Video Transcript: Non-Profit Executive Compensation Part 2: Legal Requirements and Documentation

Dan: Welcome back to Executive Insights. I'm Dan Daly. We're meeting again with Jim Hudner, a partner in the executive compensation firm, Pearl Meyer, here in Boston. Jim and I have been discussing a much-needed topic. That is "Executive Compensation in Non-Profit Institutions." Jim, welcome back. Let's continue.

In our first session, you talked a lot about the importance of paying the CEO and Executive Director, and then you walked us through how you develop comparable pay references from your peers. I think that's all good. Jim, the only problem is, that's a lot of work. I'd like to sit around with four of my friends and say, "You know, Betty would be a great CEO. Let's pay her $150." Jim, why can't I do that? Make my life simple, will you, Jim?

Jim Hudner: I wish I could, Dan. That's probably not a good idea.

Dan: Why isn't it a good idea?

Jim: The reason it's not a good idea is the first of which, it's a not-for-profit organization.

Dan: Which we all know the word, what's it mean, Jim?

Jim: Well, it's designated as such by the IRS. Most not-for-profits, not all…

Dan: It's a 501(c)(3) in most cases.

Jim: 501(c)(3).

Dan: Yep.

Jim: The result of which is an expectation on the IRS's standpoint that the organization is there to serve the public good.

Dan: Otherwise, you're going to pay taxes.

Jim: Otherwise, you're going to pay taxes.

Dan: I have seen, not often, I've seen the IRS pull 501(c)(3) designators because they really weren't being run effectively for the public good.

Jim: Right. It doesn't happen very often, but ...

Dan: It does. The IRS is a consideration, yes?

Jim: Just another point about the IRS is the IRS is also the regulatory body that oversees compensation and would determine and has oversight over whether or not it would determine it's reasonable. There are implications associated with making sure the executive compensation is appropriate.

Dan: The formula you talked about in our first session, I commented was defendable, it has to be defendable to the IRS, in the first place.

Jim: Right. Basically, it's a common sense rule. The IRS basically indicates three things. It says that the process by which executive compensation is set has to be done by independent, non-conflicted board members. It has to rely upon comparability data, which we talked about.

Dan: Yes.

Jim: Lastly, when the board makes decisions, it has to document the rationale as to why it makes decisions.

Dan: I don't want to do a total sales pitch for Pearl Meyer, they're good friends, but when you get to a certain size, and let's say it's several million dollars of revenue and a complex income statement and you're setting this, you perhaps should make an investment in Pearl Meyer. You don't have to do it every year, but if we're going to defend the compensation structure, it wouldn't be bad to invest a dollar or two in Pearl Meyer, I wouldn't think.

Jim: It'd be hard for me to say, "No."

Dan: I understand that. That was an easy one. I really feel that way because I think you can really get yourself and your organization in trouble if you can't defend. Who knows when the IRS is going to come knocking?

Jim: Right. I think that the reality is, Pearl Meyer or any institution that's capable of doing this, it would be important to do at least every three years, just to be able to make sure that it's grounded and the board has a good sound process that it follows.

Dan: Who else should I worry about besides the IRS, when I'm talking about compensation?

Jim: If you're a not-for-profit, you're also then receiving private donations.

Dan: From individuals?

Jim: From individuals, fulfilling contractual requirements with federal government, so the result of which is, those parties are going to be pretty interested in how many is being expended within your organization including executive compensation.

Dan: How will they know?

Jim: How will they know? They'll know through the federally submitted documents, Form 990s, which are filed with the IRS. They are tax documents. In those tax documents, there are disclosures that are made about pay levels.

Dan: If I have a government contract for services of $1,000,000, there may very well be someone in that government agency that looks at the 990 or their reporting requirement will ask it specifically. It's in the 990, but the government agency may say, "What are you paying your top three executives?"

Jim: Right.

Dan: It doesn't have to be the 990.

Jim: It does not have to be the 990.

Dan: It may be in the compliance for that regulatory agency.

Jim: Right.

Dan: Then, you're talking about…Let's say you're getting money from a wealthy philanthropist. They may have an attorney that pulls the 990 before that check goes out to you for half a million dollars. The attorney may pull the 990 and say to the check writer, "Here's how they're spending your money. Are you comfortable with that?"

Jim: Exactly.

Dan: Could that happen?

Jim: Sure it could happen, sure.

Dan: It would probably be an attorney or advisor to that philanthropist.

Jim: Right.

Dan: Got to defend it with the IRS. A government contractor may ask for it in their compliance form, and the philanthropist may very well say, "How are you spending my money?"

Jim: Right.

Dan: Three very good reasons why you have a compensation committee that goes through a defendable, professional method of assigning or awarding that. Compensation has to be defendable.

Jim: Absolutely.

Dan: Got a couple of minutes left, Jim. I serve on several non-profit boards. We talk and have considered—this is the for-profit word—pay for performance. What is happening in non-profits with the top one or two, but the CEO and the Executive Director in terms of "pay-for-performance." Tell me a little bit about that, how it might be done, what it might be based on, and perhaps some of the dangers. I'm seeing a trend. Are you seeing any trend along those lines in bigger non-profits?

Jim: Certainly in bigger non-profits, you're seeing more utilization of either bonuses or some form of incentives. I think that if a not-for-profit organization's considering something, the first step that they need to go through is, we talked about comparables.

Dan: Yes.

Jim: Refer to the comparables, identify the extent to which those kinds of vehicles—bonuses or incentives—are being used.

Dan: Are being used by the comparables?

Jim: Right.

Dan: If they're not, that doesn't say you don't use them, but just realize they're not being used by the comparables.

Jim: Exactly. Then, not only whether they're being used or not, if they are being used, what kinds of amounts are being paid out in those. At least, there's some sort of external frame of reference.

Dan: I'm interrupting you. How is the compensation being paid? Is it cash today or is it deferred two or three times? It can't be stock, because there is no stock.

Jim: Right.

Dan: You want to look around your comps and your peers, are they doing it, one. What is the amount and how are they doing it?

Jim: The "how they are doing it" usually falls into one or two camps. On one, it's discretionary in nature. You actually see a lot of that with the not-for-profits. By that I mean, there's no real formal plan. It's the board exercising its judgment and providing a bonus or an incentive or an award for some extraordinary accomplishment. There's no expectation at the end of each year that an executive is actually going to get something. There's pros and cons to that kind of approach, but that is an approach that is sometimes used.

Dan: It's not…I'm hearing there, a motivational bonus, which is always there and almost guaranteed, isn't a motivational bonus.

Jim: Right.

Dan: There ought to be some review and arbitrary decision being made. Fine.

Jim: Your other obviously, where what you see more in the for-profit sector and starting to be a little bit more in the not-for-profit, is the use of actual incentive orientations, which is basically based upon pre-defined measures. There's pre-defined goals.

Dan: That's what I'm more comfortable with. Continue down that road for a minute, if you would. Redefine measurements.

Jim: Predefined measures. Obviously with the not-for-profit, there's some issues with being careful about what it is that you're using for measures. Financial metrics are fine, but they have to be carefully used. You certainly aren't going to be looking to define surplus as being a…

Dan: Or skimping on a government contract. That's right.

Jim: It's oftentimes what you'll see is, there may be a financial metric, but there may also be some operational metrics. There, honestly, are often more qualitative goals that are established. The launch of a new program, the construction of a new building, whatever the case may be.

Dan: Or, a significant hire, a new CFO, or a new head of development, or a successful capital campaign, perhaps not measured solely on financial gain.

Jim: Exactly. Correct.

Dan: There's some common sense. Avoid financial gain so that you're not saddled with a, "Well, they did it just for the money."

Jim: Exactly.

Dan: We build a new building. It came in on budget. It came in on time. That's good. That deserves a bonus. I hired a wonderful new Senior Vice President of Development or a new CFO. Avoid something that would appeal necessarily to the shareholders in the public company. Again, defendable.

Jim: Right.

Dan: You started off by talking, "Well, we usually give Betty a bonus. We've done it the last ten years." That really is part of base compensation. That's not entirely motivational.

Jim: Exactly.

Dan: I'm with you that it should be out there as a "maybe" and based on some defendable criteria and probably those criteria, Jim, am I correct, should be written down somewhere.

Jim: Clearly.

Dan: Maybe it's in the annual review or something.

Jim: Yeah. They clearly need to be written down. They need to be agreed to. The board has to approve what they are, particularly for the CEO or the Executive Director, for sure.

Dan: "Jim, you do a great job. We'll give you a 10% bonus." That ain't going to cut it.

Jim: It shouldn't. It really shouldn't.

Dan: All right. "We did your annual review. We're talking about the next year. Jim, we're going to give you a 0 to 10% bonus based on the following criteria that were written down here. Are you comfortable with the methodology in what we're doing?" You're verbally signing off on it and perhaps physically signing off. That is part of the records of the compensation committee.

Jim: Exactly.

Dan: Defendable.

Jim:	Defendable and I think in any instance, when an organization goes into this for the first time, it's really important to phase it in. In other words, you mentioned 0 to 10, as an example, right?
Dan:	Right.
Jim:	You want to be as probably modest with the award amounts at the beginning and then, if you decide to grow them over time, that makes sense. Any time you go into a program for-profit or not-for-profit, there's always going to be bumps in the road the first time around about what the measures are and so forth.
Dan:	The compensation committee should step back outside and look in and say, "What does the average person on the street, how do they view this?" Just as important, the IRS, yes, our funders, yes, but also the media.
Jim:	Correct.
Dan:	Also the media. I mean, they love it. This is a non-profit. The CEO Executive Director got a $75,000 bonus. When we're talking about pay-for-performance, it shouldn't be arbitrary. It should be based on some things that aren't necessarily just financial goals, because we are a non-profit. It should be spelled out beforehand. It should be agreed upon and documented in discussions or review with the CEO. It should be part of the permanent record.
Jim:	Exactly.
Dan:	You say, I think, with very good advice, "Start out slowly. See how it works and then you can tweak it and do it. Don't start out with some compensation pay-for-performance program that you got out of IBM. It doesn't work." Non-profit, we're seeing a trend. Jim, in our two sessions, really what I've heard here is there is value to doing your research and your homework to come up with a better comp plan, whether it's base or whether it's pay-for-performance, and being able to defend that to a whole host of individuals. The IRS, your philanthropic supporters, your contractors, and, regretfully, in most cases, the public and the media.
Jim:	Exactly.
Dan:	Well worthwhile putting in the time. It's no longer four of us in a room, winging it. It's got to be much more professional. I think that's a good thing and it's also a trend.
Jim:	It clearly it. It clearly is.

Dan: Good. Jim, thank you so much. Jim Hudner, Pearl Meyer, Executive Compensation Specialist, here in Boston. Jim, thanks so much. Very good insight. I think our viewers will enjoy it. Thank you.

Jim: Thanks, Dan.