



**DEPARTMENT OF JUSTICE**  
CIVIL ENFORCEMENT DIVISION

December 19, 2005

Thomas C. Young, Chair  
Board of Directors  
Goodwill Industries of the Columbia Willamette  
1943 SE Sixth Avenue  
Portland, OR 97214

Re: Audit Report

Dear Mr. Young:

In April 2004 the Department of Justice began an audit of Goodwill Industries of the Columbia Willamette (GICW). As the audit evolved, the primary focus became whether the level of compensation paid to the organization's chief executive officer (CEO) was and is excessive. Secondly, the investigation examined representations about program services made by GICW in its advertisements and publications, on its website, on its tax return, and in the annual performance review of the CEO to determine whether those representations were consistent with the actual level of program services provided in 2003, the sample year chosen for our investigation.

The decision to open an audit was made in response to published reports that total compensation and benefits paid to the CEO had risen over a period of time to a level high in comparison to what other nonprofit executives in Oregon are paid. In addition, a citizen complained to our office about the level of compensation and certain aspects of GICW's operations.

The Department of Justice has completed its review. This letter serves as our public audit report of our findings and conclusions.

To the extent that this report identifies concerns as to the level of the CEO's compensation, we first communicated those concerns to GICW in October of this year. Since that time, the organization has proceeded in good faith to address those concerns, culminating in full board approval of new policies and procedures and a revised CEO compensation package. We commend the board for responding, positively and swiftly, to our concerns. The policies and procedures, in particular, represent an effort to be at the forefront of best practices. Each of these items will be discussed at the conclusion of this report.

## **ATTORNEY GENERAL'S ROLE**

The Attorney General is responsible for supervising charitable organizations holding or soliciting assets in Oregon. *See* ORS 180.060(1)(d) and (6), ORS 128.610 *et seq.*, and ORS Chapter 65. In particular, the Attorney General is authorized to investigate whether the purposes of the charitable organization are being advanced and whether any person has violated a fiduciary duty arising under the common law. *See* ORS 128.680.

## **SCOPE OF REVIEW**

In determining whether CEO compensation was reasonable or excessive, we examined both the total amount paid for the periods 1998 to 2004 as well as the process followed by the Executive Committee in setting compensation. To determine if representations about program services made by GICW were consistent with the level of program services provided, we chose 2003 as a sample period.

We interviewed several individuals as part of the audit process. Interviewees included Board Directors Thomas C. Young, Chair (Young) and Kent L. Aldrich, Treasurer (Aldrich). We also interviewed Michael M. Miller, President and CEO (Miller), whose executive compensation package was reviewed. Throughout the audit GICW personnel were very cooperative. We appreciate their responsiveness in providing requested information and making themselves available.

## **BACKGROUND**

Goodwill Industries was founded in 1902. Goodwill Industries International, Inc. (GII) headquarters are in Rockville, Maryland. Local, autonomous member organizations are located throughout the United States and in foreign countries. In addition to GICW (headquartered in Portland) there are two other GII organizations with Oregon headquarters: Goodwill Industries of Lane and South Coast Counties (Eugene) and Southern Oregon Goodwill Industries (Medford).

According to its website, GII organizations collectively are “one of the world’s largest nonprofit providers of education, training, and career services for people with disadvantages, such as welfare dependency, homelessness, and lack of education or work experience, as well as those with physical, mental and emotional disabilities.”

GICW has defined its mission as being “To provide vocational opportunities to people with barriers to employment.” This mission is pursued through a variety of training and employment programs and services. Examples include: the Job Connection program (free job-search skills training and assistance with finding employment); the Donated Goods and Retail program (employment at attended donation centers and retail stores); and the English-as-a-Second-Language program (classes are available at no cost). GICW’s job development and

employment services have been accredited by the Commission on Accreditation of Rehabilitation Facilities as meeting recognized industry standards.

GICW was incorporated in 1927 pursuant to Internal Revenue Code (IRC) §501(c)(3). The Internal Revenue Service (IRS) exempts GICW from federal income tax. In recent years GICW has grown substantially in all aspects of operation: annual revenue and program services; number and size of retail thrift store locations; and number of disabled and disadvantaged people served. For instance, total revenue steadily grew from \$36,823,906 in 1998 to \$58,130,276 in 2003. The majority of the revenue comes from the sale of donated thrift items sold at one of the 36 retail stores located throughout the Portland/Vancouver metropolitan area, the Willamette Valley and in Bend/Redmond. GICW's income is largely sufficient to fund its operations. GICW does not rely extensively on government contracts. GICW regards itself as one of, if not the most, successful Goodwill organization in the country. We uncovered no information to the contrary. It is also one of the most important and successful social service organizations in our community.

GICW is governed by a Board of Directors (Board) of at least 15 individuals. Most have strong business backgrounds.

## **GICW PROGRAM SERVICES**

### **Representations**

As noted earlier, representations about the level of program services provided by GICW appear in the organization's advertisements and publications, on its website, on its tax return (which is open to public inspection) and in Miller's annual performance review. Some of these representations specifically state the number of disabled and disadvantaged people who received services.

Because donors and thrift store shoppers may rely upon representations about program services when deciding whether to support the organization, an objective of the audit was to determine if these representations were accurate. The accuracy of these representations is, therefore, significant for both the primary and secondary purpose of this investigation.

### **Audit Process**

We began the audit process by identifying the representations that had been made. To accomplish this we requested from GICW copies of all print, radio and television advertisements for the 2003 calendar year as the sample period. This identification process was supplemented by our own research.

We determined that most advertising and publications tell stories about particular individuals and include general representations about changing lives. The most specific representations appear on the organization's website where specific numbers and percentages

about program service levels are reported. The same statistics appear in the annual performance review of the CEO.

To determine their accuracy, we focused on the specific representations about GICW's performance that we considered the most important. These representations are listed below as they appeared on GICW's website at the time of our review.<sup>1</sup>

- In 2003, Goodwill employed 2,700 people, paying them wages, taxes and benefits totaling \$35,780,597. Approximately 2/3 of Goodwill's employees are people with disabilities or other barriers to employment.
- Store revenues also fund other Goodwill services like our free Job Connection program and English-as-a-Second-Language classes. In 2003, we served 6,561 people through our Job Connection program.
- Thanks to your generosity in 2003, 11,445 people received services through Goodwill's vocational programs.

We then attempted to understand what GICW meant when it referred to "people with disabilities" or "other barriers to employment" (otherwise known as "disadvantaging conditions").

We determined that GICW has created a list of "disability" and "disadvantaging" conditions and has written definitions that describe the characteristics of each condition. If one of GICW's employees or a nonemployee recipient of services has one or more of these conditions, that individual is counted in tabulating the number of people served during the year.

The "disability" conditions are relatively straightforward; they include disabilities such as *Blindness*, *Hearing Impairment*, and *Neurological Disorder*. However, as described more fully below, what constitutes a "disadvantaging" condition is somewhat subjective. Although there would be no argument as to whether to classify blindness as a disability, whether someone has a disadvantage is in some instances open to interpretation.

The next step in the audit process was to learn how individuals are classified as having a disability or disadvantaging condition. To accomplish this, we met with the administrative employee who is primarily responsible for making that determination as to newly-hired GICW employees. For these employees, this determination is in most instances made through a review of the self reported conditions listed on the application for employment and the medical history questionnaire which is completed after hiring. Classification can also be made based on observations of, or interactions with, the individual. For instance, someone enrolled in the English-as-a-Second-Language program would be classified with the disadvantaging condition of *Non English Speaking* which GICW considers is a barrier to employment. If someone has more than one disability or disadvantaging condition, the individual is only counted once under the most severe condition. GICW assigns a code to each disability and disadvantaging condition.

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<sup>1</sup> [www.meetgoodwill.com](http://www.meetgoodwill.com)

We then tested the accuracy of the codes assigned to a sample of current employees by GICW. Without exception, GICW's documentation demonstrated that classification was made in accordance with company procedures. Through additional audit steps, we were able to verify the accuracy of total program service numbers and percentages used in representations by reviewing supporting detail reports and records.

### Commentary

As noted above, GICW systematically and consistently classifies the disabilities and disadvantaging conditions of its employees, and we verified the accuracy of other representations made by GICW. Nevertheless, we recommend that the Board examine several procedures. During our review we found that, in some circumstances, people who received services through GICW's different vocational programs may be counted more than once. For example, this can occur if someone with a disability or disadvantaging condition is placed through the Job Connection program into a position of employment at GICW. In that case, the individual will be counted once as having received services through the job placement program and again as an employee. This is appropriate in accounting for services rendered by each of the programs (job placement and direct employment) separately, but results in a misleading statistic when data about the programs are combined.

Employees retain their original classification for the duration of their employment. Yet there are instances where, over time, the condition changes. For example, an employee originally classified as being *Illiterate* may learn to read. Conversely, an employee with no disability or disadvantaging condition at hiring could subsequently be disabled or be afflicted with a disadvantaging condition.

Because GICW makes specific numeric representations about the level of its program services and the characteristics of those served, it should periodically review and adjust classifications applied to long term employees.

In 2003, those with disadvantaging conditions accounted for 65% of the 11,445 people who received services while those with disabilities accounted for the other 35%. As stated previously, the determination of whether someone has a "disadvantaging condition" is subjective. For example, one disadvantaging condition is *Advanced Age* which, according to its definition, is an individual aged 55 or above. We agree that age may be a barrier to an older worker attempting to find employment in certain fields. But we do not agree that every individual over the age of 55 years is disadvantaged in relation to every potential vocation. For example, a 56-year old retiree working on a part-time basis at GICW to earn some supplemental income would be classified as having a disadvantage regardless of the retiree's skills and capabilities.

Two-thirds of GICW's workforce is classified as having either a disability or disadvantage. Of this two-thirds, just under half are included in the disadvantaged categories of *Chronically Unemployed*, *Dislocated Worker* or *Working Poor* with the vast majority being *Working Poor*. Since these categories account for such a large percentage of the overall

represented program service levels, their legitimacy as barriers to employment takes on added importance.

GICW defines *Chronically Unemployed* to be individuals who are without jobs for 27 weeks or more while being available to work, and *Dislocated Worker* as individuals affected by mass layoffs, plant closings or those who reside in areas of high unemployment. Although we might reasonably infer that a person unemployed for 27 weeks or more faces one or more “barriers” to employment, the “Dislocated Worker” classification may be overinclusive. A worker laid off by a plant closing or residing in an area of high unemployment may or may not face barriers to reemployment.

The *Working Poor* disadvantaging condition may also be misleading. This condition applies to those who earn less than a living wage. In defining “living wage,” GICW selected the rate identified by the Northwest Federation of Community Organizations in its 2004 Northwest Job Gap Study. This is \$10.17/hour for a single adult (and \$10.96/hour if very basic private health insurance is added). The living wage increases with the number of dependents. The minimum wage in Oregon is currently \$7.25/hour, and many positions in both the private and nonprofit sectors pay less than the “living wage” defined by GICW. Workers employed in such positions do not uniformly confront “barriers” to other employment. For example, we doubt that the public generally would consider that a college student working part-time in a school cafeteria for minimum wage confronts a “barrier” to employment.

Whether the *Working Poor* disadvantaging condition results in misleading reports is further called into question because GICW itself pays less than a “living wage” to some of its newly hired competitive position employees classified as having a disability or disadvantage. GICW’s representations imply that persons employed by GICW *formerly* experienced “barriers to employment.” Instead, GICW’s compensation may be insufficient to eliminate the barrier. In addition to salary, GICW does provide its employees with several benefits including medical and dental insurance after six months of employment. Many Oregon employers do not offer such benefits. Yet, when salary and benefits are combined, GICW still pays some of its disabled and disadvantaged workforce less than the Job Gap Study rate. We realize, of course, there are instances when GICW offers employment to someone who is either unemployed or inexperienced and provides the opportunity to acquire the skills and experience necessary to find a better paying position at or above a living wage either through promotion within GICW or at another employer.

It is worth noting that GICW does not automatically classify everyone with a history of low paying jobs as *Working Poor*. Instead, consideration is given to the individual based on his or her particular circumstances. For instance a 20 year old high school graduate whose limited job experience includes a few menial positions would not be classified as *Working Poor*, but a 40 year old with a history of low paying jobs and an inability to hold steady employment would be.

We understand GICW may find it useful to use categorical classifications such as the foregoing for internal tracking purposes. However, when GICW uses this data in its external representations, it must be careful not to mislead the reader into thinking it provides charitable services to more individuals than it really does.

One way GICW can avoid overstatement is by distinguishing between the number of disabled people it serves and the number of disadvantaged people it serves, instead of combining them and reporting the combined data without further explanation. Providing information about how reported figures are distributed among the various conditions, and making the definitions of these conditions more widely available, would also be of value.

The Department of Justice does not question that GICW provides valuable services to needy individuals, nor do we question the reported levels of service provided as they are defined. But we believe some changes are needed in how service levels are compiled to prevent double counting and to remove outdated classifications, and that added care needs to be given in using this data in representations. Taking these actions will allow potential donors to be more knowledgeable when deciding their level of support for the organization and will also allow the Executive Committee to make more informed decisions when setting CEO compensation.

## **GICW CEO COMPENSATION**

### **Compensation Process**

In determining whether executive compensation is reasonable or excessive, it is necessary not only to look at the total salary and benefits but also to have an understanding of each piece of the overall package.

The total remuneration paid to Miller as CEO is a combination of compensation and benefits. The compensation portion is composed primarily of base salary and bonus, while the benefits portion is composed primarily of deferred compensation and retirement plans.

At least five of GICW's executives have salary/benefit packages in excess of \$100,000, as reported on the organization's 2003 Form 990 return. Except for Miller, the total package for each of these individuals ranges between \$100,000 and \$200,000.

Miller's compensation and benefit totals as they were reported on GICW's Form 990 tax return are listed in the table below.

Form 990	Compensation	Benefits	Total
2004	\$ 575,454	\$ 256,054	\$ 831,508
2003	533,278	252,168	785,446
2002	484,348	51,229	535,577
2001	441,859	144,540	586,399
2000	405,358	120,283	525,641
1999	362,524	147,480	510,004
1998	346,251	170,858	517,109

Since these totals have multiple components, we obtained from GICW a year-by-year breakdown of component amounts to aid our review. *See Attachment #1.*

In 1996 GICW and Miller entered into an employment agreement which was modified slightly in 2000. The initial agreement was for a five year term and allowed one year extensions. The agreement established a starting base salary to be adjusted annually for a cost-of-living increase. This agreement also provided for a discretionary annual bonus to be awarded based on performance during the preceding year. The stated purpose of the bonus is to compensate the CEO for above average or outstanding performance “and/or to make total compensation equal to the reasonable value of the CEO’s services”. Base salary and bonus are the two largest compensation components.

In 1996 GICW and Miller also entered into a deferred compensation benefit agreement. This non-qualified supplemental retirement plan, as it is described in GICW’s audited financial statements<sup>2</sup>, provides a severance benefit equal to \$74,000 times the number of full or partial calendar years between December 19, 1996 and the date of eligible termination of employment. For Form 990 reporting purposes, GICW correctly does not report the full \$74,000 each year as an expense but instead reports only the change in the present value of the accumulated balance of the liability that has been accrued. Because nine years have transpired since origination, the total liability that will ultimately be paid is \$666,000 as of December 31, 2004.

Another benefit component afforded to Miller is a “Rabbi Trust”<sup>3</sup>. As explained in the footnotes of its audited financial statements, GICW established this trust in 1993, to encourage and recognize efforts of management employees the Board selected as trust participants. As of the date of this report, Miller is the only manager who has been so selected. Under this plan, discretionary contributions made by the Board are held and invested by the trust, subject to the claims of GICW’s general creditors in the event of insolvency, until the funds are paid to the participant. For Form 990 reporting purposes, GICW includes as a benefit both the annual contribution to the trust (which for each year since 1998 has been 15.4% of base salary) and the change in the accumulated balance (which for some years has been a decrease due to poor investment returns). As of December 31, 2004 the accumulated balance in the trust had a market value of over \$636,000.

The other compensation and benefit components that appear on Attachment #1 but are not described above account for only a small percentage of the total remuneration and, therefore, will not be separately discussed except as they relate to our analysis of total remuneration.

For the period under review, the authority to determine compensation paid to the CEO was delegated by the Board of Directors to the Executive Committee. After we began our audit, GICW modified its process. In the future, the Executive Committee will instead make a recommendation to the full Board of Directors for its final review and decision.

The Executive Committee is composed entirely of members of GICW’s Board. It meets on a bimonthly basis and in the spring the Executive Committee devotes one of its meetings to

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<sup>2</sup> Audit conducted by Jarrard, Seibert, Pollard & Company, LLC

<sup>3</sup> We understand a “Rabbi Trust” to be a type of nonqualified deferred compensation arrangement in which amounts are transferred to an irrevocable trust to be held for the benefit of one or more executive employees. It is so named because it was first used to provide deferred compensation for a rabbi.

evaluating the CEO's performance and to setting compensation. At each of the meetings between 1998 and 2003, the Executive Committee decided, based on positive performance reviews, to provide a base salary cost-of-living adjustment equal to the Consumer Price Index – West Index; award a discretionary performance bonus; award a discretionary Rabbi Trust contribution; and extend the employment agreement for an additional year.

Throughout 2005, the Board has deferred making compensation decisions based on 2004 performance pending completion of our audit. Consideration of this bonus is discussed at the end of this report.

Until 2003, the Executive Committee did not keep minutes of its annual performance review and compensation setting meeting. Prior to 2003, the Executive Committee relied upon its notification letter to Miller as documentation of its decisions regarding executive compensation but kept little record of how and why it arrived at those decisions.

To learn the process followed by the Executive Committee in making its decisions about executive compensation, we met individually with Young and Aldrich who both serve in key officer positions and are long serving members of the Executive Committee. We also reviewed the compensation studies and surveys and other documentation used by the Executive Committee in making its decisions. In the following paragraphs we summarize this process. Our analysis of this process is discussed in a later section of this report.

One of the documents reviewed by the Executive Committee each year was a report on GICW's performance in achieving the main objectives of the organization. The report includes both financial and nonfinancial results compared against set corporate goals and includes a list of achievements. Within this report are the same representations on program service levels that appear on the organization's website and the accuracy of which was tested during our audit.

GICW participates in an annual executive salary survey conducted by GII and receives a copy of the survey results. This survey was reviewed by the Executive Committee as part of its compensation setting analysis. The survey participants are different GII organizations located throughout the country. Responses to the various questions on compensation and benefits are reported in total for all respondents and are also categorized by revenue levels. This allows an organization to see how its executive compensation compares with other organizations of a similar nature and size.

In 1999 the Executive Committee obtained a copy of a compensation study prepared by James & Scott Associates, Inc. for Goodwill Industries of Southeastern Wisconsin whose Executive Director is Miller's brother, John Miller. According to Young and Aldrich, the Executive Committee relied on this study. After we began our audit, GICW commissioned its own compensation study by Milliman, Consultants and Actuaries.

## Legal Background

The subject of excess compensation is frequently discussed yet imprecisely defined. This audit represents the first time that this office has addressed the issue in some detail. This is primarily because the vast majority of charitable organizations do not pay substantial compensation. By way of example, for year 2003, the Department registered 11,484 reporting charitable corporations and trusts headquartered in Oregon. Of those organizations, only 156 paid one or more executives or key employees a salary of \$100,000 or above. Most of these executives or key employees work for universities, hospital/health care systems, major foundations or international relief organizations headquartered in Oregon.

Principles for establishing the propriety of executive compensation have been established for some time. However, those principles are evolving; authoritative sources describing “best practices” have recently emerged. Below, we review the state and federal law and then highlight guidance from emerging “best practices.”

Oregon law provides little explicit guidance. The Oregon Nonprofit Corporation Act makes no direct reference to the subject. ORS 65.551 provides that a nonprofit corporation shall not make any distributions. However, the Commentary of the Revised Model Corporation Act (adopted by Oregon in 1989) provides that “the payment of reasonable compensation for services rendered” is not an improper distribution. There are no noteworthy state executive compensation decisions defining “reasonable compensation.”

At the federal level, the Internal Revenue Code (the “Code”) at Section 501(c)(3) has long prohibited “private inurement” of a charity’s net assets. In 1996 Congress added Section 4958 to the Code, which imposes “intermediate sanctions,” i.e., excise taxes, on persons who have substantial influence over a charity and who engage in “excess benefit transactions” with the charity. Section 4958 does not impose any liability on the charitable organization itself. An organization’s payment of reasonable compensation for services rendered does not constitute private inurement or excess benefit. Treasury Regulations under Section 4958 were issued in final form in 2002. Section 4958 applies to transactions entered into after September 14, 1995. The final Treasury Regulations were effective January 22, 2002.

The federal regulations establish a process for an exempt organization to establish a rebuttable presumption of reasonableness. There are three conditions in order to qualify for the presumption: (1) the compensation was approved by a disinterested board or committee of the corporation or trust, (2) that obtained and relied upon appropriate data as to comparability, and (3) that adequately documented the basis for the comparison. *See* Reg. §53.4958-6(a). As to the last requirement, the documentation must be prepared before the next meeting of the board or committee which authorized the compensation, or within 60 days, whichever is later. *See* Reg. §53.4958-6(c)(3)(ii). To qualify for the presumption, all three components must be satisfied. *See* Technical Advice Memorandum (TAM) 200244028.

The regulations also describe relevant information for purposes of identifying appropriate data as to comparability.

In the case of compensation, relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person. *See* Reg. §53.4958-6(c)(2)(i).

The federal regulations do not go further in describing similarly situated organizations. The legislative history provides that existing law (such as IRC §162(a) relating to reasonable compensation as a deductible business expense) would continue to apply. Therefore, it may be appropriate in assessing the reasonableness of Miller's compensation to consider factors cited by the courts in applying §162 to evaluate the reasonableness of for-profit corporation salaries. For instance, one decision found a compensation package to be excessive in part because it was "bonus-heavy and salary-light" (in the case of a salary of \$300,000 and a bonus of \$600,000). *See Rapco, Inc. v. Commissioner*, 85 F.3d 950 (2d. Cir. 1996).

Congress is reviewing federal law. Faced with significant evidence of a variety of abuses within the nonprofit charitable sector, Senator Charles Grassley, Senate Finance Committee Chair, initiated hearings in June 2004. The Finance Committee's review remains a work in progress, although Senator Grassley has promised to introduce reform legislation in 2006. One of the concerns identified at the initial committee roundtable discussion was that nonprofits abused the use of for-profit compensation as a "comparable." Some witnesses suggested abolishing or seriously modifying the rebuttable presumption. In response, the American Bar Association Section of Taxation wrote to the committee on September 15, 2004 urging the committee not to repeal the rebuttable presumption or abolish all uses of for-profit compensation data. The Section of Taxation urged retention of comparisons to for-profit compensation, subject to the following limitations:

We believe that the Regulations should require nonprofit organizations to look *primarily* to comparisons from the nonprofit sector in determining whether compensation is reasonable. For-profit comparison data may be used to supplement nonprofit data, but the nonprofit organization would have to explain the necessity of looking to the for-profit sector.

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We suggest, however, that in setting . . . performance-based incentive payments and other benefits, the nonprofit employer should not simply adopt the compensation structure of the for-profit entities. Incentive compensation that would not be excessive in the Wall Street context might well make the total compensation package excessive in the nonprofit context. Thus, it may be appropriate . . . to put in place a dollar cap that would limit the total compensation, including all performance-based incentives, to a figure that is objectively reasonable.

We also believe that there are at least two instances when it is entirely

appropriate for a nonprofit employer to rely “primarily” on comparability data from the for-profit sector. Specifically, the Regulations should state expressly that a nonprofit organization will be permitted to rely “primarily” on for-profit comparables if the organization can demonstrate either that (a) sufficient nonprofit comparables do not exist to enable the governing body to make a decision consistent with its fiduciary duties, or (b) there is a single labor market in which both for-profits and nonprofits must compete for the same limited pool of qualified candidates. The Regulations should provide examples of both the insufficient data and single labor market exceptions to provide guidance regarding the parameters of each. We offer the following illustrative examples:

*Insufficient data:* There may be insufficient nonprofit comparables for nonprofit employers that work with emerging technologies or that develop innovative economic development programs for the underprivileged, such as micro-lending for inner city businesses, global financing of medical treatment programs in Africa, or the development of effective and low-cost distribution systems for medical services in developing countries.

*Single labor market:* Surgeons, intensive care nurses, and other medical professionals are in short supply and are sought by both for-profit and nonprofit hospitals. Technology experts, auditors, accountants, and the like perform tasks that are substantially similar whether they work for a nonprofit or for-profit employer. Because of the limited labor pool and the substantial similarity between the for-profit and nonprofit jobs, a nonprofit organization would have difficulty hiring qualified employees if comparable compensation packages were not offered. (Emphasis in original)

### **Best Practices**

Authoritative sources recently have described best practices in the field of nonprofit compensation. One of the most comprehensive sources is a recent publication by BoardSource (formerly the National Center for Nonprofit Boards): Vogel, Brian H. and Quatt, Charles W., *Dollars and Sense: The Nonprofit Board’s Guide to Determining Chief Executive Compensation* (2005).

The BoardSource publication offers the following guidelines:

**(1) Review of the chief executive’s compensation is a matter for the full board.**

“Review of chief executive compensation by the full board (regardless of whether or not a separate committee bears major responsibility for setting compensation) is not just good practice; it is vital because chief executive compensation is public domain information. Each board member should therefore understand and be able to justify the full board’s compensation decision, as well as the board’s overall process for setting

and reviewing chief executive compensation, including the respective roles of the full board and any smaller committee(s)”. *Dollars and Sense*, p.2.

- (2) **Nonprofit executives should be well paid but should not expect compensation packages equivalent to the for-profit world.**  
“Nonprofit salaries have risen over the last decade, and pay practices such as bonus and deferred compensation, formerly seen only in for-profit organizations, are now increasingly common in nonprofit organizations, though they remain a minority practice. Nevertheless, pay in the nonprofit sector remains below that of the for-profit sector, especially at the top of the organizations. Even chief executives who expect competitive pay do not generally expect that their nonprofit compensation will equal what they could earn in the for-profit world. Earning money is not the mission of nonprofits. Most nonprofit employees – and all good nonprofit chief executives – get their deepest job satisfaction from helping their organizations achieve their missions”. *Dollars and Sense*, pp. 17-18.
- (3) **Executive cash compensation should be compared to the total cash compensation (salary plus bonus) of the marketplace.**  
“The base salary amount will also depend on whether or not the organization chooses to include a bonus or incentive element. In looking at the marketplace, the organization should compare the proposed total cash compensation for the chief executive (base salary plus bonus or incentive) to market total cash for its marketplace. An organization may choose to offer a higher base salary and no bonus or incentive, or a lower base salary with a bonus or incentive; but in either case the total package should be benchmarked against market total cash for the organization’s marketplace”. *Dollars and Sense*, p. 37.
- (4) **The chief executive’s pay should not be disproportionately higher than other staff.**  
“Staff members expect that the chief executive’s pay will be broadly consistent with the pay levels and compensation structure for the rest of the organization and with the chief executive compensation offered in the past. Broadly consistent does not mean identical; it means logical given the existing compensation structure and the culture of the organization. The chief executive’s pay will in almost all cases be higher than that of other employees, but it should not be disproportionately higher”.

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“In the author’s experience, the chief executive salary is set at most 60 to 70 percent above that of the next highest paid employee”. *Dollars and Sense*, pp. 33-34.
- (5) **Bonus and incentives tied to performance are appropriate, however, with nonprofits, they should be relatively modest.**

“Bonus and incentive amounts at nonprofits are relatively modest by the standards of for-profit organizations. Recent surveys have found a median chief executive bonus amount of 15 to 22 percent of base salary for those organizations that provide extra compensation. In the authors’ experience, incentive percentages can be as low as 5 percent of base salary; they are rarely higher than 25 to 30 percent of base”. *Dollars and Sense*, p. 40.

### Observations

Applying the preceding legal and best practices principles leads to the following observations.

**(1) Review of executive compensation is a matter for the full Board of Directors.**

There is a growing sentiment within the nonprofit sector that the compensation of the chief executive should be approved by the full board. Most recently, Independent Sector, in its report to the Senate Finance Committee, unequivocally adopted this position. *See Report to Congress and the Nonprofit Sector on Governance, Transparency, and Accountability*, p. 67, (2005). Historically, the full Board of GICW neither approved nor critically reviewed the work of the Executive Committee in setting CEO compensation. In the case of GICW, one of the problems with this approach was the insular nature of the Executive Committee. There was very little turnover of the membership of this committee, resulting in little or no critical examination of its historic approach to the compensation issue. In the course of our audit, we were advised that, beginning in 2005, GICW has changed its procedure so that the Executive Committee will make a compensation recommendation to the full Board of Directors which will make the final review and decision. We commend this change.

**(2) GICW’s historic procedures have been inadequately documented.** GICW did not keep minutes of annual executive compensation decisions until 2004. The preparation of the 2004 Executive Committee minutes suggests that the organization intends to institutionalize documentation procedures in compliance with Reg. §53.4958-6(c)(3). Again, we approve this change.

**(3) The amount of cash bonuses awarded exceeded current best practice standards.** A key feature of the annual compensation package has been a substantial cash bonus based on a review of the CEO’s performance for the prior year. There is nothing inappropriate or illegal about providing annual financial performance incentives. On the contrary, doing so for nonprofit managers is a forward-looking concept. Nevertheless, the nonprofit must establish meaningful performance metrics to use in calibrating bonuses. We encourage the Executive Committee and Board to take the time periodically to review the performance measures to determine if they need to be revised or updated and, of course, to carefully and objectively rate the performance of the CEO annually. Historically, GICW has used the same performance metrics for a number of years. Because of the lack of minutes, we could not determine how often the measurements were critically reviewed. Because the measurements are objective, and the data support a conclusion that the measurements were annually achieved, we have no quarrel with the

proposition that Miller was annually entitled to a bonus. However, the size of the bonus (now almost equal to the base salary) is inconsistent with bonuses paid to nonprofit organizations (the median is 15% to 22% of base salary). *See Dollars and Sense*, p. 40, footnote 33. Likewise, as will be discussed below, the total compensation package must not exceed that of comparable organizations in the marketplace.

**(4) Miller's compensation package from the late 1990s to 2004 has been unreasonable.**

It is clear that the Executive Committee believes Miller deserves to be well-paid and that the Executive Committee believes he would be difficult to replace. However, we did not uncover any information documenting that Miller seriously entertained the prospect of leaving GICW at any time during the period covered by our audit. Certainly, no written job offers from other employers were delivered to the Executive Committee.

Compensation may not be decided in a vacuum; there must be some frame of reference to ensure that it is reasonable. The IRS reasonableness standard provides a good starting place: what would ordinarily be paid for like services by like enterprises under like circumstances? *See IRS Instructions for Form 990 (2004)*, p. 12. The result is that the organization must develop a methodology for determining a like marketplace. An excellent list of factors is summarized in the BoardSource publication:

**Factors to Consider When Defining Your Organization's Marketplace**

- *The organization's mission:* Executive Committee and Board members should first consider which organizations are doing the same or similar types of work.
- *Organization size:* Organizations should compare themselves to others within a reasonable size range as measured in terms of budget and number of staff. Standard surveys usually organize their data into budget and staff size groupings, for example, below \$2.5 million, \$2.5 million to \$5 million, \$5 million to \$10 million, and so on. Endowment size (for those organizations that have endowments, such as foundations) is another measure of organization size.
- *Organization scope:* Does the organization work entirely at the local level? Is it statewide? Regional? National? International?
- *Organization location:* Where is the organization based? An organization may be national in scope, and hence recruit in a national marketplace, but be located in a place with an unusually high or low cost of living that should be reflected in the salary. For example, compensation in New York City is generally above national market levels because of the extremely high cost of living in Manhattan.

- *The specific requirements for the position:* The strategic analysis and job description should determine the specific and special needs for the position. Special technical skills can be a factor in determining the appropriate marketplace – for example, the chief executive must be an M.D. or a lawyer, or have experience in media or information technology.
- *Length of service and experience:* In determining the appropriate marketplace for a serving chief executive, it is appropriate to look at organizations whose chief executives have comparable length of service and experience.
- *Chief executive recruitment sources:* Types of organizations from which a chief executive might be recruited, or to which he or she might go, can be included even if the missions of such organizations are somewhat different. The goal is to establish the market for the chief executive's services. A word of caution here: although understanding recruitment sources can help in setting compensation, it does not determine compensation, especially when the candidates are being recruited from the for-profit sector. The fact that an executive from the for-profit sector is considered a viable candidate for a nonprofit position does not necessarily define the marketplace. Pay must always meet nonprofit market standards. *Dollars and Sense*, p. 19.

As suggested by the first two factors, the organization should begin by developing a list of organizations of the same relative size with the same or similar program mission. Because staff size information is more difficult to obtain, the focus is usually on organizations with similar revenues and expenditures.

The GICW Executive Committee has applied few, if any, of the above factors. The only specific nonprofit data in the possession of the committee has been the GII annual survey, and it is unclear how that has been used or what weight has been attached to it. There has been no attempt to isolate comparable organizations by similar mission statement, geography, scope of program or organization location. The overriding methodology seems to have been to focus on the retail aspect of GICW's operations. To the extent comparables were used, the overwhelming emphasis was on paying compensation equal to nationwide for-profit retailers, many of which were generating revenue two to three times the size of GICW. There was no documentation that suggested the committee gave substantial thought as to whether incremental compensation increases would be better spent on other employees or the beneficiaries of its charitable program.

Based on interviews with Young and Aldrich, it appears that the Executive Committee arrived at a compensation package for Miller based initially on what the committee intuitively thought he was worth. As the compensation climbed, the committee decided it was important to obtain a compensation study to ensure that the intended compensation figure was within an appropriate range. Sometime in 1999, the organization obtained a study prepared for the Milwaukee, Wisconsin-based Goodwill prepared by the firm of James & Scott Associates, Inc. GICW relied on this study until it first commissioned its own study in 2004 following the

commencement of this audit. The 2004 study was prepared by the Seattle office of Milliman, Consultants and Actuaries.

With respect to Miller's compensation, the most revealing document is a letter from Young to Aldrich, dated January 17, 2000, *see* Attachment #2. It seems to conclude that (1) the compensation committee could rely on the James & Scott study, (2) that the study generally was designed to develop data on for-profit compensation structures, including stock options, for "relevant" sized for-profits, and (3) based on the study, Miller's compensation was "fair and reasonable" (if anything, he was underpaid). This analysis formed the basis for subsequent years' compensation decisions. As will be discussed shortly, we believe the analysis was flawed. But it is also important to recognize that the committee clearly relied on a peer group analysis of all *for-profits* of a "relevant" size. There was no attempt to take an in-depth look at comparable *nonprofits*.

For the calendar year 2000, the committee ultimately approved total compensation of \$506,366, *see* Attachment #1. This is less than the total compensation 25<sup>th</sup> percentile number (\$678,832) cited in the Young letter. The chart on page 2 of the Young letter is duplicated from a chart attached to a letter from Aldrich to the committee on November 9, 1999. In turn, Aldrich relied on the James & Scott findings in compiling the data for the chart. Careful examination of the James & Scott study is, therefore, important. There at least four fundamental problems with the analysis/use of the James & Scott study.

First, there is no identification of the entities that form the composite data. It therefore becomes difficult to critically evaluate that data. Second, it is not clear how nonprofit data is incorporated in the study. For all appearances, James & Scott relied heavily on general for-profit comparables. Third, the James & Scott study used a target peer group of \$120 million in projected sales, *see* Attachment #3. At the time, GICW had annual revenue of approximately \$44 million. There is no effort to reduce the James & Scott numbers accordingly for an organization which is only 37% the size of the target peer group. This is contrary to generally recognized methodology.<sup>4</sup>

Next, the "total cash" compensation for all surveyed retailers in the 25<sup>th</sup> percentile is \$264,700 or approximately 19% more than base salary. However, Aldrich/Young use a bonus percentage of 45% and a stock option percentage of 159%, *see* Attachment #4. There are two problems with these percentages. They are from data for all for-profits (not even limited to retailers) and they are based on data collected *only* from companies that either pay bonuses or give stock options. Companies that neither pay bonuses nor give stock options are excluded. As a result of these flaws, GICW did not have objective data from comparable organizations when it made successive decisions about Miller's compensation.

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<sup>4</sup> "A showing of comparability requires detailed data showing that the total compensation and benefits provided to executives is comparable to those provided by similarly situated organizations for similar positions. Make sure that the organizations represented in market data are of a similar size to the organizations being examined (primarily in terms of annual net revenue). If data from significantly larger organizations are used, and if the data are reduced to be comparable to the organization being examined, be sure that this reduction is clearly indicated in the reports and minutes." *Tax-Exempt Organizations Face Compensation Scrutiny from the IRS*, Taxation of Exempts, Elizabeth M. Mills, p. 79, (September/October, 2005).

The data suffered from a further flaw. The IRS rebuttable presumption rules refer to “current compensation surveys.” The IRS has categorically rejected five year old data as “not meaningful.” See TAM 200244028. GICW did not update the James & Scott data – collected before 1999 – until the latter part of 2004. In TAM 200244028, the IRS also rejected the offered survey because it had not been reviewed by the Board of Directors until well after the executive compensation decision was made. Similarly the Milliman study commissioned in 2004 by GICW would have no rebuttable presumption value for purposes of the 1998 – 2004 GICW compensation decisions.

What then is the appropriate methodology? GICW should begin by identifying organizations with the same or similar mission. If a significant number cannot be located in the proximate regional area, a nationwide search is permitted. Next, emphasis should be placed on the size of the organization. One of the most readily available ratios is executive compensation as compared to the organization’s revenue. We considered the available data for four groups.

**(1) Other Goodwill Member Organizations**

The national organization, GII, regularly compiles an executive compensation survey from its member organizations. We have reviewed several of these surveys. The format is not informative. James & Scott make reference to it in their study but it is not clear how James & Scott used the information.

Today, the information for each member organization is readily available on GuideStar ([www.guidestar.org](http://www.guidestar.org)). We have summarized the data. See Attachment #5. We believe this to be a better source than GII’s compilation. The most relevant inquiry is comparing total compensation as a percentage of total revenue (“compensation ratio”). Based on GuideStar data, Miller’s 2003 compensation ratio is 1.19% (adjusted to delete the gains to his Rabbi account). The overall average is 0.61% and no other Goodwill organization with revenue in excess of \$40 million has a ratio in excess of 0.72%.

**(2) Other Related Nonprofits**

GICW may view its operations as relatively unique. Even so, other sizable nonprofit organizations are engaged in vocational rehabilitation. Many report receiving a significant amount of program service revenue. This suggests that those organizations are conducting some form of selling of goods or services akin to GICW’s retail operations. Attachment #6 provides executive compensation information for all such organizations throughout the country with annual revenue in excess of \$25 million. The compensation to revenue ratio demonstrates that GICW is out-of-step with this group. For organizations with revenue ranging from \$27.2 million to \$167.4 million, the average compensation ratio is 0.40%.

**(3) For-Profit Thrift Operations**

As suggested in *Dollars and Sense*, the executive compensation for nonprofits should be compared to organizations with the same or similar missions. *Dollars and Sense*, p. 19. We have not been able to locate any for-profit organizations devoted to vocational rehabilitation and none has been cited in any of the studies relied upon by GICW.

GICW achieves its objectives, in part, by operating retail thrift stores. GICW believes that this justifies comparisons with for-profit retailers. Even assuming that comparisons to for-profit companies is appropriate, at least two difficulties counsel more caution than GICW has exhibited. First, the for-profit segment of the retail industry most closely approximating GICW's mission would be other thrift stores. For example, TVI, Inc. operates thrift stores under the name Value Village. Data from that segment of the retail industry would be much more useful than comparisons to other retail stores. Second, salary comparisons to other thrift retailers will be difficult because they appear to be privately owned. This means that salary data are not publicly available.

#### **(4) For-Profit Retail Comparables**

State law is silent on the use of for-profit comparables in setting nonprofit compensation. In general, our expectation is that data from the nonprofit sector will be the primary source for comparables. Except in the case of insufficient nonprofit data or a "single labor market, nonprofits that rely on for-profit data likely will set executive compensation at excessive levels. *See Dollars and Sense*, p. 19.

As noted above, the James & Scott study relied upon by GICW cannot be critically analyzed because no for-profit entities are specifically identified. In the case of the later Milliman study, it is apparent that the authors focused on retailers of consumer products (such as apparel, shoes, furniture and general retail merchandise). Milliman was able to produce a list of 12 such retailers, most substantially larger than GICW with revenue in excess of \$100 million.

Using data from Economic Research Institute, a prominent executive compensation consulting organization with a substantial database, we were able to locate an additional 11 similar retailers (the annual revenue for the total 23 entities ranges from \$31.2 million to \$177.1 million). We combined our results with the Milliman sample. Attachments #7 and #8 show the results.

The first attachment (Attachment #7) includes all identified compensation except for stock options. The average total revenue is \$89.7 million, average chief executive compensation is \$331,934 and the average ratio of compensation to revenue is 0.45%. This compares to \$58.1 million, compensation of \$693,270 and a ratio of 1.19% for Miller in 2003.

The second attachment (Attachment #8) includes stock options. Many competing methods for arriving at a valuation exist.<sup>5</sup> The attachment includes the valuation calculated by Milliman for each of the Milliman identified entities that offered stock options. We doubt the utility of using the present value of stock options as a factor in setting nonprofit executive compensation. First, no definitive methodology exists to fix the present value. Second we are not aware of any authoritative source, including the IRS, that has recognized stock options as an important component of valuation comparables for nonprofit charitable organizations.

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<sup>5</sup> See Pratt, Shannon, Reilly, Robert and Schweih, Robert, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, p. 553-564 (2000).

Beyond the speculative nature of the valuation and the absence of legal authority approving their use, there are at least two additional reasons for de-emphasizing stock options. Both are illustrated by entities in the Milliman group. First, although publicly traded, some of these organizations are closely held. There is no completely independent Board of Directors and there is little management turnover. In some cases, management owns a substantial portion of the outstanding shares. In such companies, managers are deciding how much to reward themselves and it seems unlikely that CEOs who themselves own part of the company will be recruited by competitors or that the company will need to recruit new executives. For example, Jennifer Convertibles is a publicly-traded firm that was included in the Milliman study. Harvey Greenfield is a co-founder of the company, has served as CEO since 1986, owns approximately 10% of the outstanding shares and serves as one of two individuals on a committee with full authority to award stock options, including his own.

Stock options in other for-profit companies represent a questionable comparable for a further reason: an executive position with some of them is extremely risky. In such companies, CEOs hired from the outside who fail to produce a level of expected profit face swift termination. Harold's Stores, Inc. is an example of such an organization. Harold's Stores has had three CEOs in a five year period (2000 – 2004). Stock options are perceived as an offset for this climate of job volatility. No evidence exists suggesting that GICW specifically or nonprofits generally have similar turnover at the executive level.

And even if stock options held by CEOs in for-profit companies were to be considered comparable to GICW, the ratio of Miller's compensation to revenue is more than twice that for CEOs in for-profit firms (0.53%).

## **RECENT CHANGES**

As previously noted, during the course of our audit, GICW took initial steps to update its executive compensation policies. For example GICW transferred the final annual review and decision to the full Board of Directors. The organization also commissioned its first custom compensation survey in the fall of 2004, and followed up with a second survey in December 2005.

Subsequent to learning of the Department's concerns, GICW embarked upon an accelerated program to address the majority of the findings contained herein. First, the Board approved two new policies/procedures. It adopted an Executive Compensation Committee Charter and a Total Compensation Philosophy policy statement (*see* Attachments #9 and #10).

With respect to the Committee Charter, the committee is to develop goals and performance criteria to be used in determining annual and long-term executive incentives, is directed to engage a compensation consultant who is to gather appropriate comparability data and, ultimately, to develop compensation recommendations to be presented to the full Board of Directors. The philosophy document describes the values and parameters for establishing market-based executive compensation.

Following approval of these documents by the Board of Directors, a new Compensation Committee was selected and it worked with the compensation consultant to craft recommendations for the Board relative to the CEO's compensation. To be determined was the CEO bonus for 2005 (based on 2004 performance goals) and the framework for a 2006 compensation package.

The consultant recommended a median market base pay of \$300,000 and that the organization adopt a target annual incentive of 30% (with a maximum award of 60% of base pay). We note that, in recent years, the incentive pay was trending toward 100% of base pay. (though on a substantially lower base salary of \$243,600). The consultant further recommended that GICW adopt a long-term incentive plan beginning in 2006 with a minimum 3 year focus. No incentives would be paid until the conclusion of the focus period with a target incentive of 20% of average base pay over the period.

The committee recommended a 35% incentive for the 2004 bonus (based on a 2004 base salary of \$292,500). The result is a 2005 direct cash compensation of approximately \$394,000 compared with over \$500,000 in 2004. In the end, the downward adjustment represents a 24% reduction in direct compensation.

The consultant also recommended that GICW consider restructuring the components of the CEO's retirement package beginning in 2006. While contributions will continue to be made to the organization's qualified retirement plan, the consultant recommended terminating future contributions to the Rabbi trust (historically in the range of \$30,000 - \$40,000 per year). The consultant further recommended that allocations to the unfunded non-qualified deferred compensation plan be made in the future only to the extent necessary to generate a composite retirement income in the neighborhood of 55% of the employee's compensation (historically, GICW has accrued an annual liability of \$50,000 - \$70,000 to continue this plan). We understand that, on December 14, the full Board of Directors approved the recommendations of the consultant and the Compensation Committee described above with respect to 2004 and 2005.

At this time, the Department is not prepared to make a conclusive judgment as to the reasonableness of the restructured compensation package for the current or future year. A determination of the reasonableness of compensation is very fact specific. Our original analysis was based largely on 2003 numbers from Goodwill and those we perceived to be comparable nonprofit and for-profit organizations. Our initial perception is that the Board approved reductions are substantial; it is conceivable that, when viewed in the context of updated comparable data, the CEO compensation package may no longer be the outlier which formed the basis of our judgment as to earlier years. We understand that GICW has received updated comparable information from its consultant and we expect to engage in a further exchange of comparable data and analysis as to the impact of the reductions.

## CONCLUSION

GICW provides benefits to thousands of individuals who are challenged to overcome economic and physical barriers to productive careers. It achieves its results with relatively little government assistance. Under Miller's leadership, the organization has grown, both in terms of revenue and the number of people who benefit from its charitable programs.

Despite GICW's success, or perhaps because of it, GICW has not historically adhered to best practices in setting executive compensation. As detailed in this report, the historic implementation of compensation packages for Miller has been flawed in terms of both process and substance. As noted, the historic Executive Committee deliberations have not placed sufficient emphasis on nonprofit comparisons. As a result, Miller's pay has been substantially more than that earned by the CEOs of Oregon's other prominent social service organizations. *See Attachment #11.*

Law does not require executives to take a vow of poverty to work in the nonprofit sector. But "reasonable compensation" is a substantive legal standard. Although difficult to define precisely, we are certain that it at least means that very compelling reasons must underlie the decision of any nonprofit to pay an executive a salary in the very highest rank of all salaries paid in all industries. Miller's 2004 compensation ranks him in the top ½ of 1% of all American wage earners.

Having conveyed these concerns to GICW, the Department is impressed with the rapid response by the organization to address these concerns. All the changes detailed in the preceding section have occurred in the span of a little over one month. The adoption of new policies and procedures as well as the commitment to substantially reduce the CEO's salary and benefit package demonstrate a good faith endeavor to utilize new information and recommendations from its compensation consultant and to respond in a prudent and timely manner.

While the Department is encouraged with this initial response, we anticipate further work and dialogue between Goodwill and the Department in at least three areas.

- (1) Development of new and improved annual and long term goals when used as performance criteria for awarding annual and long term compensation incentives.
- (2) Continuing communications as the Board works to restructure the components of the CEO's retirement package consistent with the consultant's recommendations.
- (3) A continuing exchange of compensation data between the Department, GICW's compensation consultant and Compensation Committee to insure that compensation is targeted in a range consistent with Oregon law and the newly adopted GICW Total Compensation Philosophy document.

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We look forward to making further progress with respect to all of these issues in early 2006.

Sincerely,

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Attachments