BRIAN H. VOGEL & CHARLES W. QUATT, Ph.D.

NONPROFIT EXECUTIVE COMPENSATION

PLANNING, PERFORMANCE, AND PAY

THIRD EDITION

BoardSource
Quatt ASSOCIATES

Library of Congress Cataloging-in-Publication Data

Library of Congress Cataloging-in-Publication Data

Vogel, Brian H.

Nonprofit executive compensation : planning, performance, and pay / by Brian Vogel and Charles W. Quatt, Ph.D. -- Third Edition.

pages cm

Includes bibliographical references and index.

ISBN 1-58686-146-8 (alk. paper)

1. Chief executive officers--Salaries, etc. 2. Nonprofit organizations--Management. 3. Compensation management. I. Quatt, Charles W. II. Title.

HD4965.2.V64 2014

658.4'072--dc23

2014036400

First printing, October 2014
ISBN 1-58686-146-8

Published by BoardSource
750 9th Street, NW, Suite 650
Washington, DC 20001

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ACKNOWLEDGMENTS

The list of those to whom we are indebted continues to grow for this, the third edition of *Nonprofit Executive Compensation: Planning, Performance, and Pay* (first titled *Dollars and Sense*). The authors again start with thanking our original staff partners at BoardSource — Marla Bobowick, who first suggested to Charlie Quatt that we write a piece on chief executive compensation; Claire Perella, who managed the writing and editing process; and our editor Deborah Kennedy. For the second edition, we thank our editor, Danielle Henry, and Karen Hansen, BoardSource's director of publications. Danielle has again been the superb and patient editor of the third edition.

For the third time, we owe Celia Roady and Greg Needles of Morgan, Lewis & Bockius an enormous debt for their help in understanding the complicated legal regime that applies to nonprofit chief executive compensation. Without Celia's unsurpassed knowledge of nonprofit law and her editing skills — and Greg's expertise on deferred compensation — we never would have been able to complete the legal sections of the book.

For their work on the first draft, thanks remain due to three former members of Quatt Associates: Alex Rabinovich for his meticulous review and editing of multiple drafts, and to both Alex and Chris Potter for their research assistance.

For the second draft, we had the invaluable support of our Quatt Associates colleague Thomas Schumann, who deserves to be considered the third author of not just of that edition, but of the third edition as well. As was the case last time, Thomas is responsible for much of the redraft. Reid Thompson, also a former colleague at Quatt, was our second edition source on the IRS Form 990.

In addition to the past generations cited above, we want to thank the whole Quatt team for its work on the third edition. Special thanks to Veronika Bordas and James Wynn for their review of the legal sections. Veronika also updated the citations and the glossary. In the final rush to the printer, she was also a dogged and eagle-eyed proofreader. James revised Chapter 9 on the CEO contract. Stephen Buchanan and Simon Quint contributed their special knowledge on foundations and trade associations; both also shared their files on unlucky organizations that have come to public or IRS attention for real or perceived problems with executive compensation. Perhaps the advice offered here will preserve others from a similar fate.

To everyone who helped us, your assistance was invaluable; any remaining faults are ours.

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INTRODUCTION

Hiring and retaining the chief executive are among the most important functions of a nonprofit organization's board. While the board is ultimately responsible for the organization's mission and strategy, the chief executive is the executor — and very often the main architect — of that strategy.

Recruiting and retaining the best possible chief executive often depends on offering the right compensation plan. An effective, market-based compensation plan enables a board to hire the best candidate for the job. By rewarding effective leadership, a good compensation plan helps retain a strong executive. A well-executed plan also improves performance by providing regular feedback.

In developing the chief executive compensation plan, the board must perform a careful balancing act. On the one hand, it must offer a salary and benefits package that can attract the best possible candidates for the chief executive position, and then keep that person in office. On the other hand, it must not offer a compensation package that is out of line with the organization's mission or with the overall culture of the nonprofit sector, whose work is regarded, both within and outside the sector, as properly being driven by mission rather than profit.

INCREASED PUBLIC AND IRS SCRUTINY

To complicate matters, the environment in which boards must make decisions about chief executive compensation is ever more difficult. Outside scrutiny of nonprofit salaries has increased; both the media and the Internal Revenue Service (IRS) are paying much closer attention than they have in the past to nonprofit senior executive compensation. There is particular focus, of course, on the compensation of the chief executive, usually the highest paid and most prominent employee of a nonprofit organization.

Recently, the IRS completed its Colleges and Universities Compliance Project. Launched in 2008, the project distributed detailed questionnaires to 400 randomly selected colleges and universities. The IRS selected 34 of the 400 for further examination on the ground of possible non-compliance. In its final report, issued on April 25, 2013, the IRS found that 20 percent of the organizations had failed to meet the test for the "rebuttable presumption of reasonableness" — there had been failures to specify a defensible set of comparator organizations, or to explain their criteria for selecting comparators, or to base their analysis on total remuneration rather than base salary.[1]

1 "IRS Exempt Organizations Colleges and Universities Compliance Project," *The Internal Revenue Service,* posted April 25, 2013, available at http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf.

The Colleges and Universities Compliance Project was the latest sign of stepped-up IRS scrutiny. The IRS announced in June 2004 that it was stepping up scrutiny of nonprofit salaries. In April 2009, the IRS director of tax exempt organizations again announced increased scrutiny and stepped up hiring of new staff. Congress continues to take an active, and often critical, interest in nonprofit compensation.[2]

That said, we note that the problem of excessive nonprofit compensation reflects only a small percentage of U.S. nonprofits; in a 2007 IRS study of 1,200 nonprofits with incomplete or possibly erroneous tax filings, only three percent were found to have excess benefit transactions.[3]

Changes made to the IRS Form 990 in the 2008 tax year have also increased scrutiny of nonprofit compensation practices. The current 990 requires detailed disclosure of compensation and perquisites for the chief executive and other senior and highly compensated nonprofit executives. Organizations must also describe their process for establishing the compensation of the chief executive.

Form 990 data must be available to the public; the Form 990s from the past three years must be made available to anyone who visits a nonprofit and asks for them, and nonprofits have 30 days to send out a photocopy if one is requested in writing. If an organization posts its Form 990 on the Internet, however, it is exempt from the other disclosure requirements. More than five million nonprofits post their Form 990s on the GuideStar (www.guidestar.org) website.

The detailed Form 990 data is regular fodder for the media writing about the highest-paid nonprofit executives — from the annual summaries in *The Chronicle of Philanthropy* and *The Chronicle of Higher Education* to articles in the local or national press. Ironically, the more detailed Form 990 likely puts upward pressure on CEO compensation, since it is now much easier for a nonprofit CEO to find out what his or her peers are being paid.

Some would like to see even more detailed reporting. The Massachusetts Attorney General recently issued a report evaluating executive pay at various large Massachusetts nonprofits, in which she proposed further expanding the level of

2 Jay Hancock, "Grassley: Who Approved These Hospital CEO Bonuses?," *Kaiser Health News,* June 25, 2013, available at http://capsules.kaiserhealthnews.org/index.php/2013/06/grassley-who-approved-these-hospital-ceo-bonuses/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+Capsules-TheKhnBlog+(Capsules+-+The+KHN+Blog); Rick Cohen, "Senator Grassley Proposes New Nonprofit Regs Thanks to Investigation of the Boys and Girls Clubs," *Nonprofit Quarterly,* July 26, 2011, available at https://nonprofitquarterly.org/index.php?option=com_content&view=article&id=14406:senator-grassley-proposes-new-nonprofit-regs-thanks-to-investigation-of-the-boys-and-girls-clubs&catid=155:nonprofit-newswire&Itemid=986.

3 Internal Revenue Service (March 2007) Report on Exempt Organizations Executive Compensation Compliance Project.

detail of disclosure than is currently requested on the Form 990 Schedule J.[4]

See Appendix I for more on the IRS Form 990.

States too continue to tighten rules regarding the internal practices of nonprofits — with compensation becoming increasingly important. California's Nonprofit Integrity Act of 2004 requires the boards of charitable organizations with revenues of at least $2 million to review and approve the chief executive and chief financial officer's compensation packages to ensure their reasonableness. As of 2006, Texas law requires that compensation for directors and officers be reasonable. New York's Nonprofit Revitalization Act, enacted in 2013 and with most provisions taking effect on July 1, 2014, introduced a suite of new standards to strengthen nonprofit governance. The year before, the governor issued an executive order capping the amount of state funding that can be spent on an executive's compensation at a nonprofit receiving state funding and imposing controls on additional compensation from other sources.[5]

Meanwhile, state attorneys general are aggressively pursuing nonprofits seen as overcompensating chief executives, bringing lawsuits that result in judgments ordering chief executives to repay millions of dollars in excess compensation. The head of a small family foundation in Texas was recently found in violation of the provision of state law requiring officers' compensation to be "reasonable" and ordered to return $5 million in excess compensation that he had awarded himself without board knowledge.[6]

A series of high-profile cases have attracted press scrutiny that has seriously affected the reputation of leading nonprofit organizations, including arts organizations, foundations, and universities — and destroying, in some cases, the careers of their chief executives.

In 2010, the CEO of the Boys and Girls Club was the subject of intense national press coverage, as well as Congressional criticism, for reported compensation of

4 This proposal would require an organization to disclose more information about its CEO's compensation, including 1. Providing compensation information for the past three calendar years; 2. Describing the nature of each compensation component and form of payment; 3. Listing any loans between the organization and the CEO; 4. If any compensation consultants were used, listing the consultant and his/her firm by name; 5. Listing how often the CEO's compensation is reviewed for reasonableness; and 6. Describing if the organization's process for setting compensation for other senior management substantially differs from the process used for the CEO. "Massachusetts Public Charities CEO Compensation Review," Massachusetts Attorney General Martha Coakley, December 2013, available at http://www.mass.gov/ago/docs/nonprofit/ceocomp/ec-review.pdf.

5 "A.G. Schneiderman's Nonprofit Revitalization Act Signed Into Law," New York State Office of the Attorney General, December 19, 2013, http://www.ag.ny.gov/press-release/ag-schneidermans-nonprofit-revitalization-act-signed-law. "Governor Cuomo Announces Proposed Regulations to Ensure that State-Funded Providers do not Pay Excessive Executive Compensation or Administrative Costs," Andrew M. Cuomo, May 16, 2012, available at http://www.governor.ny.gov/press/05162012State-Funded-Providers.

6 Nonprofit Issues, "Foundation Exec Ordered to Repay Excess Compensation," available at http://www.nonprofitissues.com/public/features/leadfree/2009jul1-IS.html#.U7q6D7FZhO-.

almost $1 million.[7] While the case was more ambiguous than it first appeared (much of the compensation was a payout of deferred compensation accrued over more than one year) the press attention was, at best, distracting to the organization.

Colleges and universities have been particular recent targets of press scrutiny reported on the 990. The former president of Brandeis was criticized for receiving more than $600,000 in salary and benefits the year *after* he retired. The post-presidential pay was intended to both recognize his past accomplishments and to compensate him for consulting services to the university. Former presidents at Amherst, Tufts, and Harvard have come under similar scrutiny.[8]

As a consequence of this scrutiny, many nonprofits have made commendable progress in changing their compensation plans and increasing the transparency of their processes for setting compensation and reviewing chief executive performance on a regular basis. Sound practices are not, however, universal. Many boards still do not take full steps to monitor chief executive compensation. BoardSource, for example, found that only 65 percent of full boards approve the chief executive's compensation, and 75 percent review comparable data on CEO compensation.[9] While, as discussed in more detail later (see pages 13-14), there is no federal legal requirement that the full board formally approve chief executive compensation, the full board needs to know what it is paying its chief executive, and therefore the authors strongly recommend that the full board in fact review and approve chief executive compensation. The IRS Form 990 asks if the board has received and understood the form, with its detailed compensation information, before the form is finalized and filed.[10] This is an unsubtle hint in favor of full board review.

7 Matthew Jaffe, "Boys & Girls' Club CEO Roxanne Spillett's $1M Total Compensation Under Fire," *ABC News,* March 12, 2010, available at http://abcnews.go.com/Business/boys-girls-club-ceo-roxanne-spilletts-1m-salary/story?id=10086264.

8 Todd Wallack, "A Gilded Goodbye for Many Private College Leaders," *The Boston Globe,* November 17, 2013, http://www.bostonglobe.com/metro/2013/11/17/brandeis-president-reinharz-landed-college-jobs-with-big-pay-few-responsibilities/s9TXo4v2UdjE9lfqJND2pM/story.html.

9 BoardSource, *Nonprofit Governance Index 2014.*

10 Internal Revenue Service, *Instructions for Form 990 2008*, p. 15.

TRENDS IN CHIEF EXECUTIVE COMPENSATION

Perhaps not coincidentally, the increased scrutiny from the government, the press, and the public comes at a time when compensation practices at many nonprofits are coming to resemble, at least to some degree, those in the for-profit sector. Salaries at many nonprofits have been rising, and salaries at some large nonprofits have reached levels formerly associated only with parts of the for-profit marketplace.[11] In addition, some nonprofits have introduced compensation features such as bonuses, incentives, and deferred compensation that were formerly seen almost exclusively among for-profit corporations. Some nonprofits have found that these compensation features can offer distinct advantages in encouraging focused performance while controlling compensation costs — although, as discussed in more detail later in the book, they are not for everyone. The IRS has recognized that untraditional forms of compensation, such as bonuses and incentives, can contribute to stronger and more successful nonprofit organizations. Estimates of the percentage of nonprofits with chief executive bonus or incentive programs vary: A 2013 Quatt Associates cross-sectional survey of large nonprofit organizations (exclusive of trade associations) showed that 47.2 percent offered such programs.[12] A 2011 survey by the Council on Foundations found that 24.1 percent of foundations offered incentive pay to chief executives.[13] A 2013-14 survey by the College and University Personnel Association found that performance-based incentive opportunities were provided to 25.6 percent of chief executives of single institutions and 19.9 percent of chief executives of multiple-institution systems.[14]

Of course, few nonprofit organizations have the luxury of offering excessive compensation to any of their staff members; the challenge that many smaller organizations face is not to control unreasonably high salaries, but to find enough money to pay reasonable salaries at all. This all too common financial challenge is one of the reasons that chief executive compensation in the nonprofit sector, like sector salaries in general, remains below the levels found in the for-profit world. In addition, nonprofits cannot offer some of the more lucrative features found in for-profit compensation, such as equity, and deferred compensation in the nonprofit sector is subject to stricter rules than it is in the for-profit world.

11 Noelle Barton and Ben Gose, "Executive Pay Outpaces Inflation: Median Compensation Rose 5 percent," *The Chronicle of Philanthropy,* October 2, 2008.

12 Aggregate of Quatt Associates, 2013 *Not-for-profit Compensation Survey,* p. 10 and Quatt Associates, 2013 *Custom Foundation Survey.*

13 Council on Foundations, 2011 *Grantmakers Salary and Benefits Report,* p. 71.

14 CUPA HR, 2013-14 *Administrators in Higher Education Salary Survey,* p. 9.

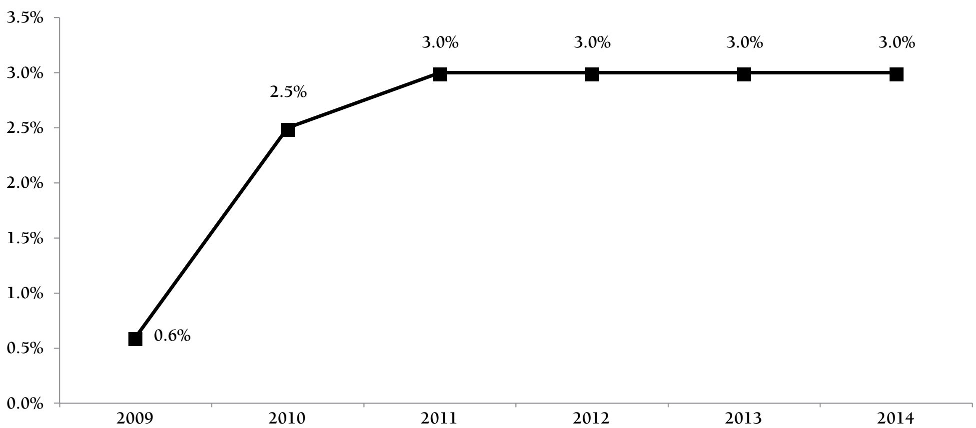
Q: How do nonprofit executive salaries compare to those in the for-profit sector?

Many nonprofits are now appropriately competitive — paying enough to ensure they can hire the talent they need, but not so much that they risk violating the public trust that expects them to focus on their main responsibility, their mission. At least among more complex nonprofits, the gap in salary compensation between for-profits and nonprofits has narrowed. Moreover, some pay practices, such as bonus and deferred compensation, formerly seen only in for-profit organizations, have become increasingly common in nonprofit organizations.

Q: How quickly have nonprofit salaries been rising in recent years?

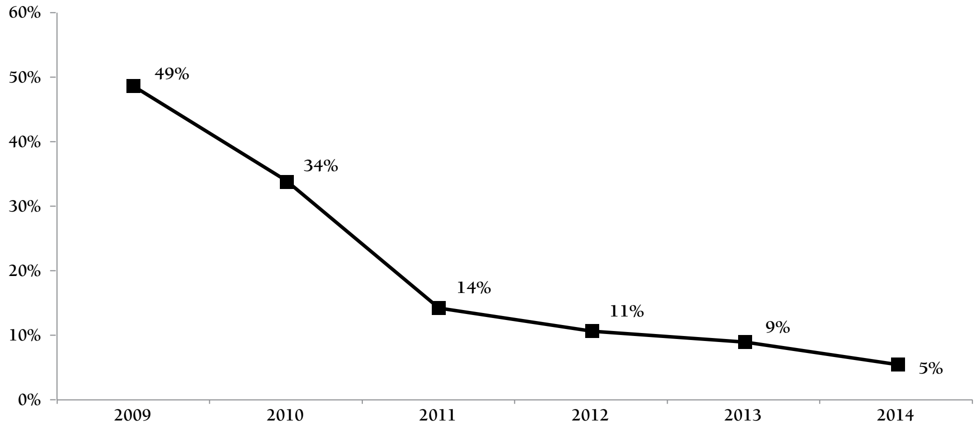
Nonprofit salaries, for both executives and staff, rose steadily until the onset of the Great Recession in 2008. Salary increases began to rebound in 2010, at least among larger nonprofits. By 2013, salary increases had returned to pre-recession practice and were projected to continue at the same level in 2014.

Median Executive Salary Increase Budget



According to Quatt's annual Salary Planning Survey, salary increases for nonprofit executives have recovered since 2010, with organizations budgeting three percent at median for executive salary increases. Since 2010, median salary budgets have been the same for executives and staff. Other surveys report very similar salary budgets at for-profit organizations.

Percentage of Organizations Holding Executive Salaries Flat



According to Quatt's Salary Planning Survey, the percentage of nonprofits giving no salary increases to executives spiked in 2009, at the height of the recession, and declined to a low level in 2014. The percentage of nonprofits giving no increase to staff has been similar over this period, albeit slightly lower.

That said, nonprofit total remuneration still lags behind for-profit pay for positions of the same impact and complexity, and probably always will. In part this is because nonprofits cannot offer equity or other lucrative forms of long-term compensation. The larger reason, however, is that external scrutiny, federal and state oversight, and the internal culture of nonprofits generally discourage the payment of very high levels of compensation. For many nonprofits, financial considerations are also significant limits on executive pay.

PUBLIC EXPECTATIONS

Perhaps the most significant factor differentiating compensation for chief executives in the nonprofit sector from that of their counterparts in for-profit businesses is public expectation. The public rightly believes that a nonprofit organization has a responsibility to channel as much of its donor money as possible toward the fulfillment of its mission. Many members of the public also believe that staff at nonprofits should be willing to receive lower salaries than staff members in comparable positions in for-profit businesses, because the nonprofit staff person is dedicated to the organization's mission. These expectations create a value system in which an apparently generous, and perhaps appropriate, salary can be seen to imply a lack of dedication to the organization and its mission. Compensation practices that are universal in the for-profit sector, and increasingly common among nonprofits, such as pay for performance and bonuses, are sometimes perceived as inappropriate.

Nonprofit boards must be prepared to work within the constraints imposed by this publicly held value system. They must also recognize that the same value system may be an integral part of their organization's internal culture as well. When this is the case, board members and staff alike may object to the use of market-based comparisons for making salary determinations and to the provision of benefits and perquisites for the chief executive. They may even resist giving the chief executive more than a token annual salary increase.

Q: Are chief executive pay records public information? What about the pay of other employees?

Chief executive pay, including cash pay and benefits, must be reported on the annual IRS Form 990 that almost all tax-exempt organizations must file. Organizations must also report on their 990s compensation for: a) officers, directors, and trustees; b) "key employees" (employees who receive at least $150,000 in reportable income and either have responsibilities, power, or influence over the organization similar to those of officers, directors, and trustees or who have fiscal or program management responsibility or control for at least 10 percent of the organization's financial resources or activities); and c) the top five employees not included in (a) or (b) who receive at least $100,000 in reportable compensation. IRS Form 990s must be made available to the public upon request.

BALANCING PUBLIC EXPECTATIONS WITH THE NEED TO COMPETE FOR STRONG LEADERSHIP

On the other hand, boards need to be aware that unrealistically low expectations about executive compensation can be detrimental to a nonprofit organization. The chief executive is a nonprofit's single-most-important employee. Failure to pay a competitive salary, however noble the motivation for doing so, can cause a nonprofit to lose a strong chief executive or find it almost impossible to recruit an effective one, harming the organization's success and its ability to fulfill its mission. Below-market chief executive compensation can also act as a cap on the pay of other senior staff, leading to further losses in effectiveness as key employees are recruited away by other organizations.

Board members should therefore consider carefully the potential costs of underpaying their organization's chief executive. Competitive salaries, based on the nonprofit marketplace, and innovative compensation practices — for organizations that can afford them and are prepared to justify them — can help recruit and retain skilled and experienced leaders. For organizations that are facing budget constraints, it may make sense to economize in other areas rather than risk the loss of an effective organizational leader. Of course, each nonprofit must decide for itself what mix of compensation features makes the most sense for its circumstances.

A nonprofit organization's board can most effectively meet public expectations and justify its decisions regarding chief executive compensation when it approaches compensation as a strategic decision. The board's principal duty in setting chief executive pay, in addition to meeting legal norms and stakeholder expectations, is to ensure that the compensation package supports organizational success. The compensation package must be an integral part of overall organizational strategy and planning. By ensuring that the chief executive's compensation will contribute to the realization of the organization's mission and objectives, the board provides a rationale for its decisions that will stand up to public scrutiny.

Between the second and third editions of this book, the worst recession since the 1930s was affecting nonprofit and for-profit compensation alike. Boards have not forgotten the bad times, and are much more likely to closely scrutinize both the level and elements of senior executive pay. They are also much more likely to insist on a clear link between performance and compensation.

WHAT YOU WILL FIND IN THIS BOOK

This book is intended as a practical guide for nonprofit boards to use in setting chief executive compensation — both when hiring a new leader and when reviewing the pay of a sitting chief executive. It is designed to serve as a reference tool and as a step-by-step guide that a board can use to establish an effective compensation structure within the context of the organization's mission, history, goals, and marketplace. It seeks to provide information and guidelines that will be useful to nonprofits of all sizes, while recognizing that small, medium-sized, and large nonprofits have differing needs and circumstances. Above all, it aims to help nonprofits of all types increase the transparency and integrity of their chief executive compensation practices as part of their stewardship of the public trust.

Chapter 1 discusses the board's role in setting chief executive compensation. It places the issue in the larger context of the board's responsibilities to the organization, and outlines procedures for the board to follow in setting chief executive compensation. Chapter 2 covers the role of organizational culture, mission, and strategy in setting chief executive compensation. Chapter 3 explains how to develop a profile of the specific qualities desired in the chief executive. A formal profile helps a board target its recruitment to the correct marketplace and set compensation in light of the marketplace and desired skills; it is also helpful in determining how to reward those skills. Chapter 4 discusses the compensation philosophy: the set of values and mechanisms used to set compensation. Chapter 5 describes how to define the chief executive's marketplace and obtain data from the marketplace for use in setting compensation. It includes detailed subsections on the challenges in establishing the correct marketplace for subsets of the nonprofit sector, such as colleges and universities. Chapter 6 focuses on the legal requirements surrounding chief executive compensation, and how the board should act to protect itself, and the organization's executives, from liability. Chapter 7 discusses disclosure and explanation of chief executive compensation to the organization's various stakeholders, including staff, donors, and the public. Chapter 8 discusses the elements of the compensation package and their implementation. Chapter 9 covers chief executive employment agreements.

Readers familiar with the previous editions will find the following updates and additions:

- Additional guidance on how to use survey data in market pricing
- An updated section on legal standards
- Discussion of the special challenges for establishing market based pay in different nonprofit sectors — we have used colleges and universities as an example
- An expanded discussion of how to assess annual CEO performance, including sample assessment and CEO "competency" forms
- A new sample contract
- The board's role in reviewing compensation for other senior executives beyond the chief executive

USING THIS BOOK

This book is organized to provide a logical, step-by-step method for boards to follow in thinking about chief executive compensation. The authors understand, however, that concepts referenced in one section may raise questions that are answered in detail only in subsequent sections. The authors have therefore included answers to frequently asked questions (FAQs) throughout the text. A full list of these FAQs is also included as Appendix II. The authors have also included boxes on major subjects and concepts for ease of reference.