Current Developments in Non-Profit Executive Compensation

Finance and Administration Roundtable

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Discussion Topics

- Current Trends in Executive Compensation
- Approaches to Market Pricing and Establishing Market Value
  - Data Selection and Interpretation
  - Valuing Benefits – Intermediate Sanctions
- Defending Compensation Practices with Stakeholders, The Board, and the IRS
  - Defining “Fairness”: as it Relates to Executive Compensation
- Executive Compensation Governance
  - Impact on Compensation Committees
  - Top Issues Committees are Facing
- Use of Compensation Consultants
Trends – Base Salary

- Base salary continues to be a very important component of executive cash compensation in not-for-profit organizations. However, the ratio of incentive to base salary is increasing, as incentives play a great role.

- The base salary gap between not-for-profit organizations and general industry is narrowing:
  - Many not-for-profits have grown into large, complex systems and recognize the value of executive talent
  - Many organizations have turned to general industry to fill senior executive positions in IT, HR, Finance and other disciplines
  - Demand for talent from industry has driven compensation levels up.

- In 2010, base salary increases for top executives in not-for-profit organizations for those receiving increases were on average 2.2% versus 2.6% in general industry
  - Median increases, including those of executives who did not receive increases, for 2010 were less than 1%
  - Approximately 19.3% of not-for-profit versus 9.5% of for-profit organizations did not increase executive base salaries in 2010 due to the economy

- For 2011, base salary increases are projected to be 3%; only 12.6% of organizations plan no increase
Trends – Base Salary

- 2010 vs. 2011 Projected Salary Increase Comparison:

Results of the Quatt Not-for-Profit Salary Increase Surveys for 2009 and 2010

<table>
<thead>
<tr>
<th></th>
<th>2011 Projected Data (Data Obtained in October 2010)</th>
<th>2010 Projected Data (Data Obtained in October 2009)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chief Executive Total Salary Increase $^1$</td>
<td>3.00%</td>
<td>0.57%</td>
</tr>
<tr>
<td>Executive Total Salary Increase $^1$</td>
<td>3.00%</td>
<td>0.57%</td>
</tr>
<tr>
<td>Staff Total Salary Increase $^1$</td>
<td>3.00%</td>
<td>2.00%</td>
</tr>
<tr>
<td>Percentage of Organizations Holding Salaries Flat</td>
<td>12.60%</td>
<td>48.57%</td>
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$^1$ Results include organizations reporting holding salaries flat.
Trends –Annual Incentive Plans

- Annual incentive plans have become an integral part of the executive compensation package in many not-for-profit organizations:
  - Incentive programs are used for recruitment, retention, and to support “pay-for-performance”
  - Generally, not-for-profits that compete directly with for-profit organizations or not-for-profits that have easily quantifiable objectives and measurement systems are quicker to adopt pay-for-performance plans
  - Many other mission-based not-for-profits have also adopted pay-for-performance plans
  - Compared to general industry, however, annual incentive payouts for not-for-profit executives are moderate and represent a much smaller percentage of total cash compensation
    - The typical target incentive award is 10% - 30% of base salary for senior executives, with 130% to 150% of target for superior performance
    - Organizations should evaluate total compensation levels when determining the appropriate annual incentive target
  - Despite this trend, however, not-for-profit employers are still restricted in their ability to compete with the stock-based compensation programs available to executives in general industry. To compensate, not-for-profit executive compensation plans tend to have very strong benefits and deferred compensation plans.
Trends – Annual Incentive Plans (cont’d)

- Boards and Compensation Committees of not-for-profits with incentive plans are focusing on ensuring that:
  - Goals are defined relative to mission and strategy.
  - Incentive levels are supported by meeting financial goals.
  - Plan is driving the right types of results and leadership behaviors.
  - Incentive payouts (individually and in total) correspond to the level of performance achieved.

- More not-for-profit organizations are using formal, objective-based, formula-driven plans rather than using discretion in determining awards.
  - The best formula-driven plans have formal plan documents and define:
    - Formal tie between performance goals and the compensation plan.
    - Measurements for success – both an institutional “scorecard” and a leadership assessment score.
    - Award levels: threshold, target and maximum.

- Performance awards may also consider:
  - Probability of achievement versus market level (e.g., target performance results in compensation relative to median market total cash compensation).
  - Performance relative to peer organizations or trend data.
Trends – Long Term Incentive Plans

The prevalence of long-term incentive plans (LTIPs) has been increasing in the last few years, especially among large and complex not-for-profit organizations (10% – 20% have an LTIP). (We note that addition of an LTIP still requires that overall compensation be reasonable with respect to market practices.) LTIP’s are often structured in 457(f) plans.

The main objectives of LTIPs are to:
- Reward long-term performance and promote executive retention
- Reinforce strategic mission goals
- Recognize exceptional performance on major initiatives

Performance measures typically reflect organization-level performance and fall in three categories of measures:
- Mission-based (e.g., mission accomplishment, specific strategic initiatives, mission results, customer value.)
- Organizational improvement
- Financial (e.g., operating margin, revenue growth)

Three year performance cash plans with overlapping performance cycles are most common

Award amounts are usually much lower than in for-profits, where they can generate a significant portion of an executive’s pay package.
Trends – Supplemental Benefits and Perquisites

- Benefits and perquisites vary widely, based on the organization’s mission and objectives

- Typical executive benefits - most often used to supplement broad-based benefits - may include:
  - Supplemental Executive Retirement Programs (SERPs)
  - Supplemental long term disability, life insurance and other plans that may be capped
  - Deferred compensation plans
  - Restoration plans (i.e., those that restore pension benefits limited by the statutory pay cap)

- Perquisites are most often provided out of business necessity, due to public scrutiny on “visible” pay components
  - Recent trends indicate a more limited use of executive perquisites in both for-profit companies and not-for-profit organizations
Approaches to Market Pricing: Defining the Marketplace

- Defining the peer group of market comparators is the most crucial step in market pricing. The IRS requires that executive salaries be compared to those of “like organizations.” Other stakeholders have the same expectation. As a result, there is increasing scrutiny of the peer group by Board members, the public, other stakeholders and government oversight agencies, such as the IRS.

- Factors in developing an accurate and defensible comparator peer group:
  - Organizations with similar
    - Mission
    - Location
    - Scope
      - Budget
      - Staff size
    - Impact
    - Similar talent pool for executive attraction/retention
  - Specific characteristics of the executive
    - Work history, professional background, other (e.g., political background)
    - Education and experience requirements
    - Tenure
Defining the Marketplace

- Internal issues:
  - Compensation philosophy
  - Organization financial status and affordability of executive compensation
  - Internal pay practices among executives and staff
  - Board opinion

- Importance of recognizing that not-for-profit organizations do not compensate uniformly. There are different categories of not-for-profit organization with different pay practices.

- Example: trade associations on a comparable scope basis pay very differently from charities. Therefore trade data (e.g., ASAE data) may not be appropriate for a charity or advocacy organization

- Not-for-profit data vs. For-profit data
  - IRS and Quatt look first to not-for-profit data sources
  - For-profit data can be used with caution if clearly relevant and necessary
Defining the Marketplace

- Identifying Data Sources
  - IRS 990 data from peer group
    - Look carefully at reported data
    - Look at history over several years
    - Is deferred compensation payment accurately reported?
    - Are reported benefits values making sense?
  - Custom/proprietary “Club” Surveys
    - Regular participant-only surveys of particular markets (e.g., trade, major-not-for-profit)
    - Customized surveys of peer group (ad hoc)
  - Published surveys
    - Care in understanding
      - Data sources,
      - Data breadth,
      - Survey reliability,
      - Appropriate survey cuts
Importance of Valuing Benefits, Particularly at the CEO level

- All elements of compensation and benefits are included for determining reasonableness of total compensation by the IRS and others.

- Depending on the level of cash compensation, prevalence of the benefit and the level provided needs to be considered and assessed.

- Total compensation components
  - Cash compensation (base salary plus variable pay)
  - Health & Welfare
  - Retirement
  - Recruitment bonuses
  - Retention bonuses
  - Split dollar life insurance
  - Severance
  - Deferred Compensation
  - Non-compete/consulting payments
  - Housing allowance
  - Low interest/no interest loans
  - Executive disability
  - Executive life insurance
  - Club memberships
  - Benefits unique to sector such as sabbatical
Executive Compensation Governance

- Increased level and demands of governance related to executive compensation and performance assessment due to:
  - Increased availability of compensation information through the new 990 reporting requirement
  - Significantly greater scrutiny of compensation data by the public, stakeholders, the press, government and internal staff

- Governance evolution:
  - Board Committees, not individual Board Chair, making decision
  - Greater engagement of full Board
    - New 990’s are asking if all Board members have received the 990.
  - Greater practice in documenting compensation philosophy, system, annual performance and decision processes
  - Documented defensibility
Executive Compensation Governance

- Participants in the governance process may or should include:
  - Board members
  - Compensation Committee members
  - Organization leadership
    - Supported by HR staff
  - Consultants and advisors
Executive Compensation Governance

- The Board charters an independent committee (e.g., Compensation Committee) with executive compensation oversight.

- The committee has the following responsibilities:
  - Establishes a total compensation philosophy (pay and benefits)
  - Utilizes appropriate comparable third-party data for any analysis
  - Makes determinations in the Committee’s executive session
  - Keeps meeting minutes to contemporaneously reflect the decision making process and the decisions
  - Ensures appropriate tax filings are fully completed, timely filed and reviewed by the Board prior to filing
  - If a consultant is engaged, hires a compensation consultant directly
  - Supervises the work of the consultant
Impact on Committee Members

- Compensation Committees or those with responsibility for executive compensation decisions, increasingly:
  - Are obliged to exercise their fiduciary and stewardship responsibility to establish compensation packages that effectively:
    - Attract, engage and retain talented executives
    - Satisfy federal guidelines for being reasonable and consistent with the organization’s mission
  - Need to navigate evolving regulatory environment and increased public scrutiny while understanding emerging best practices
  - Must have the courage and conviction to do the “right thing” for stakeholders
Top Issues Compensation Committees Are Addressing

- Our comparable organization data or group – are they defensible?
- Incentive planning – do we have the right measures, targets and payout opportunities?
- Severance pay – is it necessary and reasonable?
- Deferred compensation – is it necessary, is it reasonable, and should it be re-structured with a link to long term pay-for-performance?
- Outside optics – how is our executive compensation program viewed and could it negatively impact public perceptions?
- How do we defend our compensation decisions, however justified, to our board members and other stakeholders if our decisions are different from their experiences in compensation?
Fairness As It Relates to Compensation

- Fairness is a balance between what the executive believes is fair and what the stakeholders believe is fair:
  - Stakeholders include:
    - The Board
    - The “customers” such as members, donors, recipients of services
    - Employees
    - The Public
  - Fairness overlaps with the reasonableness standard of oversight bodies (e.g., the IRS/state regulators); compensation that meets legal standards may not, however, be seen as “fair” by all stakeholders (and at times vice versa).
Factors for determining “fairness” in executive compensation

- Market value of the position
- Pay trends in the sector in which board members and stakeholders operate
- Compensation trends among peer organizations and in the geographical area
- Contract terms and compliance with the established compensation philosophy and compensation system, including the pay for performance system
- The performance of the organization, including its financial performance
- Staff compensation practice, for example the differential between executive compensation and staff compensation
- Perceived fairness on the part of observers, including:
  - The board members
  - The stakeholders
  - The public
What Boards Need and Should Expect from a Compensation Consultant

- Board Guidance and Advice
  - Compensation committee orientation
  - Decision making facilitation
  - Regulatory issues and developments
  - Reasonableness opinions

- Market Information and the Competitive Environment
  - Education on the overall compensation marketplace, which varies among industries
  - Advice on appropriate peer group(s) for purposes of benchmarking pay
  - Competitive reference points
  - Help interpreting available data and make inferences from conflicting or incomplete data
What Boards Need and Should Expect from a Compensation Consultant (cont’d)

- Compensation Plan Design
  - Technical assistance with some more complex compensation issues, such as some of the new pay-for-performance plans, deferred compensation and benefits plans
  - Focus on organization, as well as, compliance aspects of pay design

- Compensation and Performance Strategy
  - Content for pay practices and decisions
  - Development of programs to help drive organization performance
Reports vs. Opinions

- Reports provide data for compensation committees to rely on in making decisions. For IRS purposes a report is not an opinion.
- Opinion letters give organizations, committees and disqualified persons a higher level of protection because the compensation expert performs a comprehensive review of the total compensation package and provides a reasoned opinion for compliance with Internal Revenue Code Section 4958.
- Below is a model for providing reasonableness opinions.

<table>
<thead>
<tr>
<th>Accept Assignment</th>
<th>Conduct Work</th>
<th>Report Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consultant requires:</td>
<td>Special fact-finding and analysis procedures</td>
<td>Letter contains:</td>
</tr>
<tr>
<td>Access to and a clear understanding of all relevant factors</td>
<td>Substantial review conducted by an independent Intermediate Sanctions Expert</td>
<td>Detailed analysis of total compensation</td>
</tr>
<tr>
<td>Freedom to make a thorough, candid and independent assessment</td>
<td>Review by technical resources group staffed by legal and tax experts</td>
<td>Compensation</td>
</tr>
<tr>
<td>Reporting relationship to Board, Compensation/ Governance Committee or client counsel</td>
<td></td>
<td>Benefits</td>
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Letter contains:
- Detailed methodology and valuation results and commentary
- Reasonableness opinion regarding findings
- Certification of Consulting Firm’s qualifications to provide reasonableness opinions
Reports vs. Opinions: Our Advice

- The consulting firm should give you an opinion regarding the defensibility of the compensation plan in comparison to market practices.

  - A report is not the same as an opinion. Providing market data alone does not endorse pay practices or confirm that pay practices are “reasonable”.

  - The consultant is accountable to the Board in matters of compensation for disqualified persons and in our opinion is responsible for providing the Board with an informed professional judgment on the organization’s compensation practices.

- The opinion letter will often have an attached report as the analysis backing up the opinion letter.

- An opinion is particularly important when compensation is high relative to the market or when the organization has concerns about public or stakeholder scrutiny.

- The organization should ask the consultant if there are any concerns about the compensation level that would warrant an opinion letter. The consultant should also inform the Board if he or she sees concerns.