By Mike Conover

We have included articles in the past three issues of the Nonprofit Standard (see the September 2011, July 2011 and December 2010 issues) that deal with the issue of executive compensation from various angles. Each article begins with an introduction of surprise, lamentation or resignation to the ongoing stories of sensational executive pay practices being exposed among various nonprofit organizations. As 2011 draws toward a close, the “bad examples” and investigations by outside authorities continue. Interestingly, the issues continue despite extensive information about IRS intermediate sanctions being spread far and wide by BDO and numerous other professional service firms serving nonprofit organizations, embarrassing public disclosures and expanded reporting requirements. That brings us to our topic for this edition, an examination of Form 990, Schedule J reporting related to compensation practices. Specifically we will share our thoughts about the need to ensure that the “right things” are being done AND whether they are actually being done right.

California, Massachusetts and New York are at least three of the states that have launched significant investigations into tax-exempt pay practices in 2011. Compensation for executives, board member pay practices and executive severance awards are among the areas examined. In most cases these situations were triggered by media reporting on a specific situation for a single organization. It is interesting to know that these organizations (and probably many others) all “checked” the “right” boxes on their Form 990 and Schedule J filings. To many observers this suggest that despite efforts to ensure compliance with intermediate sanctions, the types of issues sensationalized in the media can still occur. How could this happen?

Form 990 and Schedule J contain inquiries directly related to intermediate sanctions and other practices used by an

organization to manage its executive pay practices. For example:

Form 990 – Part IV – Section B – Policies – Item #15

“Did the process for determining the compensation of the following persons (CEO, other officers and key employees) include review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberations and decisions?”

Form 990 – Schedule J – Part 1 – Questions Regarding Compensation – Item #3

“Indicate which, if any, of the following the organization uses to determine the compensation of the organization’s CEO/Executive Director. Check all that apply.

- Compensation committee
- Written employment contract
- Independent compensation consultant
- Compensation survey or study
- Form 990 of other organizations
- Approval by Board or Comp Committee”

Those already familiar with intermediate sanctions and the “presumption of reasonableness” available to exempt organizations will immediately recognize that these two examples actually provide an organization with the opportunity to report compliance as well as the major components of the process used to do so. Other items throughout the Form 990 and Schedule J touch on related areas and even go so far as to ask if the organization has somehow managed to engage in an “excess benefit transaction”.

The more extensive probing about compensation practices is, of course, a part of the IRS’ stepped-up efforts to ensure that nonprofit organizations are correctly compensating their leadership and executive levels. And, not surprisingly, the
“check box” responses provided by many organizations suggest that the majority of organizations are doing most, if not all, the right things. If so, the question remains as to why the continuing “bad examples” appear.

Despite claims that the “right” things are being done, we often note that they are not being done “right” by some organizations. In some organizations, longstanding practices (i.e., “traditions”) continue unchanged aside from a few new steps which are solely to check the boxes. I’ll share some observations related to intermediate sanctions guidelines and offer some suggestions about how best to make the effort to comply.

► REVIEW AND APPROVAL BY INDEPENDENT PERSONS

The annual pay decision or discussion of budget appears on the calendar of many organizations at fiscal or calendar year-end. For any number of reasons, the event has settled into a comfortable (sometimes uncomfortable) routine where a group of individuals who’ve always participated do so again.

Sometimes because the process is so familiar, the organization so small or the practice so informal, it may not be carried out with the full level of independence and objectivity one would hope to find. Input on pay recommendations, discussions about proposed pay actions and final decisions may somehow involve participants who are not completely independent. A former organization executive sitting on the board, executives or board members with family relationships in the organization, etc., may not be as removed from the deliberations and decision making as they should.

Steps should be taken to ensure that these sorts of independence situations do not occur. Excusing affected individuals from the room while deliberations and decisions take place ensures that only independent parties engage in them. And, as noted later, this should be clearly documented in meeting minutes (e.g., “Person X was excused from the meeting at 2 p.m. and the compensation program discussion continued:”; “Person X rejoined the meeting at 3 p.m. and the committee continued with other business.”)

► COMPARABILITY DATA

In some instances, organizations do not use authoritative information about pay practices among relevant and comparable organizations as a context for their compensation decisions. Because the organization is too small, unique or simply “never has done it that way,” little if any pertinent information finds its way into pay deliberations or discussions. Anecdotal information may be drawn from outsiders in different fields on the board. Form 990s filed by other organizations, articles from a recent business publication or some other source may be offered. Worse yet, many of these informal sources are not formally entered into the meeting record or kept for future reference.

For some, these efforts may be sufficient to prompt them to check the box on Schedule J. However, it is quite doubtful that a claim could be supported that reasonable and relevant information was used to support the organization’s pay decisions.

Organizations would be well advised to take steps to obtain authoritative information from several different sources for use in compensation decision making. Published compensation surveys are available for many different types of exempt organizations (e.g., foundations, higher education, trade & professional associations, etc.). Public filings can also be used so long as the organizations are reasonable and relevant to the organization in question (i.e., same field of interest, similar size, scope of operations, etc.) and a sufficient sample can be drawn from which legitimate conclusions can be reached. There are also consultants who specialize in virtually every type of exempt organization who can provide information and advice.

Finally, any data sources obtained and used in compensation deliberations should be kept and included in the minutes as part of the record of a meeting concerned with compensation. If inquiries are ever made about the organization’s pay practices it will be important to be able to provide the data sources.

► CONTEMPORANEOUS DOCUMENTATION

While many organizations maintain some form of documentation related to meetings where compensation decisions are made, the documentation often has one or more of the following issues:

- Fails to satisfy the “contemporaneous” requirement. Minutes must be prepared before the next meeting or 60 days after the meeting, whichever is sooner.
- No information about the basis for, substance of, or participants in any deliberations upon which a decision is based are noted.
- Documentation does not include copies of any pertinent documents used in the decision making (e.g., reports, surveys, Form 990s, etc.)
- Sometimes documentation includes information that may raise more questions than answers.

Clearly, organizations should maintain complete and contemporaneous records of all meetings related to compensation for executives. These records should be sufficiently detailed and supported by related documents to allow an independent reviewer to fully understand the basis for the actions undertaken by a compensation committee or executive committee in the past.

There are some steps that can be taken to determine the adequacy of an organization’s practices and make sure that the right boxes are checked on the forms and that more importantly the steps behind these boxes are being done right:

- Review responses to questions on Form 990 and Schedule J. Examine the practices that the organization uses to determine if all the components support the fact that the box was checked.
- Ensure that committee minutes, especially those for the Compensation Committee, are documented in a timely fashion and contain all necessary information.
- Ensure that the competitive/ comparability data used by the organization for its compensation decisions are maintained with the minutes and that the minutes document the reasons this data was used.

Taking some time to actually examine the facts that substantiate the organization’s