On the 2018 higher education audit committee agenda

Financial reporting, internal control, risk, and compliance oversight will continue to be put to the test in 2018. Focused, yet flexible agendas—exercising judgment about what does and does not belong on the committee's agenda and when to take deep dives—will be critical. Drawing on insights from our recent survey work as well as interactions over the last year with audit committees and senior management of colleges and universities, we have highlighted several areas under two banners—core responsibilities and enterprise risk management—that audit committees should keep in mind as they consider and carry out their 2018 agendas.

Core responsibilities: Financial reporting, internal control, and external/internal auditors

Management is responsible for the preparation of the institution's financial statements and related disclosures, as well as maintaining effective internal controls. That said, the experience, skills, and leadership of board members can provide real value in terms of effective oversight.

With respect to its review of the annual audited financial statements, the audit committee should be satisfied that they are consistent with information known to committee members and convey well the institution's financial story. That story may be expanded upon in an annual report, MD&A, or conveyed in the Form 990 and within Web site content. Management should seek consistency in the messages across those venues. The financial reporting risk associated with those areas where management may need to make difficult judgments and estimates requires a disciplined, robust, and unbiased process. The audit committee should understand management's framework and related controls and ask for the independent auditor's views.

There should also be robust discussion with respect to significant and unusual transactions as well as material related-party transactions. Tap the external auditor's industry-specific expertise as well as experience in dealing with different business transactions and arrangements to help put issues into context.

The audit committee's oversight over internal control, including fraud prevention and detection controls, relies upon management's representations and the auditors' recommendations. The committee should help ensure that management is setting the appropriate tone in communicating the importance of internal control. The committee should also consider the integrity, ethical values, and competence of employees, as well as the appropriateness of assigned levels of authorities and responsibilities. Changes to internal controls that may result from technology-driven or other business transformation activities should also be monitored.

Because external and internal auditors play a vital role in the financial reporting process, effective oversight of auditors is at the core of the audit committee's responsibilities. Audit committee effectiveness is enhanced when a good working relationship between the audit committee chair and the lead audit engagement partner is developed. From walking together through the agenda and pre-meeting materials to discussing important developments on a real-time basis, informal conversations represent time well spent.

For those institutions with an internal audit function, audit committees typically review the internal audit plan and results. Is the audit plan risk-based and flexible, and does it adjust to changing business and risk conditions? Is collaboration between the internal and external auditors maximized? Are advisory services, if any, provided by internal audit to other departments clearly distinguished from traditional audit responsibilities and are appropriate safeguards in place? Does internal audit have the skills, resources, and stature—and a direct line to the audit committee—to ensure that its voice is heard and valued? A challenge for the audit committee is to establish a relationship that helps the head of internal audit and internal audit staff operate effectively in their dual management/monitoring role.

In our annual audit committee agenda publications since 2014, we have discussed major financial reporting and accounting changes on the horizon. With respect to private, not-for-profit colleges and universities, we have covered important aspects of FASB's Accounting Standards Update (ASU) 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities;* ASU 2016-02, *Leases;* and ASU 2014-09, *Revenue From Contracts with Customers.*

Developments relative to these updates since the issuance of our 2017 paper include the early adoption of the *Presentation* standard (effective no later than for fiscal 2019) by a handful of colleges and universities in their fiscal 2017 statements, with more early adopters expected in fiscal 2018. As anticipated, the quantitative and qualitative disclosures with respect to liquidity and availability were among the most demanding aspects of implementation. Generally, early adopters found that implementation did not require accounting system or chart of account changes.

The adoption of the *Presentation* standard provides opportunity to consider other areas where financial statements and/or disclosures might be modified. For example, the *Presentation* standard requires institutions to present expenses by both functional category (now the only required information) and natural classification, typically in matrix format. We see opportunity to reevaluate the nature and number of functional categories currently reported and have seen meaningful natural classification information presented in as few as four to six line items. Ultimately, the new matrix should be built for the long-haul: it should include components that are well-defined, including any necessary narrative disclosure, utilizing a consistent methodology that facilitates understanding by the board and management of activities and trends over time.

In response to questions with respect to revenue recognition of grants and contracts, in August 2017, FASB issued a proposed ASU, *Not-for-Profit Entities: Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made.* Per FASB, this proposed ASU would "provide a more robust framework to determine whether a transaction should be accounted for as a contribution or as an exchange transaction... whether a contribution is conditional or unconditional, and better distinguish a donor-imposed condition from a donor-imposed restriction." FASB intends to further deliberate and issue a final ASU in mid-2018 with the same effective dates as the *Revenue* standard – fiscal 2019 for most private institutions.

FASB's activity with respect to the *Leases* standard over the last year has been intended principally to ease implementation for financial statement preparers. That said, the move of most lessees' obligations from footnote disclosure onto balance sheets—grossing up assets and liabilities and making leases more prominent—will occur when the standard is effective in fiscal 2020 for most private colleges and universities.

Public institutions continue to contend with various GASB statements and most schools and systems are now preparing to report the liability for other post-employment benefits (OPEB) in their fiscal 2018 financials, three years after GASB issued Statement 75. Despite considerable discussion and analysis since 2015 (including the possible impact on debt covenants and financial ratios) and reflective of the import of this Statement, in November 2017 GASB issued its implementation guide to assist preparers. Also, while perhaps less significant for most, some institutions will tackle the adoption of GASB 81, *Irrevocable Split-Interest Agreements,* in 2018.

As anticipated (and similar to FASB's guidance for private institutions), in June 2017, GASB issued Statement 87, *Leases,* which, when effective in fiscal 2021, requires most leases to be on the balance sheet with the recognition of a long-term liability and an offsetting intangible right-to-use lease asset. Similarly, a lessor will be required to recognize a lease receivable and a deferred inflow of resources.

The results of a blind third-party survey of 150 companies for whom the *Leases* standard will be effective in 2019 were published in KPMG's *Reality Check* in February 2018. In the survey, KPMG found that only 15 percent of the respondents had completed their implementation work. In addition to assessing the impact well before the effective date, private and public institutions may view the adoption of the new lease standards as an opportunity to enhance systems to ensure all significant lease obligations are recognized and calculated properly, as well as to amend financial debt covenants that may be impacted.

Enterprise risk management (ERM)

One of the more recent published looks at the state of ERM in higher education is included in *"ERM and Reputational Risk: More Talk Than Action?,"* authored by Janice M. Abraham, President & CEO, United Educators (UE); and Paul L. Walker, Executive Director, Center for Excellence in ERM at St. John's University. This paper was informed by a UE survey administered by the Association of Governing Boards of Universities and Colleges in early 2017. Noteworthy findings include (i) a more than doubling (to 70 percent) since 2013 of the percentage of institutions having a formal ERM process and structure in place, (ii) the audit committee continues to play a leading role with 73 percent discussing risk (only 14 percent of respondents reported having a board risk committee), and (iii) more than half of respondents reported discussing ERM-level risk at a board meeting at least once a year, but nearly one-third of respondents felt their boards were under engaged in discussions of ERM. Looking forward, the "business model" was by far the number-one cited reputational risk.

Our own experience confirms that a large majority of institutions have assigned responsibility for oversight of risk management *processes* to the audit committee. Among the questions to be addressed in the oversight role are: How rigorous are management's processes to identify and assess risks, including emerging risks, to the institution? Who is involved and who is championing management's effort? How far down in the organization does it go? Is there a good understanding of the risks inherent in the institution's strategy and a process in place to monitor changes in the environment that might alter key assumptions? And, in institutions with the function, does internal audit provide added assurance regarding the adequacy of risk management systems? Oversight of individual risks is generally assigned to other board committees (for example, management of risk areas such as student mental health, sexual assault, and Greek organizations may be overseen by the Student Affairs Committee), although certain risks such as compliance with laws and regulations and cybersecurity are frequently deemed to be within the purview of the audit committee. When delegation of specific risks to committees occurs, the audit committee should address these additional questions: How effective are we and other committees in coordinating and communicating risk oversight activities? Does the full board understand the nature of committee-based oversight activities and the top risk areas?

It is the responsibility of management, with the oversight of the board, to ensure that the institution's operations are conducted in accordance with the provisions of laws and regulations. The sheer number and breadth of the legal and regulatory requirements confronting colleges and universities makes compliance a challenge for management and the board as well. The Higher Education Compliance Alliance provides a centralized repository of information and resources to support institutional compliance efforts. Among the most significant compliance areas are laws and regulations with respect to participation in federal and other government sponsored financial aid programs, research & clinical activities, intercollegiate athletics, environmental health & safety, and Title IX, specifically regarding sexual discrimination and assault matters. Board members should seek to stay informed about the regulatory environment and changes thereto. Management (including general counsel, HR, and compliance officers) as well as outside counsel and independent auditors are often the principal providers of such education.

Two very recent developments—the new tax law and the House's proposed bill ("PROSPER Act") to reauthorize the Higher Education Act—are examples of regulatory actions that have the potential to impact financial results, related policies and internal controls, and much more. While the final version of the tax law does not include several of the most alarming elements of the House proposal, there is much to be concerned about. Congress's willingness to view the exempt purpose activity of colleges and universities as a source of tax revenue should worry the entire exempt organization community. Like other not-for-profit organizations, colleges and universities are uncertain about the impact on contributions of both the near doubling of the standard deduction and the doubling of the exemption level (and ultimate repeal) of the estate tax. Other provisions, including those associated with unrelated business income, executive compensation, and advance refunding bonds, may impact on operations of colleges and universities. Key provisions of the PROSPER Act as initially released include a capping of annual federal loans to undergraduate and graduate students at $12,500 and $28,500, respectively. The loan limits, if imposed, may create enrollment obstacles by making college less affordable. As reported by *Inside Higher Ed* on February 7, 2018, "major higher ed associations have issued forceful criticisms of the PROSPER Act."

In last year's audit committee agenda paper, we devoted considerable attention to cybersecurity risk and continue to see institutions include this risk among their most significant because of the potential to disrupt operations, be financially painful, and threaten reputation. The U.S. Department of Education's (ED) interest in institutional compliance with respect to data security regulations has not abated. In a recent update to ED's FAQ about cybersecurity compliance, institutions were reminded that the Student Aid Internet Gateway Agreement requires that "as a condition of continued participation in the federal student aid programs, [institutions] report actual data breaches, as well as suspected data breaches,... **on the day**... detected or even suspected." ED has the authority to fine institutions for noncompliance.

According to the aforementioned UE paper, nearly a third of respondents reported not having a formal ERM process in place. Perhaps many of these institutions have a partial ERM process in place or have plans to implement one; others with a process are or will be revisiting their approach. The ERM process and structure need not be cumbersome, nor is inordinate precision in risk measurement required. Although the UE paper focuses on reputation risk, it noted that "Whether identified separately in a risk register or viewed as the results of events that tarnish or enhance it, higher education leadership consistently confirm that reputation is the most valuable asset. We believe that whether reputation risk is its own category or is a "risk of risks", debating this may not be an effective use of valuable time. In fact, while many or perhaps most schools with formal ERM have utilized "risk categories," we believe assigning risks to specific categories is not necessarily required for an effective ERM process.

Final thoughts

Effective handling of the audit committee's core responsibilities (financial reporting related risks) and other risk-driven agenda items requires efficiency. Committee meetings can be streamlined by insisting on quality pre-meeting materials, making use of consent agendas to address items that do not require discussion, and reaching a level of comfort with and confidence in management and auditors so that some aspects of financial reporting and internal control can be addressed more routinely but with appropriate attention. The audit committee chair's leadership is vital to the committee's effectiveness and efficiency, but spreading the workload among committee members can enhance overall committee performance.

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