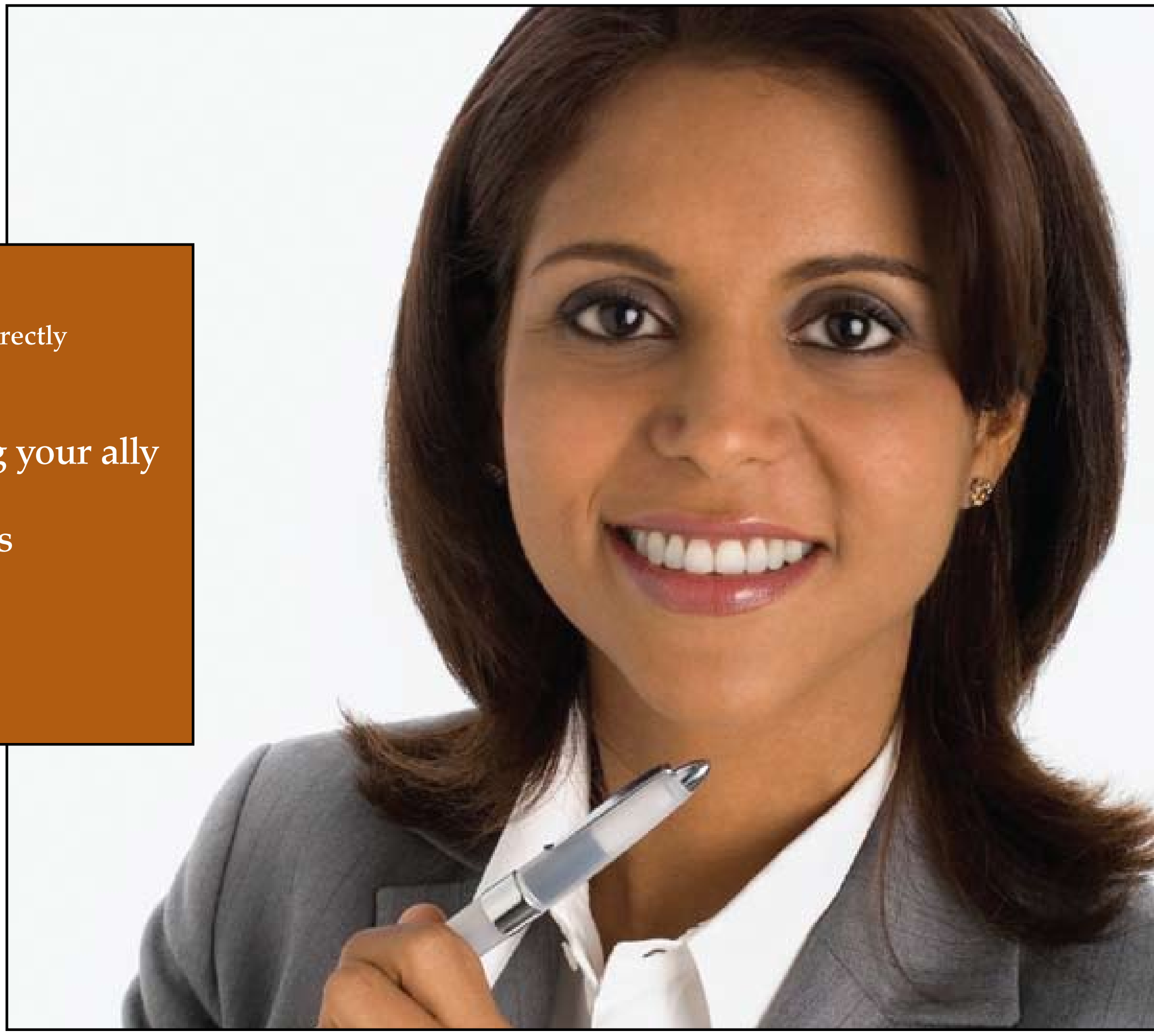
Profitable **Solutions** *for* **Nonprofits**



Summer 2009

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By the book

Setting executive compensation correctly

Overpaying executives is a sizzling topic this year, as legislators — and the public — fume over salaries in the financial, automotive and other industries getting federal bailout dollars. In the nonprofit arena, the IRS, too, is cracking down on salaries it considers unreasonable and is requiring stringent information about compensation on the new Form 990.

To protect yourself from sanctions, you need to make sure that your board of directors, at the time it sets an executive salary, arrives at a "reasonable" amount based on comparables for similar positions and adequately documents that research. And the person who will benefit from the salary-setting decision shouldn't be involved in the data-collecting and salary-setting process.

ENSURING COMPENSATION IS "REASONABLE"

The IRS demands "reasonable compensation" for key employees, defining it as the amount that ordinarily would be paid for like services by like enterprises, whether taxable or tax-exempt, under like circumstances.

Your board of directors ultimately is responsible for compensation, even if a compensation committee determines the amount. Either way, disinterested parties should set compensation. And specific procedures should be in place for times when a conflict of interest arises. For example, committee members with a conflict should excuse themselves from the compensation discussion and abstain from taking part in the decision.

Board committee members making compensation decisions should properly document their steps. For instance, they should retain the data used for comparability, an analysis of the employee's qualifications and documentation of the discussions leading to the final decision.

COMPARING APPLES TO APPLES

When evaluating a compensation issue, your board's committee should compare the position with others sharing similar duties. It also should consider the scope of the position (national or local), number of subordinates managed and size of the budget it oversees.

Another factor in the compensation decision is whether the employee will manage multiple functions, facilities, departments or entities. For example, you'd expect higher compensation for an executive director who oversees an organization with a $100 million budget and multiple entities than one who leads a $5 million organization with only one program.

Also, the committee should consider the number of hours the employee works. A $100,000 annual salary probably would be unreasonable for someone working two hours a week.

FINDING COMPARABLES

Using comparables from both nonprofit *and* for-profit entities is important in establishing compensation. Organizations should have at least three comparables, with more recommended for larger nonprofits. Use comparables for a geographic area similar to your organization's. A suburban not-for-profit hospital might, for example, use salary information from both for-profit and not-for-profit hospitals in the same, or an economically similar, suburb.

Commissioning a custom survey is probably the most accurate method of obtaining comparables. An accounting or consulting firm can design a survey to match the specific position you want to compare.

You also can glean this information from trade association surveys, telephone polls and Internet research. Because the information is public record for nonprofits, it should be readily available from sites such as GuideStar.org, which publishes an annual *Nonprofit Compensation Report*.

JUSTIFYING HIGH COMPENSATION

When awarding above-average compensation, your organization must clearly justify it. Some factors to consider are:

1. The ratio of your organization's revenue and expenses to the proposed compensation,
2. The executive's track record with and outside your organization,
3. The difficulty of replacing the executive,
4. Other written offers received by the executive,
5. Competitive market pressures, and
6. Special circumstances that may impact the decision, such as the executive's unique talents that will be valuable in addressing your not-for-profit's specific needs.

For example, your college's fundraising director might have experience not only in fundraising, but in college and university fundraising, and also have worked as a university marketing director. You also might offer this director higher compensation because she received a job offer from another school that you need to match or surpass.

AVOIDING SANCTIONS

Even when you feel higher-than-average compensation is justified, the IRS can determine it's excessive — or that a key employee receives more compensation than is deemed fair market value — and impose intermediate sanctions. In this case, the employee must repay the excess compensation to the organization, with interest, and a 25% penalty tax. If the employee doesn't make repayment in a reasonable amount of time, he or she is subject to a 200% penalty.

In addition, an officer, director or trustee of a nonprofit who knowingly approved what the IRS considers an excess benefit can be liable for an excise tax of 10% of the excess amount.

It's important to note that, if you follow the steps described above, the burden of proof for imposing any sanction will be on the IRS. If you don't follow these steps, however, the burden of proof in a challenge is shifted to the nonprofit.

DISCLOSING ON FORM 990

Sanctions aside, your executive compensation practices are now subject to heightened public scrutiny due to the required reporting of substantial compensation information on the IRS's new Form 990. Starting with tax year 2008, Part VII of the core form requires you to report compensation directly from employee W-2 forms and independent contractors' Form 1099s. And you need to disclose more compensation details in Schedule J, including information on base pay, bonuses, severance, deferred compensation and nontaxable benefits.

Compensation information is required for officers, directors, trustees, key employees and your five highest-compensated employees other than the aforementioned. The IRS defines key employees as employees other than officers, directors and trustees who: 1) had reportable compensation above $150,000, 2) had organizationwide authority or control and 3) were among your nonprofit's top 20 highest-paid employees who satisfied the previous two tests.

The new Form 990 also defines who is an officer, including, at a minimum, a nonprofit's CEO. IRS officials have warned that claiming to have *no* officers is a "bad position" to take.

GETTING THE BEST TALENT

The process of setting appropriate executive compensation is a balancing act. On the one hand, you need to make sure compensation is in line with similar positions elsewhere and that the research to determine the compensation amount is unbiased and thorough. On the other hand, you must consider what the competition is offering. ✻

IT ALL COUNTS

When determining reasonable compensation, count all of the economic benefits — besides salary — that you pay employees. The IRS has identified several often-overlooked items:

- Personal components of business travel,
- Personal use of employer-owned property,
- Gifts and gift certificates,
- Expense reimbursements outside corporate policies,
- Spouse travel expenses,
- Nonaccountable expense allowances, and
- Club and other membership fees.

Spending policies

Make endowment funding your ally

These days, it might feel as if you're fighting an unwinnable war: Demand for services is up — especially if your organization provides food, housing, job-search and other kinds of community support — while donations to many nonprofits are down. Even if you've built reserves for such a situation, you can't depend on them to outlast a long economic downturn.

But don't be disheartened: You may have an ally in your endowment funds. Income from these funds may be able to help you meet operating expenses, ease cash-flow problems and supplement next year's annual budget.

SHAPE AN EFFECTIVE POLICY

The success of your organization's ability to make your endowment work for you will be affected by investment performance, inflation, operational changes — and your endowment spending policy. Of these factors, you have the most control over the latter.

KNOW YOUR RESTRICTIONS

This discussion of endowment spending policies assumes your endowment funds are self-generated — that is, received without donor restriction on how the income is used. Or, the donor was silent as to how investment income would be defined and determined. If, however, your endowments contain contributor-imposed restrictions in these areas, your spending policy must defer to them.

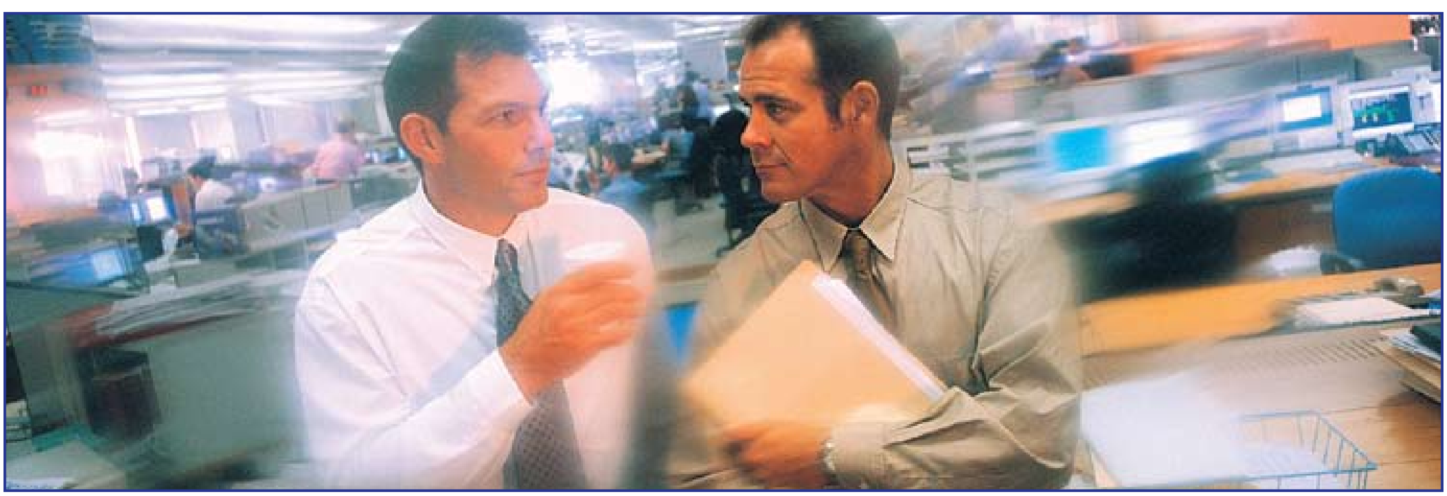
Your spending policy also must conform to provisions of the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA), as enacted by your state. So far, UPMIFA legislation has been enacted in the majority of states. Among other things, the federal act:

- Allows nonprofits to include appreciation of the invested funds as part of what is "spendable" in addition to realized gains, interest and dividends,
- Eliminates the "historic dollar-value" rule requiring that any endowment restricted by its donors into perpetuity not fall below the amount of the original gift,
- Outlines stronger guidance for the definition of "prudence" than provided in previous guidance, suggesting that spending more than 7% of an endowment in any one year is not a prudent decision, and
- Makes it easier for charities to identify new uses for older and smaller endowments that may be dedicated to obsolete or impractical purposes.

Because UPMIFA is complex and adoptions vary from state to state, you should consult your financial advisor on how it affects your organization. You also can visit UPMIFA's Web site (UPMIFA.org), which includes state law comparisons with the federal act.

DEFINE YOUR PERCENTAGE OF INVESTMENTS

A spending policy should define how much of your endowment fund's income can be spent on operations each year. It isn't required to define how that money can be spent within operations.



Most nonprofits define their spending policy as a percentage of a rolling average of the endowment investments, generally averaged over three to five years. This helps even out the ups and downs of better vs. poorer investment returns and prevents the endowment's contribution to any one budget year from being significantly lower than contributions to other years. This percentage often is set between 4% and 7% — less during halcyon investment years.

This approach may help smooth cash flow currently available to operations, but it doesn't address whether the endowment fund will be able to maintain a similar level of funding for future operations. Also, because investment returns usually don't correspond to the rates of inflation that affect your operating budget, your spending policy should be based on more than recent returns.

FACTOR IN INFLATION

To factor inflation into your spending policy, you may wish to start with a relatively conservative, inflation-free investment rate of return. Then adjust it for inflation to arrive at a spending rate you can apply on a year-by-year basis.

For example, if you determine that an inflation-free rate of return should be 3%, and the inflation rate appropriate to your sector is 2.5%, your effective spending rate to apply to your asset base would be 5.5% for that year.

It's also important to keep a spending rate policy that isn't directly linked to fluctuating investment rates of return. In other words, don't allow your withdrawals from endowment to go up just because investment growth on those funds has spiked up.

MAKE YOUR POLICY DYNAMIC

The challenge is to develop a spending policy that's dynamic enough to take the above factors into account, and not cause you to pull funds out of the endowment fund beyond what is budgeted and needed for operations. A good endowment spending policy will allow your asset base to grow and, therefore, increase your fund's chances of maintaining or growing real spending power for future budget years. ✻

How nonprofit watchdogs rate your organization

Watchdog organizations that patrol nonprofits have been around for several years, and you probably know that they aim to make available information on charities' financial health to benefit donors and funders. But do you know how they evaluate nonprofits like yours?

NAVIGATING NONPROFIT WATERS

Nonprofit watchdog Charity Navigator (CN), which describes itself as "the nation's largest and most-utilized evaluator of charities," rates more than 5,200 charities and considers itself a source of data and analysis for media, government agencies, nonprofit managers, grant makers and individual donors. This independent, not-for-profit-organization states that it has examined tens of thousands of nonprofit financial documents since its launch in 2002.

CN lists nonprofits exempt under Internal Revenue Code Section 501(c)(3) that have more than $500,000 in public support and have filed IRS Form 990 for the past four years. Using Form 990 information, CN claims to apply an objective, numbers-based rating system to assess each charity's financial health.

WHAT CHARITY NAVIGATOR EXAMINES

CN uses publicly available Form 990 or informational tax returns to analyze a charity's financial performance in seven performance categories. It concentrates on a charity's efficiency, holding that efficient nonprofits spend less money to raise more.

The best nonprofits, CN maintains, stay in line with the scope of their programs and services — and keep their administrative costs within reasonable limits. Most spending is devoted to programs and services directly related to their mission. The areas it examines are:

- Program expenses,
- Administrative expenses,

* Fundraising expenses,
* Fundraising efficiency,
* Primary revenue growth,
* Program expenses growth, and
* Working capital ratio.

From an analysis of a charity's performance in these categories, CN derives two overall scores:

Organizational efficiency (day to day). This considers the percentage of total expenses that the nonprofit spent on programs, administration and fundraising, plus the amount spent to raise one dollar (its fundraising efficiency).

Organizational capacity (over time). This is based on the average annual growth of the charity's operating revenue, programs and services expense over the past three years and the working capital ratio to total expenses.

CN's analysis results in a rating from one to four stars: poor to excellent. No stars are given for an "exceptionally poor" evaluation. More information about CN's rating system is available at www.charitynavigator.org.

BBB WISE'S STANDARDS

Another watchdog group you should pay attention to is BBB Wise Giving Alliance (BBB Wise), which was formed in 2002 when the National Charities Information Bureau and the Council of Better Business Bureaus' Foundation merged. The agency sets standards for accountability in charities and evaluates not-for-profits that report against those standards on a voluntary basis. Like CN, the organization educates donors by supplying information on intelligent giving practices.

BBB Wise's Standards for Charity Accountability's finance section outlines seven requirements. To meet the standards, your nonprofit must:

1. Spend at least 65% of its total expenses on program activities,
2. Spend no more than 35% of donations, legacies and other gifts received as a result of fundraising efforts on fundraising,
3. Avoid accumulating funds that could be used for current program activities — unrestricted net assets available for use should not be more than three times the size of the past year's expenses or three times the size of the current year's budget, whichever is higher,
4. Make available to all, upon request, complete annual financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP), and, if total annual gross income exceeds $250,000, have these statements audited in accordance with GAAP,
5. Include in the financial statements a breakdown of expenses (for example, salaries, travel and postage) that shows what portion of these expenses was allocated to program, fundraising and administrative activities,
6. Accurately report its expenses, including any joint cost allocations, in its financial statements, and
7. Have a board-approved annual budget for its current fiscal year, outlining projected expenses for major program activities, fundraising and administration.

More information on BBB Wise's standards is available at www.bbb.org, which lists as many as 2,000 national charities. Each charity provides information voluntarily, and has the option to apply for the BBB Wise Giving Alliance Charity Seal, once they meet all of the accountability standards.

BEST FACE FORWARD

In an economic downturn, when funders and individual donors spend money more cautiously, the information that appears on nonprofit watchdogs' Web sites is more important than ever. By preparing the best financial information you can in your documents of record, your organization will be in a much better position to compete for available dollars. ✻

Newsbits

FILING NEW IRS TAX FORM 990-N CRUCIAL FOR SMALL NONPROFITS

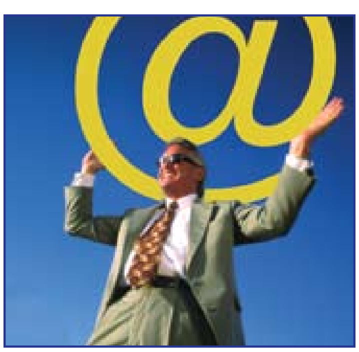
Attention, small nonprofits: Have you filed new Form 990-N with the IRS yet? If not, you're not alone. The agency reports that as many as one half million small nonprofits have yet to file — and are at risk of losing their tax-exempt status.

However, exempt nonprofits that cease operations aren't required to inform the IRS, so many of these may still be on IRS rosters. As a result, the number of organizations out of compliance could be far less than a half million.

Nevertheless, if you haven't already filed Form 990-N, now's the time to get moving. Tax-exempt organizations with annual gross receipts of $25,000 or less are now required to submit Form 990-N (also known as the e-Postcard) electronically, unless they choose to file the much more detailed Form 990 or Form 990-EZ. The Pension Protection Act of 2006 (PPA) requires exempt organizations under the income threshold for filing an annual return to provide basic information to the IRS each year. This includes your nonprofit's employer identification number, legal name and mailing address.

The Act also directs the IRS to revoke the tax-exempt status of any organization that fails to file an annual return, including the 990-N, for three consecutive years. Revocations will happen automatically starting in May 2010. You can find more information at www.irs.gov/charities. ❋

FUNDRAISING ONLINE CAN WORK



Online gifts are one-and-a-half times larger than those by direct mail, and total online donor revenue per year is higher. That was the news at the National Catholic Development Conference, at which representatives from online marketing and technology firm SilverTech also told conference-goers that 46% of U.S. adults plan to make a greater percentage of their donations online this year.

There are other reasons to consider beefing up your online fundraising efforts:

- Without high printing and postage costs, it's far less expensive than direct marketing.
- It automatically collects electronic information on donors.
- It's becoming more effective than both direct mail and telemarketing campaigns, according to SilverTech.

Plus, digital fundraising is friendly to the environment and creates a convenient and low-cost way to renew donors. ❋

HOW CAN INTERNS BE UNPAID?

Student interns have been prevalent in the nonprofit community for so long that you may not even know why your organization can use their labor without compensating them.

For federal wage protections to apply to interns, they must be "employees" as defined by the Fair Labor Standards Act (FLSA). A six-part test developed in 1947 by the U.S. Department of Labor provides guidance on FLSA's application to interns. Among other criteria, to *not* be an employee the training that the intern receives must be for his or her benefit; the trainee must not displace regular employees, but work under their close observation; and the trainee isn't necessarily entitled to a job at the end of the training period.

Many courts over the years have held that less than *all six* criteria can be met for an intern to not count as an employee. To make sure your unpaid intern is "legit," consult with an attorney who's familiar with your state's wage and hour laws, as they may vary from their federal counterparts. ❋