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Board Review of Form 990

Importance of the Review

While board review of Form 990 (Return of Organization Exempt from Income Tax) is not statutorily required, it is, however, a prudent practice. An organization's review procedures are reported on the Form 990, which is publicly disclosed. In addition to being important for tax compliance, the Form 990 is also an important tool for communication with stakeholders. It is important to consider "the story" the forms are telling about the organization. The readers of the Form 990 may be potential contributors that want to know if the organization's mission aligns with their purpose, potential board members looking for information about the organization, or external evaluators determining the effectiveness of programs.

While more than a cursory review of Form 990 may seem overwhelming, focused board review is important. Note that the additional information disclosed on Schedule O, Supplemental Information to Form 990 or 990-EZ, is an integral part of the return and should be reviewed carefully where referenced in the return.

This article discusses a few of the areas that could reveal potential tax or administrative problems for the organization to assist board members in their review efforts.

Filing Matters

Electronic Filing. While not all organizations will exceed the threshold requiring electronic filing, there is a significant advantage provided by electronic filing. An electronically filed Form 990 will be rejected if incomplete, notifying the taxpayer immediately of problems—allowing those problems to be addressed quickly. Beginning in January 2018, the IRS began rejecting incomplete Forms 990. In the first nine months of enforcement, approximately 10% of paper filed forms were rejected for incompleteness. Incomplete paper filed forms, when rejected, are returned to the organization by mail. If the corrected and complete return is not filed until after the due date, late filing penalties under IRC Sec. 6652(c)(1)(A)(ii) of $20 ($100 for large organizations) per day will be assessed.

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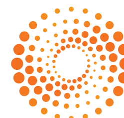

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Governance, Management, and Disclosure

Number of Voting Members of the Governing Body. Part VI, Section A, line 1a requires an organization to report, as of the end of the tax year, the total members of the governing body with the power to vote on all matters (other than when excused from voting due to a conflict of interest, as discussed later). If members of the governing body do not all have the same voting rights, any material differences should be explained in Schedule O.

Line 1b requires that the number of independent voting members be reported. The definition of *independent member* has been the subject of much debate since this item first appeared on the form. The instructions provide four conditions that must be met for a board member to be considered independent. The board member must not: (1) be compensated as an officer or other employee of the organization or of a related organization, (2) receive total compensation (including as an independent contractor) exceeding $10,000 during the tax year from the organization or a related organization other than as reasonable compensation for services provided in the capacity as a board member, (3) be involved directly (or through a family member) in a transaction with the organization that would be reportable on Schedule L, and (4) be involved in a transaction directly (or through a family member) with a taxable or tax-exempt organization that would be reportable on Schedule L.

Complete Copy of Form 990 Provided to the Governing Body. Part VI, Section B, line 11a asks if a complete copy of the Form 990 has been provided to the governing body before filing the return. The question is trickier than it appears, and the Form 990 instructions provide clarification. A *complete* copy includes all the required schedules. To be able to answer "Yes", no information can be redacted or removed from the copy of the final Form 990 provided to the board. If, for example, a donor requests that its name be redacted from the copy of Schedule B that is provided to the governing body, the organization would be required to answer "No" on line 11a. However, this omission should be explained in Schedule O.

Various methods of *providing* the return to the governing body will satisfy the requirement, including providing a paper copy, emailing the return to each board member, or providing each member a link to a password-protected website for viewing the forms. However, informing the governing body that a copy of the Form 990 is available upon request does not qualify. In addition, an organization may not answer "Yes" if the completed copy was not provided to each voting member of the governing body who was a member at the time the Form 990 was provided.

Describe the Review Process. Part VI, Section B, line 11b instructions direct the organization to describe the process, if any, by which the organization's officers, directors, trustees, board members, or management reviewed the prepared Form 990 (whether before or after being filed with the IRS). Specifics about who conducted the review, when they conducted it, and the extent of any such review should be included. Alternatively, if no review was conducted, enter "No review was or will be conducted." A "no review" comment will not be perceived well by the IRS or any other Form 990 users, including prospective donors.

Annual Disclosure of Conflict of Interest (COI). Part VI, Section B, line 12a asks if the organization has a written COI policy. A COI policy defines conflicts of interest, identifies the classes of individuals within the organization covered by the policy, facilitates disclosure of information that help identify conflicts of interest, and specifies procedures to be followed in managing conflicts of interest. A COI arises when a person in a position of authority over an organization (such as an officer, director, manager, or key employee) can benefit financially from a decision he or she could make in such capacity, including indirect benefits such as to family members or businesses with which the person is closely associated.

One might be tempted to think that because they implemented a COI policy a few years ago that they are all set. However, as questions 12b and 12c indicate, it's not that simple. Line 12b asks if the officers, directors or trustees, and key employees were required to disclose annually interests that could give rise to conflicts. This disclosure is often achieved by the board member completing a questionnaire. A list of family members, substantial business or investment holdings, and other transactions or affiliations with businesses and other organizations (and those of family members) that could give rise to a COI should be included on the questionnaire.

Line 12c asks if the organization regularly and consistently monitor and enforce compliance with the policy and, if so, to describe in Schedule O how this is done. The description should include an explanation of which persons are covered under the policy, the level at which determinations of whether a conflict exists are made, and the level at which actual conflicts are reviewed. Also, explain any restrictions imposed on persons with a conflict, such as prohibiting them from participating in the governing body's deliberations and decisions in the transaction.

Statement of Revenue

Directors should review the organization's revenue (as reflected in Form 990, Part VIII) for indications of potential financial weakness. For example, does the revenue

data suggest too much reliance on a source that could be jeopardized by a weak economy, a declining stock market, or other significant external factor (i.e., should other revenue sources be considered)?

Primary Purpose. Section 501(c)(3), (c)(4), and certain other exempt organizations jeopardize their exempt status when their exempt purpose ceases to be their primary purpose because unrelated business activities have become the dominant activities. Such organizations should be cautious when unrelated business activities consume a substantial amount of time or resources or produce a significant part of total support. Directors should compare the total of unrelated business income in Form 990, Part VIII, column (C), and its sources with total revenues in column (A) to see whether the organization is in potentially dangerous territory.

Statement of Functional Expenses

Form 990, Part IX requires an extensive breakdown of the organization's expenditures for the year. Certain expenditures merit close scrutiny by directors because they may suggest extravagance by officers and key employees. Questions that should be considered in this analysis include:

Compensation and Benefits. Compensation and benefits (lines 5 through 8) should not consume too much of the organization's revenue.

Necessary and Justifiable Expenses. Certain expenses are necessary or justifiable, such as fees for attorneys, lobbyists, and professional fundraisers; travel and entertainment; and expenses for conferences, conventions, and meetings.

Section 501(c)(3) and (c)(4) organizations are required to allocate their expenses to one of three columns in Form 990, Part IX. This allocation enables perceptive directors to gauge the organization's effectiveness in using each dollar of revenue for exempt purposes. If the total of columns (C) (management and general expenses) and (D) (fundraising expenses) is high relative to the total of column (B) (program service expenses), the organization's image may be tarnished in the eyes of donors and investigative reporters.

The Balance Sheet

While it may be tempting to skim over the balance sheet presented in Part X if the organization is in good financial position, several areas warrant careful consideration.

Related Party Loans. If there are related party loans (on lines 5 and 6), are resources being diverted from program service activities to fund such loans? Is appropriate oversight being exercised over these loans to ensure there is adequate collateral, a reasonable interest rate, and timely repayment?

Notes and Loans Receivable. Are other notes and loans receivable (line 7) adequately collateralized and timely repaid?

Accounts Payable. Does an increase, if any, in accounts payable and accrued expenses (line 17) during the year suggest potential cash flow problems?

Net Assets or Fund Balances (Form 990, Part X, lines 27–30). A challenge for this section results when the organization's externally prepared financial statement presentation of fund balance does not align with the Form 990. The form's presentation in this section uses the terms unrestricted, temporarily restricted, and permanently restricted net assets and has not been updated to reflect the language of the new accounting standards (ASC 958-205), which was effective December 15, 2017, for an organization's externally issued financial statement. The new standards use the terms donor-restricted and board-designated (quasi) endowments. Note if the organization is subject to the Uniform Prudent Management of Institutional Funds Act (UPMIFA), it may affect the amounts reported on lines 27 through 29.

While this lack of alignment may be confusing, the instructions recommend only using line 27 (unrestricted net assets) and line 29 (permanently restricted net assets) and explaining in Schedule O (Supplemental Information to Form 990 or 990-EZ) how the organization's financial statements translate to the previous terminology. Remember, funds that have been restricted by a board designation differ from donor-restricted funds (reportable on line 29). Therefore, for Form 990 presentation, board designated funds are considered unrestricted (reportable on line 27).

Practical Consideration:

PPC's 990 Deskbook includes Checklist C501, "Board Review of Form 990," to aid the board in reviewing the return.

Tax Brief

EO APPLICATION BACKLOG. The Director of IRS Tax-Exempt and Government Entities Division (TE/GE) recently indicated the late December–January shutdown of the federal government increased the backlog of unprocessed applications for tax-exempt status from 72 days to 119 days. Replies that might have been received within a month before the shutdown may now be extended to about 55 days.

ASU Clarifies Grants and Contributions—Part 2

After the issuance of ASU 2014-09, *Revenue from Contracts with Customers*, one of the issues identified for nonprofit organizations was how to determine which grants are within the scope of the new revenue recognition standard. FASB noted that (a) difficulty in characterizing grants and similar contracts with resource providers as either exchange transactions or contributions is a long-standing challenge, which results in diversity in practice, and that (b) ASU 2014-09 placed new focus on those difficulties. In addition, once a transaction was determined to be a contribution, difficulty in distinguishing between conditions on which a promised contribution depends and donor-imposed restrictions, which typically only place limits on a specific activity, create further diversity. In response, in June 2018, FASB issued ASU 2018-08, *Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made*, to clarify the existing guidance to address these diversities. Last month we covered distinguishing an exchange transaction from a contribution, classifying contribution revenue, understanding disclosure requirements, and understanding the effective dates and transition requirements. This article focuses on distinguishing a donor-imposed condition from a donor-imposed restriction.

Distinguishing a Donor-imposed Condition from a Donor-imposed Restriction

The basic approach to distinguishing a donor-imposed condition from a donor-imposed restriction is essentially unchanged. A donor-imposed condition is a donor stipulation that represents a barrier that must be overcome before the recipient is entitled to the assets transferred or promised.

Failure to overcome the barrier gives the resource provider a right of return of the assets it has transferred or releases the resource provider from its obligation to transfer its assets. In contrast, a donor-imposed restriction specifies a use for the transferred assets, but does not affect the resource provider's obligation to transfer them to the nonprofit organization.

So that the evaluation of whether a donor stipulation is a condition or a restriction is more consistent from organization to organization, the ASU adds the following guidance:

- Explicitly states that a donor-imposed condition must have both one or more barriers that must be overcome before a recipient is entitled to the assets transferred or promised and a right of return to the contributor for assets transferred (or for a reduction, settlement, or cancellation of liabilities) or a right of release of the promisor from its obligation to transfer assets (or reduce, settle, or cancel liabilities).
- Removes the phrase "specifies a future and uncertain event" from the definition of a donor-imposed condition. Removing the phrase is intended to reduce diversity in practice caused by the implication that an organization could assess the likelihood of a condition being met when determining whether to recognize contribution revenue.
- Explicitly states that if an agreement includes a right-of-return or a right-of-release-from-obligation clause but imposes no barriers that must be achieved before an organization is entitled to the resources, the resources would be considered unconditional, and revenue would be recognized immediately.
- Explicitly states that if an agreement includes multiple requirements that must be overcome before an entity is entitled to transferred assets or a future transfer of assets, the organization must consider facts and circumstances and use judgment to determine which stipulations, if any, of an agreement are deemed to be a barrier or barriers that must be achieved before the organization is entitled to assets.
- Explicitly states that existence of a barrier should be determined on the basis of indicators, which are intended to provide additional guidance while allowing preparers to exercise judgment on the basis of individual facts and circumstances. FASB ASC 958-605-25-5D provides a table that contains a new list of indicators that may be helpful in determining whether an agreement contains a barrier. The indicators include the following:
  - A measurable performance-related barrier or similar measurable barrier that identifies a task or tasks that must be performed before the organization is entitled to the promised or transferred assets, and often specifies a timeframe by which the task(s) must be complete. Examples of performance-related barriers are a specified level of service, an identified number of units of output, a specific outcome, or raising a specified dollar amount.

   - Limits that are more specific than a donor-imposed restriction on the discretion of the organization to conduct the activity that is the purpose of the contribution. Examples of limitations that are barriers are a requirement to follow specific guidelines for incurring qualifying expenses, a requirement to hire specific individuals as part of the workforce conducting the activity, and a requirement to follow a specific protocol.
   - Stipulations stating that the purpose of the agreement must be accomplished. Examples include a requirement for a homeless shelter to provide a specified number of meals to the homeless (also an example of a measurable performance-related barrier), a requirement for an animal shelter to expand its facility to accommodate a specified number of additional animals, and a requirement for a research report that summarizes the findings from a grant on gluten-related allergies. However, stipulations that are unrelated to the purpose of the agreement (for example, administrative and trivial stipulations) are not indicative of a barrier.
- Adds nine examples that illustrate how an organization might apply certain aspects of the new guidance when determining whether a contribution is conditional.
- Reiterates that, consistent with current GAAP, stipulations that are administrative or trivial are not indicative of a barrier. For example, a stipulation that an annual report must be provided by the donee to receive subsequent annual payments on a multiyear promise is not a barrier if that administrative requirement is not related to the purpose of the agreement.
- Reiterates that, consistent with current GAAP, in cases of ambiguous donor stipulations, an agreement that contains stipulations that are not clearly unconditional should be presumed to be conditional.
- Supersedes the guidance in FASB ASC 958-605-25-12 that states that a conditional contribution is considered unconditional if the possibility that the condition will not be met is remote, and explicitly states that a probability assessment about whether the organization is likely to meet the stipulation is not a factor when determining whether an agreement contains a barrier.

Practical Consideration:

PPC's Guide to Nonprofit Contributions provides additional guidance on ASU 2018-08.

Implementation Tip #6—Equity Transfers

This article continues our series of tips on implementation of ASU 2016-14, *Not-for-Profit Entities (Topic 958), Presentation of Financial Statements of Not-for-Profit Entities*. The amendments from the ASU are effective for annual financial statements issued for fiscal year beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. The ASU permits, but doesn't require, nonprofit organizations to apply the changes to interim financial statements in the initial year of adoption.

What Is an Equity Transfer?

An *equity transfer* is a new term added by ASU 2016-14 and is defined as a nonreciprocal transaction between related nonprofit organizations if one organization controls the other or both organizations are under common control. Equity transfers are similar to ownership transactions between a for-profit parent and its owned subsidiary (e.g., additional paid-in capital or dividends). In general, transactions are classified as equity transfers if (a) they occur between nonprofit organizations and one organization controls the other or they're both under common control, and (b) the transferor doesn't receive anything of immediate economic value and has no expectation of repayment.

Equity transfers don't result in any step-up in basis of the underlying assets transferred. However, GAAP makes an exception for services received from personnel of an affiliate if those services directly benefit the organization that receives the services and the affiliate doesn't charge the receiving organization. Nonprofit organizations may choose to record such transactions at the fair value of the service if recording the service at the cost recognized by the affiliate providing the service will significantly overstate or understate the value of the service received.

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Practical Consideration:

An example of when fair value may be a better measure would be if a highly compensated CFO of a nonprofit organization also provided accounting services for a small affiliated nonprofit with simplistic accounting needs. The cost of the CFO's services may not be the best indicator of the value of the services provided and the recipient may choose to reflect the transaction at fair value instead.

How Are Equity Transfers Shown in the Financial Statements?

Before the effective date of ASU 2016-14, GAAP didn't mandate how a recipient reported the increase in net assets from unreimbursed personnel services beyond prohibiting it from being a contra-expense or contra-asset. Many nonprofit organizations reported such transactions as contribution revenue.

ASU 2016-14 requires nonprofit organizations to report equity transfers as a separate component of the change in net assets. If the equity transfer is from receiving services provided at no cost from personnel of an affiliate, a descriptive caption such as "contributed services from affiliate" could be used.

We Want Your Financial Statements!

We have begun work on the 2019 edition of *PPC's Nonprofit Financial Illustrations and Trends (Nonprofit Trends)* and are on the look out for new illustrative financial statements. We are especially interested in financial statements for entities that have implemented ASU 2016-14. We ask that the financial statements include note disclosures and *not* be for governmental units.

To comply with AICPA or state ethics requirements, you may need to obtain permission from your client before submitting financial statements for consideration. We will carefully edit any financial statements to obscure the name and location of the organization and other identifying information. If your submission is selected for inclusion in the 2019 edition of *Nonprofit Trends*, you will receive a free copy of that edition when it is available in the fall.

Financial statements may be submitted by attaching the files to an email and sending to **Checkpoint.PPC.NPT@thomsonreuters.com**.