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On the 2016 higher education audit committee agenda

Even in the absence of any new agenda items, the risks that many audit committees have had on their plates for some time—e.g., cybersecurity and IT risk, legal and regulatory compliance, conflicts of interest, and related-party transactions—have become more complex, as have the audit committee's core responsibilities. Keeping the committee effective and efficient requires an agenda that is focused and manageable.

Balancing the audit committee's demanding agenda

The audit committee chair's leadership—in setting the committee's tone (engaged, informed, probing, and willing to challenge management when appropriate) and agenda—is vital to the committee's effectiveness and cannot be overemphasized. It is entirely appropriate to spend time between meetings working with management and auditors to help ensure that all relevant issues are identified and addressed by the committee.

To help the audit committee stay focused and efficient, a leading practice is to create a formal "responsibilities checklist and calendar" aligned with the audit committee's charter. Also, consider using a "consent agenda" to address items that are routine and do not require discussion.

A strong onboarding or orientation process for new audit committee members—even those who have served on other audit committees—will enable new members to add value more quickly. In addition to covering the "basics," unique higher education issues (operating and financial reporting) and trends should be addressed.

Oversight of financial reporting and internal controls

Quality financial reporting starts with the chief financial officer (CFO) and finance organization. Management is responsible for the preparation of the institution's financial statements and related disclosures, as well as maintaining effective internal controls. If the audit committee reaches a level of comfort with and confidence in management and auditors, some aspects of financial reporting and internal controls can become what one audit committee chair called "process routine"—not getting "short shrift" but allowing time for committee members, management, and auditors to pose questions and express their views, as well as time for deeper dives into other important matters.

With respect to its review of the annual audited financial statements, among other things, 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 conveyed in or expanded upon in an annual report, MD&A, the Form 990, or within Web site content. Management should seek consistency in the messages across those venues.

The greatest financial reporting risks are often in those areas where there are a range of possible outcomes and management has to make difficult judgments and estimates. The audit committee should understand the assumptions that underlie important accounting judgments and estimates, how those assumptions have been impacted by recent events and economic conditions, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The committee should be satisfied that management's approach in this area is disciplined and unbiased, and the external auditor's views regarding accounting judgments and estimates should be clear.

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.

As we expected, audit committees did spend time in 2015 understanding the Financial Accounting Standards Board's (FASB) proposed financial reporting changes for not-for-profit entities as set forth in an exposure draft issued in April 2015. Feedback on the proposed changes was received by FASB in more than 200 letters, prompting the board to divide its redeliberations into two work streams: one for issues that might be finalized in the near term and the second for those proposed changes that require more time for reconsideration and resolution. With respect to the first work stream, it is quite possible that final guidance will be issued later in 2016, with an effective date no sooner than fiscal 2018.

Two long-running FASB projects, Revenue Recognition and Leases, have resulted in the issuance of new accounting standards. The new guidance set forth in *Revenue from Contracts with Customers* is effective for most colleges and universities in fiscal 2019. As suggested by its title, the new standard pertains to exchange transactions rather than contributions and similar revenues. Much of the attention from colleges and universities has been with respect to grant revenue. Although still under review by the FASB, preliminary discussions have suggested that most grants may be considered outside the scope of the revenue standard. We expect a clearer indication of the FASB's views in the second quarter of 2016. The updated lease accounting standard will increase, perhaps significantly, reported assets and liabilities as lease obligations and related "right to use" assets are moved onto balance sheets. Previously, these obligations were off-balance-sheet and disclosed in the footnotes. For most colleges and universities, this new guidance is effective in fiscal 2020. While there is ample time for assessment and planning, institutions will now want to evaluate the possible impact on debt covenants.

Audit committees at public institutions are contending with various recent governmental accounting changes. Changes with respect to pension obligations have already impacted the statements of many public universities, as the funded status of defined benefit pension plans was reported on 2015 balance sheets. For 2016, a new fair value measurement and disclosure standard will add more complexity to financial reporting. In addition, similar to the change with respect to pensions, public institutions are now preparing for change with respect to other post-employment benefits (OPEB) effective for financial statements for fiscal years beginning after June 15, 2017.

The audit committee provides oversight of internal controls, including fraud prevention and detection controls, relying in part 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 controls. Beyond assessing "tone at the top," the committee should 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.

Oversight of external and internal auditors

Because external and internal auditors play a vital role in the financial reporting process, including assessment and testing of internal controls, 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 premeeting materials to discussing important developments on a real-time basis, informal conversations represent time well spent.

The audit committee should consider its role (versus financial management's) in key areas, such as reviewing audit plans, evaluating the external auditor's performance, fees, and partner rotation. In all of these areas, management works closely with the engagement team and has important knowledge and insights that can help the audit committee carry out its responsibility for oversight of the external auditor.

Oversight of the financial reporting process and the external auditor requires audit committees to play an important role in supporting and promoting audit quality, yet there is no universally agreed-upon definition of a "quality" audit. At the least, quality external audit service would include a rigorous audit, with an appropriate degree of professional skepticism, conducted in compliance with applicable standards. Other essential elements might include depth of industry knowledge, the nature and extent of valuable insights and observations arising from the audit process, effective communications with audit committees and management, or well-coordinated teamwork and appropriate supervision of audit staff. Some audit committees wonder if they should strive to obtain audit service at the lowest possible cost. Obviously, we bring a natural bias to this question, but in our experience, some of the best audit committees consider this question in the same way they would any other professional service for which quality is critical to the organization.

For those institutions with an internal audit function, audit committees typically review the internal audit plan and results of their work. Two key areas for audit committee involvement are (i) helping to define or clarify internal audit's role (it is important that the internal auditors, CEO, CFO, and audit committee have a shared view of the role) and helping to ensure that it has the skills and resources to be successful in that role and (ii) defining the reporting relationship for internal audit.

There is an inherent tension in the internal auditor's role: the head of internal audit is an important member of the institution's management team, while at the same time responsible for reviewing management's conduct and performance. The challenge for the audit committee is to establish a relationship that helps the head of internal audit and internal audit staff operate effectively in this dual management/monitoring role. Does internal audit have the stature—and a direct line to the audit committee—to ensure that its voice is heard and valued?

It is common for internal audit to report "functionally" to the audit committee and "administratively" to the CEO or other C-level executives, e.g., the CFO or general counsel, who can effectively serve as the "internal audit champion." In many cases, it will make sense for both the audit committee and the champion to be jointly responsible for overseeing internal audit.

Oversight of risk

We continue to see colleges and universities initiate enterprise risk management (ERM) programs and most earlier ERM adopters are seeing programs mature and governance oversight become more formalized and effective. Consistent with New York Stock Exchange corporate governance standards, which require the audit committee "to discuss policies with respect to risk assessment and risk management," at most colleges and universities it is the audit committee that is assigned responsibility for oversight of the institution's risk *processes*. Unlike corporations, the boards of the vast majority of colleges and universities are too large for the full board to assume this responsibility. 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, although oversight of financial reporting risk is clearly within the audit committee's purview and risks such as compliance with laws and regulations, conflicts of interest/related-party transactions, and technology are frequently deemed to be within the scope of the audit committee. (Further discussion of these risk areas was included in our 2015 audit committee agenda publication: www.kpmg.com/us/2015higheredagenda.) 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 risk oversight activities and the top risk areas?

Executive sessions

Even at audit committee meetings where frank discussion is encouraged and expected, a full meeting room may not always be conducive to complete candor. Executive sessions, which are standard fare for audit committees, provide an important opportunity for auditors, management, and audit committee members themselves to share their views privately and fully.
To make the most of executive sessions, the audit committee should consider (i) holding the session as a matter of routine, otherwise the calling of an executive session may lead to speculation and concern; (ii) having private discussions with various individuals, including the lead audit engagement partner, head of internal audit, and other institution executives such as the CFO and general counsel; and (iii) providing executive session participants with questions in advance if a thorough response may require research or forethought. As one veteran board member has suggested, "Executive sessions shouldn't be a game of 'gotcha'."

About us

KPMG's commitment to higher education, research, and other not-for-profit organizations began shortly after the firm was established.

In fact, KPMG was the first major professional services firm to develop a Higher Education, Research & Other Not-for-Profits (HERON) practice. For decades, our dedicated HERON practice has served higher education and not-for-profit organizations as auditors, tax specialists, and business advisers. Our HERON practice constitutes one of our significant industry practices, with more than 1,500 professionals nationally.

We serve private and public colleges and universities across the country, and our professionals have been educated throughout their careers on the issues and challenges of higher education. Our deep experience provides our professionals with the ability to identify valuable insights to help higher education leaders address the critical issues they face in a rapidly changing industry.

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