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SETTING EXECUTIVE COMPENSATION - HOW TO ATTRACT THE BEST WITHOUT ATTRACTING CRITICISM

Nonprofits need to offer enticing executive compensation packages to attract and retain top talent. But the IRS can impose excise taxes if it considers a nonprofit executive's compensation "excessive." At the same time, in today's strained fiscal environment, nonprofits must provide adequate incentives to ensure executives are accountable for achieving organizational goals. For most nonprofits, striking the right balance isn't easy.

Attracting the best

According to Charity Navigator's 2013 survey of CEO pay, the average top executive at a U.S. nonprofit makes $126,000 per year. In practical terms, however, this number isn't very helpful for boards setting salaries that will attract skilled and experienced leaders. Such averages tend to be skewed by a few atypical organizations. What's more, compensation varies widely according to the size, budget, geographic location and mission of specific organizations. For example, the highest earners tend to work for big organizations, universities and charities located in the Northeast.

That's why your board needs to find appropriate comparable data to set salary benchmarks. Generally, comparable executives have similar qualifications, perform similar functions and work for similar types of nonprofits. While their pay is important, be sure to also consider the benefits — such as bonuses and retirement plans — that your competitors offer. For some executives, these perks are an even bigger factor than base pay when deciding whether to accept a position.

Executives also are influenced by "soft" factors such as location or how passionate they are about your mission. You may find, for example, that you can lure your ideal candidate from another nonprofit without offering significantly higher compensation if they prefer your organization's culture or core values.

Holding executives accountable

A study of nonprofit hospital CEO compensation published in October in JAMA Internal Medicine has been getting a lot of attention — for all the wrong reasons. Researchers found that higher executive compensation did not correlate with better care processes, patient outcomes or community benefit. Although some in the health care community have disputed the study's results, the research provides a timely reminder to nonprofit boards: Executives should be held accountable for their organizations' performance.

To ensure your executive is earning his or her compensation, provide the leader with specific, measurable goals based on your organization's core mission. Then, build variable components into the executive's pay that are earned only if — and when — such goals are met. Focusing on accountability shows stakeholders and charity watchdog groups that your nonprofit values results and links pay to performance. They're much less likely to question an executive's compensation amount if that person gets great outcomes. *continued on page 2*

IN THIS ISSUE

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continued from page 1

Avoiding trouble

In addition to protecting your reputation with important stakeholders, ensure that your executive compensation won't raise red flags with the IRS. To promote greater transparency, Form 990 asks filers to explain in three steps the process they used to approve executive compensation:

1. Was compensation reviewed and approved by an independent body, such as your board's executive or compensation committee?
2. Did the committee identify and refer to comparable compensation data?
3. Were compensation discussions and decisions documented?

Too often, nonprofits overlook the third requirement. Documentation must include terms of the arrangement, the date it was approved, a list of those who were present and voted, comparable data that was relied on, and any actions by a member with a conflict of interest.

The IRS isn't the only government entity concerned about nonprofit executive compensation. Several states — including Florida, Illinois, Massachusetts, New Jersey and New York — have considered regulations that place limits on compensation for charity CEOs. Ask your tax advisor about whether your state is considering such rules.

Striking a balance

Your nonprofit needs to offer a competitive compensation package to attract the best and brightest leaders. But executives must be accountable for the organization's performance, and pay shouldn't be so out of line with that of similar nonprofits that it attracts negative attention from the public and the IRS.

SIDEBAR

Creative ways to compensate staff

Nonprofit employees typically don't join the sector to make big money. However, that doesn't mean that salary and benefits aren't important to them. If your budget doesn't allow for extravagant compensation packages, consider offering other types of perks.

No-cost benefits include flexible schedules, telecommuting options and casual dress codes. Memberships to credit unions, automobile clubs or warehouse stores, as well as discounts for local gyms, parking facilities or day care centers, are other appealing and generally low-cost benefits. Or consider giving staff extra vacation days or paid time off to volunteer.

Offering a Flexible Spending Account (FSA) allows employees to set aside a pretax portion of their paychecks for qualified medical and dependent care expenses. It can help staff members stretch their budgets. And don't underestimate the power of a great retirement savings plan. If possible, match a portion of your employee's 401(k) or 403(b) contributions — even 2% can make a big difference.

Of course, motivating employees takes more than a few perks. You also need to keep their work interesting and meaningful and involve them in decision-making. But adding a few extras can help you recruit and retain well-qualified employees.

THE 1023-EZ IS HERE

by Linda Shupack, CPA, Manager

The IRS has taken a lot of heat related to its handling of nonprofit tax exemption applications. First, they were highly criticized regarding the issue of preferential handling of 501(c)(4) applications, which resulted in the eventual ouster of Lois Lerner, Director of the Exempt Organizations Unit of the IRS as well as several other top officials. Second, the excessively long processing times for 1023 applications prompted many from the tax community as well as those assisting charitable groups to demand changes in the process.

In an attempt to improve its responsiveness and reduce its backlogs, the IRS approved a streamlined application for small nonprofit startups effective July 1, 2014. The changes have the following criteria:

To be eligible for the 1023-EZ form:

- Gross receipts of less than $50,000 for the past three years
- Projected gross receipts of less than $50,000 in the current tax year and subsequent 2 years
- Total assets must be less than $250,000
- Must be filing for a 501(c)(3) exemption

Ineligible organizations:

- Churches
- Schools
- Hospitals
- Foreign entities
- Unincorporated entities
- Trusts

The new Form 1023-EZ is three pages long, compared with the 26-page Form 1023. Based on applications under review at the IRS, as many as 70 percent of all applicants already qualify to use the new streamlined form.

The change should allow the IRS to accomplish three objectives:

1. Speed the approval process for smaller groups.
2. Free up resources to review applications from larger, more complex organizations.
3. Reduce the application backlog.

Currently, the IRS has more than 60,000 501(c)(3) applications in its backlog, with many of them pending for nine months. Often, it takes the IRS nine to 15 months to process applications.

How is it doing?

Since its launch in July 2014, the application process using the 1023-EZ form has reduced processing times for some applicants to as little as one month. Additionally, it is believed the new process is also significantly reducing the costs related to obtaining an exemption. However, despite these early positive reports, many organizations still have concerns about the new form. Primary among them is whether the new process will invite fraud and abuse. They cite the fact that applicants are not required to provide financial data or copies of their key governing documents. Instead, the signer of the Form 1023EZ, on behalf of the organization, attests that the organization will be organized and operated in compliance with Section 501(c)(3) of the Internal Revenue Code. This abbreviated process reduces transparency and may allow applications to be approved that otherwise would have been rejected. Also, some commentators have accused the IRS of inappropriately shifting the burden of enforcement onto private foundations, state tax departments, and state charity regulators, which have traditionally relied on the rigorous federal process for approval of 501(c)(3) status.

In the end, the form has been approved and is in use. With an average of 60,000 applications for exemption made annually, only time will tell if the IRS made the right decision.

UNDERSTANDING BOARD RESPONSIBILITIES

by Jessica Kinney, CPA, CFE, Manager

Nonprofit leaders and their boards certainly have cause to be overwhelmed with the tasks before them. The demands for nonprofit board members and leaders has never been greater; increased compliance requirements, financial constraints and operational demands.

Does your organization struggle with balancing the demands and resources of the Board? What about understanding the fiduciary duties, board dynamics or understanding the financial statements? Courts hold volunteer board members responsible for the financial activities of the nonprofit as well as for compliance and internal governance issues.

The Washington Secretary of State has issued a guide for nonprofit board members to assist them in understanding the responsibilities they are taking on when volunteering. The standards are summarized into three categories.

Duty of care

The Duty of Care describes the level of competence that is expected of a board member, and is commonly expressed as the duty of "care that an ordinarily prudent person would exercise in a like position and under similar circumstances." (See RCW 24.03.127). This means that a board member owes the duty to exercise reasonable care when he or she makes a decision as a steward of the organization.

The Secretary of State gives example of what this includes, however one area that is a common concern is the duty to provide assurance that the organization's books and records are accurate. Common replies from Board members include "we pay an accountant for that" or "I can't even balance my own checkbook, how can I know that the organization I volunteer for is doing that accurately?". In response to this concern, many Boards provide annual financial literacy training to their members. This training gives members the knowledge necessary to effectively fulfill the "Duty of Care" requirement.

Duty of loyalty

The Duty of Loyalty is a standard of faithfulness; a board member must give undivided allegiance to the organization when making decisions that affect the organization. A board member can never use information obtained as a member for personal gain, but must act in the best interests of the organization.

Duty of obedience

The Duty of Obedience requires the board of directors to be faithful to the organization's mission. They are not permitted to act in a way that is inconsistent with the central goals of the organization. The basis for this rule lies in maintaining the public's trust that donated funds will be used to fulfill the organization's mission. Part of this requirement includes making sure that all filing requirements are met, including state and federal tax reports.

Shannon & Associates, LLP offers Board Training to help your Board of Directors understand their obligations. The training is customized for your individual organization. Topics include:

1. Financial Literacy,
2. Fiduciary Duties, and
3. Board Dynamics.

If you are interested in scheduling training please contact us, we would love to help!

http://www.sos.wa.gov/_assets/charities/QuickGuideHandbook.pdf

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