THERE'S A REPORTER ON THE PHONE ASKING ABOUT THE CEO'S PAY! WHAT DO WE DO?

PREVENTING A PR NIGHTMARE

By Mike Batts, CPA

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It's hard to imagine which would be worse for a nonprofit organization – a half-baked newspaper article improperly accusing the organization of paying its CEO too much, or one of the organization's board members being quoted in the article saying, "Wow, that's the first time I have heard he was being paid that much!" Sadly, such reports occur with some frequency, and the purveyors of such reports are no longer limited to traditional news outlets. Social media, and especially "blogs," are an increasingly significant source.

The manner in which a nonprofit organization handles compensation-setting for its leaders – especially its top leader – has a huge impact on the organization's preparedness for scrutiny in this sensitive area of operations.

And the reality is that, barring highly unusual circumstances, the actual amount of the leader's compensation is far less important than the process and documentation employed by the organization in determining it.

Imagine, for example, the different outcomes likely to occur in each of the following scenarios. Assume that in both scenarios, the organization is a disease research organization and the CEO's total compensation is $200,000 per year. The organization files Form 990 annually. A reporter has reviewed the organization's most recent Form 990, having downloaded it from the GuideStar website (where all 990s filed with the IRS are posted for public access).[1]

Scenario 1

The newspaper reporter calls the organization and asks for the person who handles questions related to the CEO's compensation. The receptionist forwards the call to the CEO. The reporter tells the CEO that she has performed research on the CEO's pay as compared to other nonprofits in the area and has determined that the CEO is paid much more than his counterparts in the area. The CEO becomes defensive and says, "We don't have any comment other than to say that the compensation of all our people is reasonable – we follow all laws." The reporter obtains a list of the organization's board members and contacts one of them. The board member expresses surprise at the amount of the CEO's pay as cited by the reporter and says, "I don't really have anything to do with that. Our executive committee handles the CEO's pay, and the chair of that committee (and the board) is Sue Ross." The reporter then contacts Sue Ross, who says the organization determined that the CEO has had strong performance for the last few years and deserves the significant raises he has received. Sue notes that the CEO has led the organization in several areas of innovation. When asked about why the CEO is paid so much more than other nonprofits in the area, Sue responds again with commentary on the CEO's excellent performance.

Scenario 2

The newspaper reporter calls the organization and asks for the person who handles questions related to the CEO's compensation. The receptionist forwards the call to the CEO. The reporter tells the CEO that she has performed research on the CEO's pay as compared to other nonprofits in the area and has determined that the CEO is paid much more than his counterparts in the area. The CEO cheerfully says, "We have a very robust executive compensation process, and it is headed up by Sue Ross, the chair of our board's compensation committee. Let me send you a copy of our executive compensation policy and I will ask Sue to give you a call." The reporter receives the policy, which states that the board has established an independent

[1] Source: http://www.guidestar.org/

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compensation committee made up entirely of board members with no conflicts of interest regarding the CEO's compensation. The policy requires the committee to commission a study at least every three years, comparing the CEO's compensation package with that of comparable organizations. The study is to be performed by an outside independent compensation expert. The committee is required to review the study and then recommend to the full board the CEO's compensation package in light of the study results. The full board must approve the CEO's compensation package on an annual basis. Sue calls the reporter and advises her that the organization has carefully followed the policy and the most recent compensation study was completed a year ago. Sue explains that, due to the nature of the organization's work in disease research, the organization requires that the CEO have a doctorate in a particular field of pathology. The CEO, a PhD, was hired from a teaching hospital and is actually compensated at a level that is lower than that suggested by the independent study performed for the organization. Sue finishes her commentary by noting that the CEO's compensation may differ from that of other organizations in the area, but the organization, its CEO, and the CEO's credentials are unique in the area. Sue provides the names of similar organizations elsewhere in the country, all of which compensate their CEO at levels comparable to or above that of the local CEO – a fact that can be verified by a review of their Forms 990.

While the CEO's compensation level may be the same in both scenarios described above, the outcomes would likely be very different. Preparedness for scrutiny should be a key element of a nonprofit board's diligence in the area of executive compensation-setting – especially if the top leader is highly compensated.

Scrutiny can come from a variety of sources – from the traditional news media, from bloggers, from tax authorities, or sometimes from an organization's own constituents. The ability to provide solid, well-developed responses to scrutiny can often determine whether the inquiring party will pursue the matter any further.

Our firm has assisted nonprofit organizations a number of times over the years in addressing inquiries from news reporters about executive compensation. In every case, where the organization was well-prepared and had robust systems in place, and where the organization responded positively and with confidence, the reporter's interest in the story quickly waned. It is important to communicate with confidence, making it clear that the organization has nothing to hide. Where there is no scandal, there is often no story.

For some organizations, risks related to executive compensation are low because executive compensation is well within the bounds of reasonableness in the eyes of any rational observer. For an organization where that is not true, however, the risk is greater, as is the need for a higher level of preparedness by the organization's board.

Additionally, for organizations like churches and church-affiliated organizations that do not file Form 990, information about the top leader's compensation may not be public. In such cases, the organization should still be prepared for inquiries about the leader's compensation. There may be no useful reason to disclose the amount of the compensation in such circumstances, but being able to describe a well-designed, robust, independent process for setting it could be very helpful.

Best Practices in Setting Executive Compensation

Best practices in setting compensation for an organization's top executive (referred to herein as "the CEO") include the following:

1. The compensation should be evaluated and established by the organization's board of directors (or equivalent) or a committee authorized by the board. The board or committee should be composed entirely of people who have no conflict of interest with respect to determining the CEO's compensation (e.g., no family members

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of the CEO, no subordinates of the CEO, no individuals whose compensation is determined by the CEO, etc.). [If such persons serve on the board and the board is the compensation-setting body, they should be excused from the CEO compensation-setting process.]

2. The board or committee should obtain valid comparability data reflecting what similar organizations pay similarly qualified people for performing similar duties. Comparability data may come from surveys (if readily available for comparable organizations), from Forms 990 of comparable organizations, or from other sources such as privately commissioned executive compensation studies.

3. The board or committee should contemporaneously document its decision about the CEO's compensation, including (if applicable) justification for approving compensation above that suggested by the comparability data.

4. The full board of directors (or equivalent) should be made aware of or should approve the CEO's total compensation package on an annual basis. [Churches and church-related organizations may follow church polity regarding the group or body charged with knowing and approving executive compensation.]

5. The organization should have a well-developed and clear communications plan for responding to inquiries about the compensation of its leadership.

On a technical note, federal tax regulations allow nonprofit organizations to establish a "rebuttable presumption" that an executive's compensation is reasonable by following specific steps that track with the best practices described above. Establishing the rebuttable presumption effectively shifts the burden of proof regarding reasonableness to the IRS, affording a nonprofit's leaders a measure of protection from the penalties that can apply when executive compensation is found to be excessive. An organization wishing to avail itself of the rebuttable presumption protection should do so under the advice of professional tax counsel to ensure compliance with the specific provisions of the regulations.

In summary, preparedness and diligence in executive compensation-setting is well worth the effort – a fact that becomes readily apparent when a reporter calls or the IRS announces that it plans to examine your organization.

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