



Executive Compensation Vantage Points

Reasonable Executive Compensation

Peer Group Selection in Nonprofit Organizations

Any nonprofit organization faces unique pressures from the labor market, regulators, donors and other stakeholders when it comes to executive compensation. Although complicated, the way forward is to establish an appropriate peer group for compensation comparisons. The committee¹ must take the necessary steps to **(1) define the criteria for peer group selection; (2) identify the right data sources that will provide appropriate comparisons; and (3) ensure the recommended compensation is competitive and reasonable.**

PEER GROUP SELECTION

Peer group selection starts with defining the criteria. A board-designated committee should discuss the organizational characteristics that influence the scope and complexity of the positions that are being benchmarked and determine how the proposed peer group organizations are aligned with those characteristics. Careful consideration should be given to organizations that are proposed but do not align with size, scope, talent or other defining characteristics. Once the committee reaches consensus on the peer group, data can be collected and analyzed for review and discussion as a committee agenda item.

DEFINING EXECUTIVE PEER GROUP SELECTION CRITERIA

When developing a custom peer group for executives, committees should consider the following criteria:

Operating Model. The operating model influences the scope and complexity of executive roles. For example, a private grantmaking foundation will have different staffing needs than a community foundation. A social service organization may have multiple chapters or affiliates, or it may be a national organization with regional offices.

Size. Executive compensation levels are correlated to the size of an organization. For private foundations, size is defined by assets, while other types of nonprofits define size by revenue and other factors, such as the number of employees. Standard practice is to include organizations that range from one-half to two times the size of your organization, although there may be appropriate circumstances in which that range is expanded. Ideally, the median size of the peer group, however measured, approximates your organization's size.

Talent Market. The talent market can influence position comparability, particularly when specialized education or experience is required. For example, research institutes can find comparable positions in higher education. Development positions can also be found in higher education, health care and arts & cultural organizations.

Geographic Location. An organization's location or where the executive is performing the majority of their work will influence the level of executive compensation. Executive pay in or near large metropolitan areas is regularly higher (attributable, in most part, to higher cost of living).

Profit Status. While the regulations define comparable organizations as both taxable (typically for-profit) and tax-exempt (nonprofit), the use of similar organizations is often the most defensible. However, there are circumstances when comparable positions can only be found in taxable organizations. For example, a large, global charity may not have sufficient peers to benchmark its head of development, but the sales and marketing positions in taxable organizations may require similar skill sets and, therefore, provide strong comparability.

CUSTOMIZING A PEER GROUP FOR UNIQUE POSITIONS

Some positions have a unique talent market that differs from the rest of the executive team. In these cases, it may be necessary to further customize a peer group to ensure comparability. Examples of such positions are Chief Investment Officer and Head of Development.

Determining a position-specific peer group starts with evaluating whether the talent market, scope and complexity of a position are different from the rest of the organization. If so, some factors to consider include the following:

Investment Executives. The top investment executive position warrants a customized peer group largely based on the organization's assets under management, which is very different from total assets. Peer group criteria should also consider peer investment objectives, risk tolerance, the type of funds being managed (endowment, pension or other type), the complexity of the portfolio and the staffing model used.

Development Executives. The top development executive position warrants a customized peer group largely based on the funds the individual is responsible for raising, which is very different from the organization's revenue. Peer group criteria should also consider where funds are sourced and the degree of complexity associated with securing those funds.

CHALLENGES IN PEER GROUP DEVELOPMENT

One of the challenges with developing an appropriate peer group is finding sufficient data for similar organizations. Generally, a minimum of 15 to 20 peer organizations will provide a sufficient sample size. However, an organization could consider adding other types of nonprofit organizations of comparable size and geographic location.

For example, a large museum in New York might recruit talent from a New York-based foundation (or vice versa), and an arts or cultural institution may recruit from academia. In any case, the rationale for expanding the diversity of the peer group should be carefully documented.

DATA SOURCES

Peer group data illuminate market practices, including competitive levels of compensation and benefits pay practices related to supplemental executive benefits and variable pay. Diversity in the types of nonprofit organizations requires consideration of a broad range of organizational characteristics when developing peer groups for compensation comparisons. In addition, some positions may require review of the pay practices from multiple peer groups to evaluate comparability from all relevant perspectives.

Peer group data can be compiled from published surveys, a custom survey conducted on the organization's behalf by a third party or the IRS Form 990.² For many organizations, published surveys provide sufficient and reliable data on executive compensation practices among comparable organizations. For others, published surveys may not fully reflect a unique operating model or talent market for particular positions. Additionally, most surveys only report cash compensation data and exclude the value of other elements, such as health,

welfare and retirement benefits that must be considered when evaluating total compensation for purposes of reasonableness.

In these cases, it may be more appropriate to gather data through a custom survey of compensation practices among peers or from IRS Form 990. However, interpreting Form 990 can be challenging because it often includes one-time taxable compensation events and accruals that may upwardly skew the total compensation data reported.

REASONABLE COMPENSATION

Nonprofit organizations must ensure that their executive compensation programs are reasonable.³ According to Internal Revenue Code Section 4958, if a 501(c)(3) or (c)(4) organization (excluding private foundations that are subject to different regulations under Internal Revenue Code Section 4941) pays unreasonable compensation to executives, those executives and the individuals who approved their compensation may find themselves subject to excise taxes. However, compensation is presumed to be reasonable if the organization meets the following three requirements for the “rebuttable presumption of reasonableness” before the compensation is paid:

- The compensation is approved by an authorized committee that is entirely composed of independent individuals.
- The committee relies on appropriate comparability data.
- The committee contemporaneously documents the basis for its determination that the compensation is reasonable.

Appropriate comparability data for the purpose of establishing the rebuttable presumption of reasonableness under federal tax law comes from appropriate peer group comparisons. According to the regulations, an appropriate peer group is one that represents similar organizations with functionally comparable positions. Even those organizations that are not able to establish the rebuttable presumption (such as private foundations) often voluntarily adhere to these three requirements in making and documenting compensation decisions in order to demonstrate good governance.

GOOD GOVERNANCE

The committee should reevaluate the data sources and the peer group regularly to ensure their continued appropriateness and document the rationale underlying any changes. By including this on the annual agenda, organizations can ensure that committee members have

an opportunity to take part in the evaluation.

The committee's minutes should articulate the review and approval process regarding the peer group, including the selection criteria used, the rationale underlying those criteria and all third-party opinions. The committee should thoroughly review those minutes to ensure that they constitute a complete and accurate record. Remember, any IRS or state attorney general audit is likely to happen well after the decisions have been made, the committee memberships changed and the memories faded.

CONCLUSION

Peer group selection is an integral part of good governance in executive compensation decision-making. It warrants a thorough discussion of the selection criteria and a critical review of proposed peer group organizations. Committees should ensure that the peer group selection process and the underlying rationale are carefully and completely documented.

1. We have used "committee" to refer to the committee of the board that has the responsibility for making decisions regarding executive compensation (or to the whole board if it has the responsibility).
2. IRS Form 990 is the annual information return for tax-exempt organizations, which includes disclosure of compensation and benefits. Private foundations file a similar Form 990-PF. References to "Form 990" are intended to encompass both versions.
3. This discussion is intended only as a high-level summary of very complex tax rules relating to reasonable compensation in tax-exempt organizations.

About C3 Nonprofit Consulting Group

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