Case 9: Using Comparables to Set the Executive Director's Compensation

I. Context

One of the board's critical functions is setting the executive director's compensation. That compensation must be reported on the agency's annual Form 990, which is filed with the IRS and available for free download courtesy of GuideStar at http://www.guidestar.org. Whenever a nonprofit runs into trouble, one of the first pieces of information the media examines is the executive director's compensation. State regulators and the IRS are both concerned with and have authority to address excessive compensation. Although setting compensation has clear repercussions for the board, the executive director also should want a defendable and objective process. Under the federal tax law, the IRS can force the executive director to return any excessive compensation to his employer, plus pay a 25% penalty to the IRS.

This case study examines how the board of a CAA might use data taken from the annual Forms 990 filed by other CAAs. The CAA and the board members in this case study are fictitious, but the salary data for the other CAAs was taken from the tax returns for existing agencies all located in the same state.

A. Other Options

Examining Form 990 data is just one available option for developing comparables. CAAs also can utilize the Economic Research Institute's Nonprofit Comparables Assessor, which is based on Form 990 data. For more information about this subscription service, go to http://www.erieri.com. GuideStar is a nonprofit corporation that maintains a database of Form 990s. They also have fee-based services for mining their databases for compensation comparables. For more information, go to http://www.guidestar.com. CAA's also can retain a compensation consultant such as Mercer Consulting or Hewitt Associates, or work with an accounting firm that has experience in developing compensation comparables.

B. Cautionary Note

While this case study uses actual Form 990 data, the sampled data should not be relied on by any agency. Each agency must examine each sampled organization to determine whether comparisons are appropriate. Moreover, the facts about each agency in the sample have been made up. This case study illustrates how a CAA might use Form 990 to assess whether the salary paid to its executive director or other highly compensated employees is reasonable.

C. Form 990 Limitations

The Form 990 has recently undergone a massive overhaul. The revised form first will be used for 2008 tax years. In the past, disclosures about positions other than the executive director had been hit or miss. Consequently, users often found it difficult to find information about each highly-compensated employee. Compounding the problem, position descriptions do not always reflect what functions are performed by the person holding the position. That said, Form 990 data often is the only relevant information that is readily available. The quality of this information should improve as organizations begin to use the redesigned Form 990 in 2008.

In reviewing Form 990 data, it is preferable to focus on agencies that the analyst knows something about — often those in the same state.

II. Facts

Madison Community Action Agency (MCAA) is a recipient of CSBG funds, as well as other federal and state grants. It has been in existence for 30 years. MCAA sponsors Head Start, Weatherization, credit-counseling, adult literacy, fatherhood skills, and family outreach programs.

A. The Executive Director

Gloria Watson has been MCAA's executive director since January 1996. She holds a masters degree in public administration from Arcade College. She is a savvy operator, having expanded MCAA's annual budget from $650,000 to $9 million. Watson earned $65,000 last year. She recently received an offer from a large bank to head its community reinvestment program. She is tempted, given the fact that the salary and benefits for the new position would be $135,000.

The board has been extremely pleased with Watson and does not want to lose her. It has asked its compensation committee to develop a pay package that would cause Watson to reject the bank's offer.

B. The Compensation Committee

The compensation committee is comprised of the following board members:

Larry Gilroy — Mayor's Office for Community Development

Melanie Rigga — Well-known community activist

Melba Jones, Attorney — general practitioner (handles minor personal injury cases, residential real estate closings, and simple divorces)

Freda Feldman — Parent of a Head Start student. Works at a local dry cleaners

Chairman of the Board Victor Gasque — Local office staff member for Congresswoman Betsy Rago

Harvey Mellon — Vice-president of Community Affairs, Carbonside Electric Power.

C. The Meeting

Victor Gasque: As you know, we have a limited amount of time to come up with a competing offer if we are going to keep Gloria on board. Of course, I am assuming that we want to keep her, but given the remarkable job she has done for us, I don't know why we wouldn't. Has everyone had a chance to review the data that we assembled?

Freda Feldman: I agree. Gloria is top notch. She has really brought in some terrific Head Start teachers and she knows how to motivate them. But I have to say, we have limited resources. I just can't see nearly tripling her salary. I seem to live pretty well on $38,000 a year.

Harvey Mellon: Freda, I am concerned about your reference to your own salary. MCAA may be a nonprofit, but we have to compete with for-profits for leaders and administrators. In my estimation, there is too much emphasis placed on keeping administrative costs down so that funds are used to serve our clients. I am all for keeping these costs low, but at the end of the day a good administrator furthers mission.

Freda Feldman: I understand that we may have to pay Gloria more, but I think anything more than $80,000 can't be justified. There are other people who can do Gloria's job for a lot less.

Melba Jones: I tend to agree with Freda. We should take great satisfaction in knowing that our organization was instrumental in developing Gloria's skills, but we have to be realistic. As people become more skilled, other opportunities present themselves and we just are not going to be able to match the compensation that comes with those opportunities.

Victor Gasque: OK, I think we are putting the cart before the horse. We are all in agreement that we would like to keep Gloria if possible and we recognize that we are going to have to pay more money to do that. I asked Larry to assemble some information about other CAAs in the state so we can see if we are even in the ballpark.

Freda Feldman: Before the meeting, I reviewed the data that Larry included in the board packet. I have some trouble with your basic premise of relying on this data.

Victor Gasque: How so?

Freda Feldman: Well, for starters, we are in a state that has agencies evenly split between urban and rural communities. We are in an urban area. Is it even appropriate to be looking at statistics for agencies located in rural areas? I also note that some of the agencies don't have anywhere near the number of programs that MCAA has.

Victor Gasque: Those are legitimate points, but I think we easily can weed out the rural agencies if you think that is appropriate. We know most of the agencies on Larry's list. As for agencies with fewer programs than us, I would think, all other things being equal, that the salaries of their executive directors should be lower—so they provide a floor. Larry, please take a few minutes to summarize your findings.

Larry Gilroy: As you can see, I obtained data for 23 agencies. When I constructed a scatter diagram to examine the correlation between the executive director's compensation and the agency's total support, I found a fairly positive correlation.   I also looked at the correlation between an agency's net assets and its executive director's compensation. I did not find a meaningful relationship.

As you know, MCAA receives about $9 million in annual support. As for the urban/rural distinction, we should keep that in mind, but the vast majority of agencies that receive support in excess of $5 million are located in urban areas.

The executive director of the Williams Agency topped the compensation list, earning $161,543 annually. Yes, that agency had $23.1 million in total support, but the executive director's salary still makes her an outlier. The next highest salary was paid by Borsman Community Action—its executive director received $141,978. Borsman receives $21.755 million in public support.

Obviously those agencies pay compensation that is competitive with the bank's offer to Gloria, but both agencies are twice the size of Madison in terms of total support.

Now take a look at the Jackson Action Agency. It tops the list in total support, at close to $28.5 million, but its executive director is paid just $110,000 per year. Larken and Kirkland also have significant levels of support, but their executive directors earn $99,000 and $117,000 per year, respectively. Based on those numbers, one could argue that the executive directors at the Williams and Borsman agencies are overpaid, although there may be justifying factors for the higher compensation.

The agency that comes closest to MCAA is Flattenbrook Action. It receives about $10 million in support. The executive director is paid somewhere around $62,000 per year.

Melanie Rigga: Larry, I will let you continue, but I know about Flattenbrook Action. Their executive director is relatively new. I knew the prior executive director. She'd been there about 20 years and was making somewhere around $90,000 a year.

Freda Feldman: Larry if I could interject. Take a look at Newburg Community Action. Their ED makes $36,731. They have $10 million in support. How can we justify paying Gloria anywhere close to $135,000 a year given that fact.

Larry Gilroy: I am glad everyone is taking a close look at the data. Freda, I am not so sure that the ED at Newburg Community Action is actually the person in charge. They have a CFO who is making over $95,000 a year.

In any event, let me summarize the data as I see it. In all honesty, I don't think we can justify matching the $135,000 offer. We've been looking at comparables and I suspect that we could justify $75,000 or $85,000—and that is a push.

I should note that Neville Social Services pays its executive director about $70,000 a year and it only receives $7.9 million in total annual support. I called the executive director at Neville to get a sense of what sort of services they provide. It turns out that their programs are quite similar to ours. Additionally, they have the same number of employees as we do. Those facts would support raising Gloria's salary to somewhere over $70,000 per year. But at the end of the day, I just don't think we can go much above $75,000 or $80,000 per year.

I should also note that we have to look beyond just the comparables. Let's not forget our budget. We were hard-pressed this past year to arrive at a balanced budget. And as you all know, there is a good chance that some of our funding may be cut next year. Our state AXA program[1] grant will likely be eliminated given the impasse between the governor and the legislature. In any event, I don't think any of us want to cut the services being funded with those dollars.

Harvey Mellon: Larry you bring up a good point about the budget. I am a firm believer in keep-

1 This is a fictitious grant program.

ing it in balance. I know that the board is not going to cut the AXA program services. As much as it pains me, I think we are going to lose Gloria. We can't go over $75,000. There is no way that we are going to keep her.

Victor Gasque: What I am hearing from everyone is that we should inform the board that we simply can't match the offer, or even come close. The level of compensation that MCAA would have to pay Gloria to be competitive with the bank's offer can't be justified given the size of our agency.

Larry, this has been very helpful. I suspect that the committee will meet again to discuss the compensation package that we will be offering to what is likely to be our new executive director. Whatever you do, don't throw the data you have gathered out. In fact, if you could refine the data, I think the committee would be very appreciative. See if you can isolate the urban agencies. Also, see if you can find out the tenure for each executive director.

III. Discussion Questions

The following questions are offered for discussion:

A. Should a compensation committee or the board look to Form 990 compensation data for comparable organizations when setting the executive director's compensation?

B. Are there other sources for obtaining comparables for purposes of setting the executive director's compensation?

C. In examining compensation data for other organizations for purposes of setting the executive director's compensation, what factors should the compensation committee or board use to assess whether other organizations are comparable to the agency?

1. Urban/ rural?

2. Asset size?

3. Gross revenue?

4. Number of programs?

5. Number of agency employees?

6. Executive director's fundraising responsibilities?

7. Executive director's tenure?

8. Executive director's experience?

9. Alternative employment opportunities?

10. The agency's prior history (e.g., in serious trouble with regulators, which has resulted in the

decision to hire a new executive director)?

11. Executive director's performance, as reflected in agency growth and tangible achievements related to mission?

D. Should MCAA even try to match the bank's $135,000 offer?

E. Should people who work for nonprofits be expected to accept a lower salary than their for-profit counterparts? Is there a different answer if the person in question is an administrative assistant or a bookkeeper rather than the agency's executive director or CFO?

F. How has your agency dealt with the problem of competing offers or opportunities that carry significantly higher compensation?

G. Should Larry Gilroy have called the executive director at Neville Social Services?

IV. One Suggested Solution

A. Overview

As should be apparent, the compensation data from the Form 990 is only as good as the thought and judgment that goes into analyzing it. As a practical matter, the board (or compensation committee) should probably begin by obtaining Form 990 data for CAAs in the same state. Presumably the board or employees of the CAA know something about other CAAs in the same state. That knowledge will prove helpful.

B. One Starting Point

1. Relevant Form 990 Data

For tax years beginning in 2008, each CAA will report compensation for each director, officer, key employee, and highest-paid employee in Part VII of the Core Form 990. A highest-paid employee is one who receives reportable compensation that exceeds $100,000, but only if the individual is one of the top five highest paid employees. If anyone required to be listed in Part VII receives over $150,000 in reportable compensation, then Schedule J must be completed (Part I for all insiders and Part II for just the individuals who exceed the $150,000 threshold). Each agency will report its net assets on Line 22 of Part I of the Core Form 990.

2. Sorting the Data Points

The compensation/net assets for each agency should then be sorted in ascending order based on compensation. This is the approach that is reflected in the schedule accompanying this case study. The agency's own net assets should then be compared to the data in the schedule. This will provide a base or starting point for the analysis. There are lots of reasons why the executive director's total compensation might or should be significantly higher or lower than the base point.

a) Program Complexity

The analyst should consider the number of programs run by each agency. The analyst will want to look at Part I, Line 1 and Part II of the Core Form 990 to assess the types and size of major programs, together with any Web site maintained by the CAAs. Line J of the Signature Block on the first page of the Core Form lists the organization's Web site. In many cases, the analyst will be familiar with the CAAs and their programs. All other things being equal, an executive director for a CAA with two programs should probably make less than an executive director who heads a CAA with 15 programs. That is particularly true if the agency with 15 programs has significantly more grant revenue, employees, and/or clients.

b) Urban/Rural Distinction

The analyst should distinguish between entities that operate in rural and urban areas. If the agency in question operates in an urban environment, that could mean simply disregarding all the data from those agencies in rural areas. The better approach would be to ascertain whether there is a relatively fixed differential between the compensation paid by urban and rural agencies.

c) Executive Director's Experience

The Form 990 is unlikely to provide any information regarding executive director job longevity, experience, or educational background. This is meaningful information, so the analyst might have to survey people within her own agency to ascertain levels of executive director experience and training for other agencies.

d) Alternative Employment Opportunities
Somebody should be keeping track of job offers that the agency's executive director has received. This information will likely be available on an ad hoc basis. Some executive directors will not say anything about offers they receive. Others may make offers known for the very purpose of influencing compensation.

e) Performance
If the executive director was hired to fix an agency with serious problems and she has been highly successful, that information should be taken into account. On the other hand, if an executive director is paid a certain amount and it is known that his agency is looking for a new executive director, the analyst might conclude that his salary should be discounted from comparable salaries.

C. Report

All the data should be assembled and analyzed in a written report to be provided to the board or its compensation committee. As should be apparent, this is a subjective process. At the end of the day, the report should provide a defensible analysis of why a particular level of compensation for the executive director is appropriate. The report should be more systematic than the discussion that took place in the MCAA board meeting, but it should reflect the issues and concerns discussed during that meeting.

D. Other Alternatives

If properly collected and analyzed, the data taken from Forms 990 for other CAAs could provide useful comparables for setting executive director compensation. Boards, however, are not limited to using Form 990 data. In fact, if a board is unable to obtain sufficient information regarding subjective factors, it should approach raw compensation information taken from Form 990s with skepticism. A board may prefer to hire an outside compensation consultant, review data from one of several services that compile compensation data, or obtain comparables for private sector positions with similar duties and responsibilities. In all likelihood a combination of these approaches is advisable even when the Form 990 data proves to be relevant. In sum, the Form 990 data is only a starting point.

E. Why Comparables Are Important — The Intermediate Sanctions

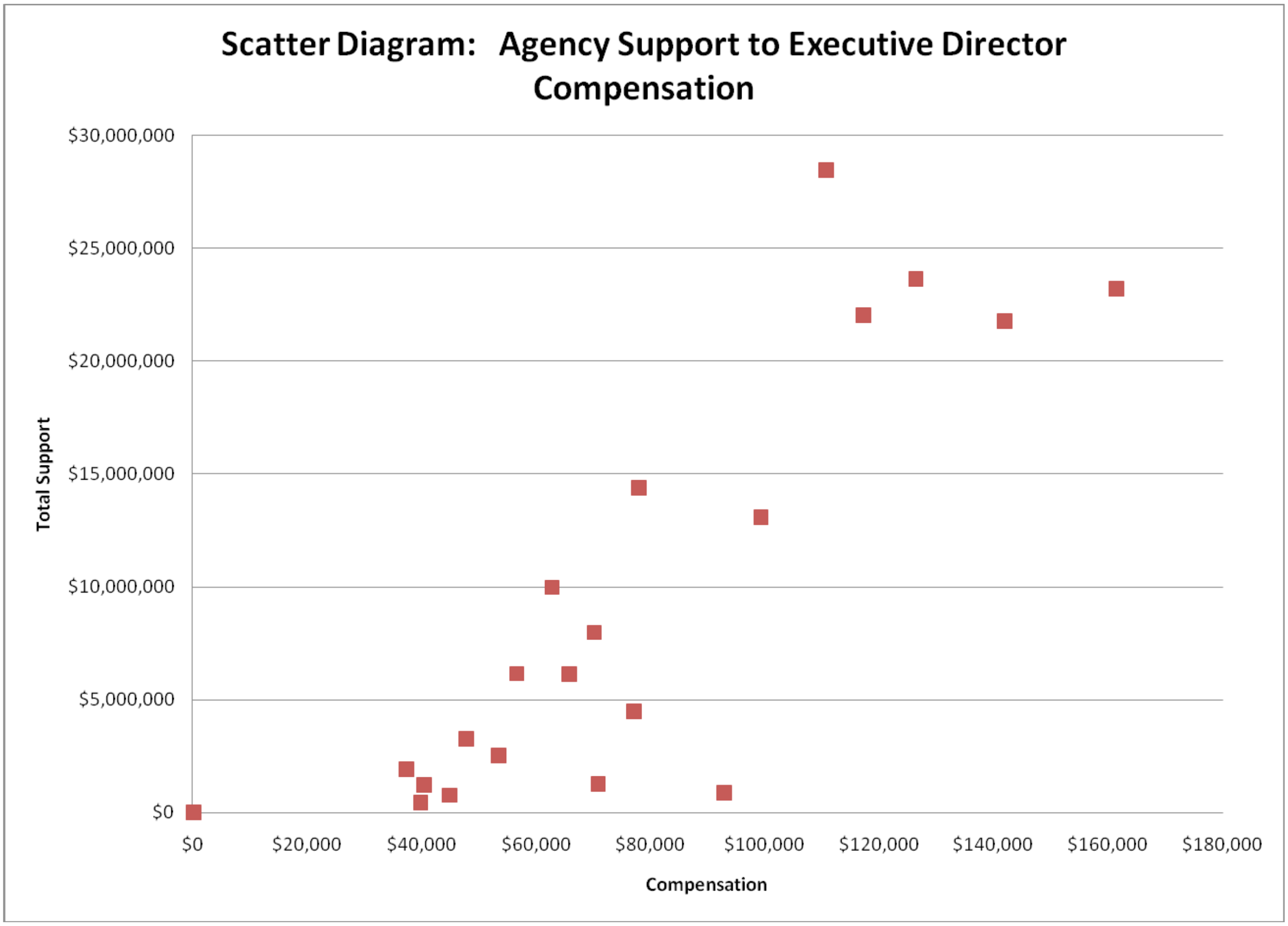
The intermediate sanctions are a comprehensive set of tax rules designed to assure that compensation paid to key employees and other insiders reflects market-rate compensation. If the IRS determines that the compensation is excessive, it can force the recipient to return the excess to the exempt organization and assess an excise tax equal to 25% of the excess on the recipient. The centerpiece of this regime is a rebuttable presumption that compensation is reasonable if certain procedures are adhered to when setting the compensation. Specifically, the organization must demonstrate that (i) the compensation arrangement was approved in advance by the board of directors (or a committee thereof); (ii) such board (or committee) was comprised entirely of individuals who did not have conflicts of interest; (iii) such board (or committee) obtained in advance and relied on appropriate data as to comparability of the compensation arrangement; and (iv) such board (or committee) adequately documented the basis for its determination concurrently with the decision. The rules contemplate otherwise conflicted individuals recusing themselves from the process.

As you can see, compensation comparables play a central role in assuring that the rebuttable presumption is available. This is why developing a solid and defendable set of comparables is so important. It is also important because under federal and CSBG grant requirements, compensation must also be reasonable. Consequently, the use of compensation comparables also is important to support reimbursement requests.

V. Background Material

For additional commentary, review Section I (Setting Compensation) and Section II (Incentive Compensation) of the Background Material accompanying the case studies.

Agency Name	Executive Director Salary	Total Support
Agency 1	$29,049	$543,198
Newburg Community Action	$36,731	$10,089,830
Agency 2	$37,469	$1,915,859
Agency 3	$39,900	$454,914
Agency 4	$40,516	$1,223,372
Agency 5	$45,000	$776,740
Agency 6	$47,905	$3,251,249
Agency 7	$53,503	$2,533,594
Agency 8	$56,695	$6,142,480
Flattenbrook Agency	$62,883	$9,977,476
Litscomb CAA	$65,832	$6,124,899
Neville Social Services	$70,255	$7,977,990
Big Community Services	$70,953	$1,261,389
Cannon Community Assistance	$77,217	$4,474,914
Tonks Action Agency	$77,998	$14,373,215
Lucas Community Action	$92,927	$874,498
Kirkland Community Services	$99,347	$13,084,644
Jackson Action Agency	$110,776	$28,443,337
Larken Community Action	$117,262	$22,002,319
Hedwig Agency	$126,431	$23,613,264
Borsman Agency	$141,978	$21,755,663
Williams Agency	$161,543	$23,193,741


Scatter Diagram: Agency Support to Executive Director Compensation
Total Support
$30,000,000
$25,000,000
$20,000,000
$15,000,000
$10,000,000
$5,000,000
$0
$0
$20,000
$40,000
$60,000
$80,000
$100,000
$120,000
$140,000
$160,000
$180,000
Compensation