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Show Me What I'm Looking For: A Trustee's Guide to Reviewing the New IRS Form 990

BY THOMAS K. HYATT

MUCH HAS BEEN MADE OF THE INTERNAL Revenue Service's introduction of the completely revised Form 990 last year. As I noted in an earlier *Trusteeship* article (January/February, 2008), this annual information return filed by most tax-exempt organizations, including private colleges and universities, has become the new report card for the nonprofit sector. Even some public colleges

TAKEAWAYS

- 1** The new IRS Form 990, required of private institutions and increasingly filled out by public institutions as well, demands review and critical analysis of the governance policies and practices that are at the very heart of effective board operation.
- 2** Review of the new form can be a daunting task, but it is now an important component of the trustee's fiduciary duty of care.
- 3** While the IRS is the primary intended audience for the information provided on the form, its public disclosure means that many other constituents of an institution, including donors and grant makers, are likely to review the information to assure themselves the organization is well run.

and universities, which are generally not required to file Form 990 with the IRS, are finding themselves preparing the 990 to satisfy disclosure requirements of fundraising campaigns, grant makers, or state regulators. The Internal Revenue Service's primary goals in implementing the revised form are to increase transparency and promote accountability and compliance. Indeed, the information required in the new form will offer the clearest picture to date of the governance practices and policies of tax-exempt organizations.

The new Form 990 is no longer a document focused on financial data. It is now a governance-centric document that places its primary focus on the work of the governing body. The board must now be a partner with management and the organization's consultants to ensure that the organization's governance is effective, up-to-date, and properly explained to the public.

Preparation and public disclosure of the form require boards to assume new responsibilities in providing leadership to the organization regarding its governance. The most fundamental of these responsibilities is perhaps the most daunting of them all: *Reading the Form 990*. Your immediate reaction may be that such a task ranks alongside root canals and/or watching paint dry. However, a trustee's review of the 990 is no longer simply an exercise in examining pages of esoteric financial data. The new form demands review and critical analysis of the governance policies and practices that are at the very heart of effective board operation.

The new Form 990 frames this responsibility with a single question: Was a copy of the Form 990 provided to the organization's governing body before it was filed? The question is intended to ensure that the board is involved in the Form 990's review. Indeed, the organization is then instructed to describe the process, if any, its board uses to review the form. If your institution does not have such a process, and if the board in fact has never reviewed the Form 990 before, you are in good company. A recent survey of the nonprofit sector showed that 55 percent of exempt organizations do not have a formal policy for reviewing the Form 990 or Form 990-T (the unrelated-business income tax return).

Of those that do have such a policy, about half of them established it only during the last year (see Grant Thornton's *2008 National Board Governance Survey for Not-for-Profit Organizations*).

The time to establish a meaningful and effective Form 990 review policy and process is now. Given that challenge, how should a trustee review the Form 990? Where do you begin and what should you be looking for?

Look at the Big Picture

A useful starting point for reviewing and analyzing the Form 990 is to see the big picture. Consider these questions: What story does the Form 990 tell about your organization? Does it reflect a well-governed organization? Does it reveal use of best practices in governing policies and procedures? Does the organization in its

ments. Business and family relationships between board members should be clearly disclosed and understood.

It is also important to understand the audience for the Form 990. Obviously, the Internal Revenue Service is the primary intended audience. However, in many ways, the IRS should not be boards' chief concern in reviewing this document. Rather, boards should consider the many constituencies that will critically review the 990 and the level of confidence it will give them that the organization is well run. These constituencies include donors and grant makers; in the case of colleges and universities, the faculty, students, and parents of students; members of the United States Congress and state legislators; the state attorney general; competing organizations; charity watchdog groups; and the media. A well-prepared 990

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board of trustees and committees reveal an appropriate level of independence and outside input? Or do many trustees have frequent business transactions and family relationships with each other that might compromise their independence?

Does the Form 990 serve its purpose as a public-relations document? That is, does it highlight the successes of the organization during the past year (for example, growth of curriculum, increased student aid, greater diversity) and, where appropriate, does it explain the organization's setbacks (for example, shrinking of endowment, material diversion of assets, excess benefit transactions)? Does the 990 demonstrate that the trustees exercise effective oversight of executive compensation? Is the compensation-review process sound and transparent?

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ments. Business and family relationships between board members should be clearly disclosed and understood.

Another threshold question for a trustee is a simple one: How should I read the Form 990? Certainly a traditional front-to-back review is appropriate. However, particular attention should be paid to the governance practices and procedures disclosed in the form. One useful technique is to look for anomalies in the form. Are certain policies and procedures missing? Are any applicable questions unanswered? Is there a significant variance in the financial data from prior years or from the trustee's experience that warrants follow-up questions? What if a response on the form causes a trustee to ask: What is this? Why is this here? In that case, the trustee should pursue answers to those questions and never feel bashful about asking the "stupid question." Those questions often can produce interesting and thought-provoking answers.

The question of timing is also impor-

tant. When should the Form 990 be reviewed? The new 990 specifically asks whether trustees received a copy of the completed form before it was filed. Originally, a discussion draft of the revised form inquired whether the form had been reviewed prior to its filing. The IRS ultimately conceded the administrative burdens of the filing process and its timing, allowing the board's review to occur after the Form 990 has been filed. However, in many ways the most valuable and timely input of the board will be obtained prior to filing, so that any necessary or beneficial changes can be incorporated into the form before it is filed. The challenge of this approach is that it requires the organization's finance staff to complete a draft of the Form 990 for review at a much earlier time than would otherwise have been the case. While an automatic filing extension is available (and is routinely taken), many organizations will nevertheless find that it is not practical for the board to review the 990 before it is filed. Accordingly, in many instances trustees will be providing after-the-fact guidance, which will be incorporated into the 990 the following fiscal year.

Alarm Bells for Two "Yes" Answers

There are two questions on the 990 that trustees should always examine with particular care. An affirmative response to either of these questions should be cause for great concern by any trustee and should prompt careful analysis and questioning so that the trustee is confident the organization has acted appropriately.

The first of these is found at Part VI, question 5 of the Core Form, which asks if the organization became aware during the year of a material diversion of its assets. This, of course, is a serious matter. It typically involves fraud or embezzlement within the organization. Few things can cause greater alarm for donors, regulators, students and faculty, or the media, than learning of substantial fraud within the organization.

The organization's explanation here is critical. In some instances, a substantial fraud can reveal a dysfunctional organization with poor internal controls and inad-

equated leadership. In other circumstances, an identified fraud reveals that there are, in fact, strong internal controls in place that are working effectively and that these controls identified and corrected the fraud that was discovered. In either situation, the board should be fully informed of the facts and should have a full opportunity to question management with regard to the responses taken. The board should consider whether its own review processes and internal controls are adequate and whether appropriate communications regarding the matter have been made to affected constituencies.

A second question that should always be considered by trustees is found at Part IV, question 25 of the Core Form. It inquires whether the organization engaged in an "excess benefit transaction with a disqualified person" during the year or in a prior year. In other words, did anyone who is in a position to substantially influence the organization, such as senior leadership or a member of the board, receive excessive compensation or were they paid in excess of fair market value for goods or services they provided to the organization?

If the answer to this is "yes," much like with the occurrence of fraud, it reveals a potentially serious problem within the organization's leadership that must be aggressively addressed by the board of trustees. A full investigation of the circumstances should be undertaken by the board in consultation with the chief executive officer, the chief compliance officer, and legal counsel. Appropriate redress must be made in accordance with IRS rules, known as "intermediate sanctions." These rules include repayment of the excessive benefit to the organization and, potentially, imposition of a tax on the individual who benefited, which must be paid to the IRS. In addition, if trustees approved an excess benefit transaction that they knew to be excessive, they may have personal liability, up to \$20,000 each, with regard to the excess payments. It is by now clear why this answer would be of great interest to any trustee.

Fortunately, it is quite rare for an organization to answer either of these questions in the affirmative. A "no" answer will send the trustee on to the remainder of the

form. A "yes" answer requires immediate intervention by the board.

The Heart of Form 990

The Core Form is the heart of the new Form 990. It is an 11-page document that must be completed by all tax-exempt organizations required to file a 990. There was a time when many exempt organizations took a minimalist approach to the form, often providing as little information as possible in response to the questions posed. The time for that approach is long gone. The primary goal of the new Form 990 is transparency, and boards should ensure that responses on the Core Form and its schedules are full and complete and properly reflect the operations and governance of the organization.

The first page of the Core Form is a summary sheet of data found elsewhere in the



form. It is intended for use as a snapshot of the organization so that similar organizations can be reviewed side by side and fundamental information about operations and board structure can be determined from a quick perusal. A review of the first page will provide you with an organization's gross revenues, expenses, gross assets, unrelated-business income, number of employees and volunteers, amount of contributions, investment income, aggregate compensation data, and total assets and liabilities. This is essential information that every trustee should know, understand, and be prepared to discuss with anyone wanting to know more about the organization.

The first line on the first page of the Core Form requires a brief description of the organization's mission or most significant activities. This provides a good opportunity for many trustees to revisit their institution's mission statement to ensure that it properly reflects the current operation and goals of the organization.

A governance feature that has received increased attention and plays greater significance in the new version of the form is found in Part I, line 4 of the Core Form. It inquires about the number of independent voting members on the governing body. Independence for this purpose means that the trustee is not a materially compensated employee or independent contractor, does not have material business transactions with the institution, and does not have a conflict of interest that would influence his or her decisions about the operations of the institution. Increasingly, the presence and participation of independent board members are being viewed as hallmarks of a well-governed organization. The response to this question should be one that reflects favorably on the organization and its leadership by showing that the board is not insular or self-interested.

The board should consider how transparent it wishes the organization to be on the Form 990 and what information will be most useful to its constituencies.

In Part III, the organization provides a statement of its “program service accomplishments.” Line 4 asks for a description of the achievements—related to its tax-exempt purposes—of the organization’s three largest (most expensive) programs. This is a stellar opportunity for the organization to put its best foot forward and to highlight its successes over the past year. When these responses are combined with Schedule O of the new form, which permits the organization to make any supplemental statement or explanation it wishes, trustees should be satisfied that the Form 990 is doing a good job of telling the organization’s story to the public. There can be no denying that the 990 is a public-relations tool, and trustees should assess its effectiveness as such during their review.

Some of the most important areas for the board of trustees to review pertain to Part VI of the Core Form, entitled “Governance, Management, and Disclosure.” This section requires information that goes

to the very heart of the effective operation and governance of tax-exempt organizations. There is no section of the new form that requires more careful and interactive review by the board of trustees than Part VI. Section A of Part VI inquires about the governing body and management of the organization. The level of independence of the board is highlighted here. As discussed earlier, line 1B inquires about the number of voting members who are independent. Line 2 inquires whether any officer, director, trustee, or key employee has a family relationship or business relationship with any other officer, director, trustee, or key employee. A clear imperative of the new form is to achieve greater transparency regarding board relationships. This information should be readily available through the conflict-of-interest policy and annual disclosure process of the organization.

Line 10 inquires whether a copy of Form 990 was provided to the organization’s governing body before it was filed, and requires that the organization describe in Schedule O the process, if any, the organization uses to review the Form 990. Trustees should be satisfied that the review process has given them ample opportunity to understand the answers and disclosures made by management and to ask questions and follow up on any items that are deemed to necessitate greater board involvement.

As with most important matters, the governing body should have received the Form 990 well in advance of the board meeting at which it will be discussed, and sufficient time for its review should be allotted on the agenda. Management should be sure to identify governance issues in the 990 that require board involvement and discussion, to ensure an effective meeting and proper leadership by the board. Additional time for follow-up should be permitted in subsequent meetings to develop and discuss any

additional board policies that the review process has found are needed.

Section B of Part VI inquires about the fundamental governance policies in place for the organization. In particular, it inquires about the existence and proper use of a conflict-of-interest policy; a whistleblower policy; a document-retention and destruction policy; and a procedure requiring the organization to act to safeguard its exempt status under applicable federal tax laws with respect to joint-venture arrangements. The section also inquires about the board’s process for determining compensation of the organization’s chief executive officer, other officers, and key employees. The section asks for a description of the compensation review process, and in particular, whether the organization adheres to a process known as the “rebuttable presumption of reasonableness.” This process calls for a review of compensation by an independent board or board committee, using objective data for comparable positions, and establishing records (typically the minutes) providing evidence of the board’s deliberations on compensation. The board’s review of this section should assure it that key governance policies are in place and up to date. Recent public scrutiny of conflicts of interest and executive compensation in nonprofit organizations warrant boards’ careful attention to responses in this section.

Finally, Section C of Part VI inquires about the organization’s disclosure policies. The section asks for a description of whether and how the organization makes its governing documents, conflict-of-interest policy, and financial statements available to the public. Unlike Form 990 and Form 990-T, which are public-record documents, other organizational documents such as the bylaws, governance policies, and financial statements are not required by federal law to be made public. Accordingly, the board should consider how transparent it wishes the organization to be on the Form 990 and what information will be most useful to its constituencies.

Part VI of the new form delves into the compensation of officers, directors, trustees, key employees, highest-compensated employees, and independent contractors.

This section requires considerable detail concerning the compensation of the organization's employees, including disclosure of compensation for many individuals for whom public disclosure was not previously required. The board should have a good familiarity with this section and an understanding of the levels of compensation and benefits paid to all of the organization's leaders. Additional information requiring review by the board with regard to the pay of highly compensated individuals will be found in Schedule J, discussed below.

In Part VII, Section B asks for a description of services and the level of compensation of the five most highly compensated independent contractors receiving more than \$100,000 of compensation from the organization. A review of this list by trustees is recommended, and if it is not clear why a particular contractor was engaged or why the level of compensation would be at the reported level, appropriate questions should be posed to management.

Part VIII is the Statement of Revenue for the organization, Part IX is the Statement of Functional Expenses, and Part X is the Balance Sheet. The financial data contained in these sections should already be familiar to the board through its receipt of regular financial reports by management at board meetings. The board should ensure that the reported items are consistent with the trustees' general understanding based on previous financial reports, and, as always, trustees should question anomalous results or any reported result for which an easy explanation is not apparent.

Schedules Seek Detailed Data

The schedules accompanying the Core Form probe much more deeply into various aspects of the organization's operation and governance. While not every tax-exempt organization filing Form 990 is required to complete every schedule, most colleges and universities will complete most of the schedules. Following are some disclosures required by the schedules that will be of particular interest to college and university trustees.

Schedule C asks for reporting of political campaign and lobbying activities. Much of this information was previously included in

Who Should Review IRS Form 990?

A common threshold question asked by boards when faced with the challenge of reviewing the Form 990 is whether a board committee can be charged with reviewing the form or whether this job must be undertaken by the full board.

IRS officials have indicated in public comments that it is acceptable for a board committee to do the review of the 990. However, it is critically important that a committee charged with reviewing the form report its findings to the full board, particularly during the first few years of use of the new form. The full board should then undertake a robust discussion of the committee's findings and pursue any questions individual trustees may have regarding the form. The new form provides an important opportunity for the board to provide leadership. Many of the governance

and policy questions it contains invite the input of all trustees to ensure that the organization follows best practices, governs effectively, and utilizes the talents and experiences of all members of the board.

If this work is undertaken initially by a committee, there are several candidates for this task. Perhaps the best choice

finance committee could undertake this duty as well. However, it is important to understand that the new 990 no longer focuses simply on financial data. While such data remains an essential component of the form, the document is now clearly centered on governance. A review of governance-related questions is not typically

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is a governance committee, if the board has one. Review of the 990 would be a core competency of that committee. Another option would be the audit committee. This committee is already familiar with much of the financial data that will appear on the form, and it is also likely to be familiar with conflict-of-interest and compensation matters. A budget-and-

undertaken by the budget-and-finance committee, and its members might need additional training for this task. Boards also could consider creating a new committee or subcommittee to handle the 990, drawing on both governance experience and business experience in selecting appropriate trustees to serve on the panel. —Thomas K. Hyatt

the body of the Form 990. Trustees should review this schedule so that they are familiar with the level of lobbying activity being undertaken by the organization and have a clear understanding as to who is lobbying on the organization's behalf and why lobbying expenses may vary significantly from year to year. Any supplemental information contained in the schedule should be carefully reviewed by trustees.

Schedule D contains supplemental financial statements for the organization. Of particular interest to trustees of colleges and universities is Part V of Schedule D, which discloses information regarding the organization's endowment funds. Detail regarding the endowment funds of tax-exempt organizations has not previously been reported on the 990. Part V examines endowment funds for the

This part of the 990 review provides a good opportunity for the board to revisit its endowment restrictions and usage.

Schedule J, regarding compensation information, is certain to receive a great deal of scrutiny by the various constituents of the organization, as well as by its regulators and other interested parties. This schedule should be thoroughly examined by trustees to ensure that they understand the types and levels of compensation being provided to senior leaders and other highly compensated employees, as well as the organization's policy for reviewing this compensation. Line 1A inquires about the types of compensation and benefits being provided. The choices available are torn from the headlines of abuses by nonprofit organizations. The section, for example, inquires about such benefits as first-class

employees, and others with the ability to substantially influence or control the organization. The schedule requires disclosure of "excess benefit" transactions, loans, and grants or assistance to these interested persons, as well as disclosure of business transactions with them. These types of transactions have been the subject of high-profile scandals involving tax-exempt organizations; they invite further investigation simply by their use. Trustees should review this schedule thoroughly and should be able to explain to anyone asking why such transactions are necessary for the organization and what measures the organization employs to prevent their abuse. Trustees should hold themselves and management accountable for implementing and using strong internal controls involving any transactions with interested persons.



Nonprofit compensation will continue to be a hot-button issue and was the subject of detailed questions in the Compliance Check Questionnaire sent by the IRS to approximately 400 colleges and universities in late 2008.

current year and up to four prior years. It discloses the level of funds used for grants or scholarships and other expenditures, as well as the investment earnings or losses of the endowment. This section also requires a breakdown of the endowment, by percentage, into three categories: board designated or quasi-endowment; permanent endowment; and term endowment.

Because of the high level of scrutiny by Congress, the IRS, and the media of the use of endowment funds by colleges and universities, boards should carefully review this section and should request additional information from management regarding any unusual or unexpected results. Close attention should be paid to the disclosures of the endowment's earnings, losses, spending rate, and the types of restrictions on the endowment. It is not unusual for tax-exempt organizations to discover that the board has restricted the use of some funds and that the reason for the restriction no longer exists, or in some cases, that no one on the board even remembers why the restriction was added in the first place.

travel; companion travel; discretionary spending accounts; payments for business use of personal residences; and payments for personal services. In any case where such a benefit has been provided, the organization is asked whether it followed a written policy regarding payment or reimbursement or provision of such expenses.

These questions are intended to ensure that the organization has effective compensation policies and internal controls. Trustees should be fully knowledgeable about the compensation, benefits, and policies identified here and should have an annual robust discussion as to their reasonableness and effectiveness. Nonprofit compensation will continue to be a hot-button issue and was the subject of detailed questions in the Compliance Check Questionnaire sent by the IRS to approximately 400 colleges and universities in late 2008.

Finally, Schedule L provides for disclosures about transactions with "interested persons," that is, current or former officers, directors, trustees, key employees, the organization's five highest compensated

Review of the new 990 can be a formidable task and is unfamiliar territory for most trustees of colleges and universities. Still, this responsibility is now an important component of the board's fiduciary duty of care. The questions and answers highlighted here can serve as a guide to shape boards' review, but they should not limit it. There is no substitute for inquisitive minds, an engaged board discussion, a direct question, and, as BoardSource framed it in its seminal book *The Source*, a culture of inquiry. The annual Form 990 review must become engrained in board culture and, with it, a more complete understanding by all trustees of the operations and governance of the college or university they serve. ■

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