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Setting CEO Pay Must be Done With Care to Avoid Donors' Wrath

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As the economy begins to recover, nonprofits are increasingly re-examining salaries that were frozen during the economic downturn. In recent weeks, both Grant Thornton, an auditing and consulting firm, and Professionals for Nonprofits, a personnel staffing company in New York and Washington, have found that a majority of nonprofits are preparing to increase compensation, if often modestly.

While it may make sense to increase the pay for rank-and-file workers, it is clear that increases in executive compensation will be more controversial. Among the signs: Under its new governor, New Jersey has limited salaries for chief executive of human-service groups that receive state money to $141,000, regardless of the size of the organization. And the Massachusetts attorney general is investigating an $8.6-million payout to the CEO of the state's nonprofit Blue Cross Blue Shield when he was forced out a year ago.

Beyond this, much attention by the news media has fallen on the heads of major hospitals, arts organizations, and universities. It isn't surprising that a *Forbes* magazine article talked about "nonprofit millionaires" and "saintly salaries" or that a *Charlotte Observer* headline commented, "For too many nonprofits, charity starts at the top."

One of the reasons nonprofit-executive compensation has been rising is that some boards see the executive director's role as comparable to that of corporate chief executive officers.

However, nonprofits and corporations operate in different worlds, with different goals and cultures. The business world is about making money, and the ethos calls for giving a healthy share of profits to those who produce it. The corporate CEO is generally considered to be the primary generator of profits.

Profit making, however, is not the mission of a nonprofit organization, and no part of any nonprofit's mission is to generate profits that can be distributed to key executives.

If nonprofits want to head off new government regulation and avoid angry calls from dismayed donors, their boards might want to consider engaging in a systematic review of executive compensation.

Setting pay is one of the key duties of a nonprofit board, and trustees must do so in a manner that balances the reward the CEO may be seeking with an institutional sense that the CEO is being fairly, but not unreasonably, paid.

Many nonprofits rely on committees to do the initial review of executive pay. Still, the burden of understanding and approving executive compensation is the responsibility of the full board and every director.

Following are guidelines and questions nonprofit boards should answer:

Compensation should be based on the CEO's and the organization's performance. To do this well, performance goals or targets are typically negotiated with the CEO at the beginning of the organization's fiscal year and evaluated at the end of the year.

Were ambitious goals set, such as a sharp increase in fund-raising revenues or significant improvement in program success, or was the status quo deemed acceptable? How well did the CEO diagnose changing conditions and lead the organization to adapt?

Conduct a review of peer organizations. The Internal Revenue Service says one reason to determine whether CEO pay is acceptable is to look at how similar organizations pay their leaders. But it should not be the case that a nonprofit sets compensation just to match the pay of other nonprofit leaders.

Instead, nonprofits need to understand the criteria used to arrive at the compensation awarded at peer institutions. Is the scope of leadership responsibilities comparable? Is the nature of mission and of financial challenges similar? Was performance a factor, especially progress in meeting defined goals or challenges?

Determine the state of the organization's financial condition. Is its budget in balance or deficit? What is the financial outlook for the next several years? What is the trend in fund raising? Did the CEO preside over the development of these conditions, or was the CEO recruited to alter them?

Focus on salary equity. Figure out how the CEO's pay compares to other people who work at all ranks of the organization. We have seen many nonprofits in which the CEO is well paid, but almost no one else is. Has the gap between the CEO and others grown over time?

Avoid setting pay as a way to convey status and prestige for the organization. The aim of compensation is to retain the talent the institution needs to operate successfully, not gain perceived prestige based on the level of compensation awarded.

Make sure that compensation consultants are hired by the board, not the staff. Does the consultant do other work for the institution that may cause a bias toward recommending what the CEO wants to hear? Does the consultant have a reputation for recommending high compensation packages?

Don't be insensitive to the setting for these decisions. Executive compensation is under fire in government and corporations as well as nonprofits. With public expenditures across the country in decline, many nonprofits are still in tough times, especially those that depend on government contracts and grants. And unemployment remains high.

Make the entire process transparent. Explain to the nonprofit's many constituents, including donors, staff members, and others, how pay decisions were made.

It will be the combination of openness and a well-documented decision that offers the best chance of gaining support from everybody who cares about a nonprofit's operations.

Fully document compensation decisions in writing, Describe the terms of the compensation approved, the information relied on in making the decision and the reasoning behind the decision, the names of the board members who were present during the discussions of compensation, and who voted for it.

Report pay data properly to the IRS. The informational tax form nonprofits file, known as Form 990, has been revised to provide more information about the compensation of highly paid employees and the process by which such compensation is determined.

These guidelines for nonprofit boards of directors will go a long way toward satisfying the IRS and others that compensation is reasonable.

Beyond that, a well-conceived process for setting CEO compensation sets an important tone throughout a nonprofit organization for the challenging financial and other decisions that must be made in this turbulent era.

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