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SCRUTINIZING NFP EXECUTIVE COMPENSATION

Upper Saddle River, NJ - January 22, 2008 - Last Spring, the Exempt Organizations Office of the IRS' Tax Exempt and Government Entities Division released a report covering the results of its latest examination of Executive Compensation issues within the Not-For-Profit (NFP) sector. The results, covering an examination of Form 990s from over 1,200 organizations, found some significant issues requiring action or additional scrutiny. The significance of this study highlights the need for NFP Boards to closely examine compensation levels of their key executives.

Since many NFP fiscal years begin on July 1, and with the budgeting process soon to be underway for next year, now is a good time to begin examining your executive compensation programs in light of the IRS' increased scrutiny. There are several realities that must be recognized when seeking to evaluate competitive compensation levels for NFP executives:

- It is unrealistic to believe that Boards of any NFPs are going to purposely hire the cheapest candidate, rather than to seek out the most qualified.
- The desire to retain key individuals justifies paying at least competitive compensation levels.
- The Total Compensation Package (TCP) for NFP executives increasingly includes the use of variable pay tied to the achievement of specific financial and/or operational objectives that serve to further the organization's mission and effectiveness.
- Many NFP Boards now comprise members with broad business experience, including that in the For-Profit world, who can provide insights into the competitive market and the importance of recruiting qualified talent.

The government's concern about executive compensation at NFPs is due in part to the strongly held belief by many that the funds of NFPs should only be used to further their missions. Since the economic concept of "supply and demand" has a marked influence on the setting of competitive pay levels, there is a strong likelihood that more qualified applicants for the position will by their nature demand higher levels of compensation. Imbedded within the Intermediate Sanctions provisions (IRS § 4958) is the recognition that, in addition to the use of data from other NFPs, they can determine market levels by looking at comparable For-Profits. To this end, NFPs are in essence given permission to examine themselves like For-Profit "businesses", and therefore, evaluating pay levels like a business makes sense.

What steps, then, can an NFP Board take to ensure that compensation levels are set correctly for their executives? In light of the increased scrutiny by both the IRS, as well as by state agencies, we believe that NFP Boards and their Compensation Committees should take five (5) steps. Three (3) of these items are covered by the requirements for Rebuttable Presumptions of the IRS code. These are:

1. Establish a separate Compensation Committee that consists of Independent Board members. The charter of this Committee would cover its responsibilities and authority for determination of executive compensation.



2. Adopt a Compensation Philosophy that will serve as the baseline for establishing the pay program. This will provide the justification for selecting the pay program components, peers for comparison purposes, and procedures for use by the Independent Directors.
3. Document all aspects of the compensation decision-making process. This includes the Compensation Philosophy, key aspects of the organization's pay strategy, minutes of Committee meetings, documentation of both the compensation plan components and procedures, and clarification of performance expectations.
4. Rely on credible external compensation advice and comparative peer data.
5. Recognize that the organization is a business, and therefore, implement an executive compensation program that will assist in meeting the organization's goals of attracting qualified talent, retaining the best employees, motivating them to perform at the highest level, and focus them on the desired objectives that best serve its mission. All of this must be accomplished within the framework of regulatory restrictions covering NFPs and the organization's financial constraints.

The results of the IRS' report highlight the need for NFP Boards to take a hard look at their organizations' executive compensation programs, and make the necessary changes, as appropriate. Undertaking a systematic evaluation process by using the five (5) steps detailed above will provide a sound framework under which to make any necessary changes in a proactive, preventative manner.

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