such as: health insurance; retirement plan; life, accident, and disability insurance; professional dues; severance pay. Less common perks include: incentive plans car allowance; entertainment expense accounts; tuition assistance; social club memberships.

Reprinted from "The Nonprofit Board's Guide to Chief Executive Compensation," *which is available for $13 (plus shipping) from the National Center for Nonprofit Boards, 2000 L Street NW, Suite 510, Washington, DC 20036. Telephone (202) 452-6262 or (800) 883-6262.*