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On the 2017 higher education audit committee agenda

Drawing on insights from our 2017 Global Audit Committee Pulse Survey as well as interactions over the last year with audit committees and senior management of colleges and universities, we've highlighted four items that audit committees should keep in mind as they consider and carry out their 2017 agendas. The sidebar below delineates a broader list of areas likely to receive attention in 2017.

2017 Higher Education Audit Committee Focus Areas

In addition to core responsibilities regarding financial reporting and internal controls – including review of external and internal auditor reports and recommendations – several risk areas will require the attention of higher education audit committees over the next year. Among those likely to receive emphasis are:

- Institutional compliance and control programs amid fast-changing, uncertain federal landscape
- Preparedness for new FASB and GASB financial reporting standards and potential expansion of OMB and Department of Education audit requirements
- Evaluating risk and mitigation trends – including proposed budget and policy changes from the new administration – under ERM programs
- Strength of IT programs: cybersecurity, data privacy and recovery, system replacements
- Campus safety and related compliance: Title IX, international students and faculty
- Global activities: impact of potential regulations, operational visibility, compliance, monitoring
- Managing conflicts of interest and related-party transactions
- Depth of resources in and succession planning for accounting, compliance and internal audit
- Measurement and verification of key non-financial metrics published by the institution
- Ensuring committee scheduling and resources are commensurate with scope and agenda
- Review of committee charter, responsibilities, effectiveness, orientation protocol

Monitor implementation plans and activities for major financial reporting and accounting changes on the horizon.

In August 2016, the FASB issued Accounting Standards Update (ASU) 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*, which brings significant changes to how private, not-for-profit colleges and universities report net asset classes, expenses and liquidity in their financial statements.

The most significant change that you will notice is that the new standard reduces the number of net asset classes presented from three to two: *with donor restrictions* and *without donor restrictions*. The FASB's decision to combine the two restricted net asset classes into one net asset class is, with respect to donor-restricted endowments, more in line with changes resulting from the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which is now law in almost all states. One of the ASU's more applauded changes relates to the treatment of underwater endowments. To the extent the fair value of an individual donor-restricted endowment fund as of the balance sheet date falls below the original amount of the gift, such deficiency or underwater amount is currently reported in unrestricted net assets, creating misconceptions. However, under the ASU, the deficiency will be reported in net assets with donor restrictions. Therefore, the entire donor-restricted endowment will be presented in one net asset class, rather than spread among up to three classes currently.

The standard also requires NFPs to:

- present expenses by their functional *and* their natural classifications in one location in the financial statements or footnotes;

— present investment return net of external and direct internal expenses; and

— disclose quantitative and qualitative information about management of liquid resources and availability of financial assets to meet cash needs for general expenditures within one year of the balance sheet date.

We believe the disclosures with respect to liquidity and availability of resources may be the most time-intensive for colleges and universities to understand and implement. One of the major objectives of the standard was to improve the quality of information users have to assess an institution's liquidity and availability of resources. We recommend that when preparing these disclosures, institutions consider the following: In terms of liquidity, how is cash in excess of daily requirements managed, is there a liquidity reserve, and are there available lines of credit? In terms of availability, how should donor-restricted and board-designated resources factor into the analysis? A clear description of the assumptions used and the interaction of these and other relevant factors will enable financial statement users to better evaluate management's assessment.

The FASB anticipates that these new disclosures will evolve over time and stated that the disclosures "provide a potential starting point for an analysis of an NFP's liquidity," acknowledging that "a comprehensive analysis of liquidity requires forward-looking information about revenues, expenses, and cash flows as well as management commentary and analysis that go beyond the scope of financial statements."

In summary, we believe the ASU offers colleges and universities the opportunity to reassess their financial statements and note disclosures and consider changes that might be made to better tell their financial story. For example, institutions should be attuned to evolving industry guidance around the appropriate level and type of functional and natural expense detail to present and may want to re-evaluate their functional expense allocation methodologies well in advance of adoption. KPMG's related "Issues In-Depth" publication is available at www.kpmg-institutes.com and provides insights and illustrations we hope will be helpful as institutions implement the new standard in their financial statements no later than for the fiscal year ending in 2019.

Two long-running FASB projects resulted in the issuance of new accounting standards set out in ASU 2014-09, *Revenue From Contracts with Customers*, and ASU 2016-02, *Leases.* With respect to revenue recognition, much of the attention from colleges and universities continues to be with respect to revenue from various types of funders, but particularly government-sourced grants and contracts. Two issues have risen to the top of the list being considered: (i) characterizing grants and contracts as reciprocal transactions (exchanges) or nonreciprocal transactions (contributions) and (ii) distinguishing between conditional and unconditional contributions. Although still under review by the FASB, it is currently anticipated that most governmental grants and contracts will be considered outside the scope of the new revenue standard (effective for most private institutions in fiscal 2019). Under the new lease standard (effective in fiscal 2020 for most private colleges and universities), reported assets and liabilities will increase, perhaps significantly, as lease obligations and related "right to use" assets are moved onto balance sheets. Currently most of these obligations are off-balance sheet and disclosed in the footnotes. The changes are focused principally on lessees; however, the lessor accounting model – impacting far fewer colleges and universities – remains mostly unchanged, but was updated to better align with changes in both lessee accounting and revenue recognition.

Implementation of these three new standards is not just an accounting exercise; audit committees will want to receive periodic updates on the status of implementation and assessment of impact, including possible impact on debt covenants.

Audit committees at public institutions continue to contend with various governmental accounting changes. Changes with respect to pension obligations impacted the financial statements of many public universities when the net pension liability for defined benefit pension plans began to be reported on balance sheets in 2015. In 2016, a new fair value measurement and disclosure standard similar to FASB's added more complexity to financial reporting, particularly around investments. In addition, public institutions are now preparing to report the liability for other post-employment benefits (OPEB) consistent with pension obligations, effective in fiscal 2018 for most schools and systems. The impact may be significant and will depend upon the nature of benefits provided and whether there are dedicated plan assets to offset liabilities. For public universities participating in one or more defined benefit OPEB plans, the financial statement impact of this new standard is also likely to reduce the unrestricted net position of the institution because many defined benefit OPEB plans historically have been funded on a pay-as-you-go basis. The audit committee should gain an understanding of the possible impact on debt covenants and financial ratios. Public institutions are also beginning to tackle GASB 81, *Irrevocable Split-Interest Agreements*, GASB 83, *Certain Asset Retirement Obligations*, and GASB 84, *Fiduciary Activities*, which are effective for most public institutions in fiscal 2018, 2019, and 2020, respectively. On the horizon, GASB is also expected to issue a new leasing standard later this year which, while different in some respects from the FASB model, would also eventually require most leases to be on the balance sheet.

Quality financial reporting starts with the CFO and the business office/finance organization; maintain a sharp focus on leadership and bench strength.

In our latest global pulse survey, 44% of audit committees were not satisfied that their agenda is properly focused on CFO succession planning, and another 46% were only somewhat satisfied. In addition, few were satisfied with the level of focus on talent and skills in the finance organization.

The National Association of College and University Business Officers' (NACUBO) *2016 National Profile of Higher Education Chief Business Officers* reports that nearly 60% of chief business officers (CBOs) are 55 or older and almost a quarter of those individuals are 65 or older. In light of those numbers, it is not surprising that nearly 20% of survey respondents expect to retire from their current positions within four years.

The expected high level of retirements among CBOs prompted NACUBO to add a suite of questions regarding succession planning, defined in the survey as "a process for identifying and developing people to fill key leadership positions within the organization." While more than 80% of respondents considered succession planning to be either "important" or "very important," less than 3% were employed at institutions with formal, written strategies to replace the CBO and nearly 40% were at institutions with no plan – formal or informal – in place.

The NACUBO definition of "succession planning," like many others, is associated with talent management and places emphasis on identifying and nurturing internal leaders. Yet, The Hanover Research Council's *Effective Practices for Succession Planning in Higher Education* (2010) asserts that there is "a widespread conception in higher education that external hiring, rather than the development of internal candidates, is the best way to fill senior administrative positions." In addition, Hanover suggests that the need to "balance succession planning with staff diversity concerns" can be an obstacle in the implementation of succession planning programs.

Often, an institution does not have the luxury of someone internally who is prepared to assume, even on an interim basis, the CFO position. Although large institutions may be limited in this regard, bench strength can be even more challenging at mid-sized and small colleges and universities. The audit committee should have an understanding of the required next steps if the CFO is suddenly unable to serve. A similar understanding may be appropriate for the chief internal audit executive and chief information officer (CIO).

How does the audit committee assess the finance organization's talent pipeline? Do employees have the training and resources they need to succeed? Do position descriptions exist for key roles? What are the internal and external auditors' views?

Refine and widen discussions about cyber risk and security.

Despite the intensifying focus on cybersecurity, the cyber-risk landscape remains fluid and opaque, even as expectations rise for more engaged oversight. As the cyber landscape evolves, board oversight – and the nature of the conversation – must continue to evolve. More often than not, we see college and university audit committees having responsibility with respect to the defensive elements of technology, namely cybersecurity and data privacy. Oversight here includes regular discussions with chief technology/information officers as audit committees strive to better understand trends, regulatory developments and the "what and where" of sensitive information requiring protection. It is becoming more common to see CIOs and/or chief information security officers attend every audit committee meeting.

Two particular types of hacking incidents have garnered recent attention – phishing scams and ransomware attacks. A February 11, 2017 headline *College students are the latest targets of aggressive phishing scams* from WTAE.com underscores the importance of educating students and employees. Both groups need to understand the nature and dangers of phishing scams and become more suspicious when checking (not simply opening) email. On January 18, 2017, the FBI issued a Public Service Announcement, *Employment Scam Targeting College Students Remains Prevalent,* warning of scammers recruiting students for fictitious positions. These scams often involve financial fraud and the obtaining of personal information from the student, leaving them vulnerable to identity theft. Again, education and skepticism are critical safeguards.

A January 24, 2017 Inside Higher Ed story*, Your Data Or Your Money: Hackers are locking colleges' data away and demanding payment to return it. But paying the ransom raises new issues, experts say*, addresses one of the fast-growing hacking strategies. Audit committees should gain an understanding of the institution's vulnerability – this includes an assessment of back-up files and the ability to avoid business interruption without the hostaged information.

In a July 2016 letter, the U.S. Department of Education (ED) reminded colleges and universities of their legal obligations to protect student information used in the administration of federal student financial aid programs. This important compliance requirement with respect to federal awards – which are critical to nearly all higher education institutions – dates back to 2003, but is now receiving more focused ED attention. ED considers any breach in the security of student records and information evidence of a potential lack of administrative capability. The letter states that institutions should have "at a minimum, evaluated and documented their current security posture…and have taken immediate action to remediate any identified deficiencies." The letter also informs institutions that ED is moving to include procedures in its annual audit guidance for auditors to perform "in order to assess and confirm institutions' compliance." While it is unclear what the scope of the audit procedures may ultimately entail, institutions should consider whether their information security plan has been subjected to recent review and testing. Institutions should also be cognizant that the security requirements likely encompass numerous IT systems in which student information resides, related security protocols connected to general IT and other application controls, and other business processes through which student data is processed. Accordingly, the breadth of potential policy and audit exposure could be significant.

The audit committee should help ensure that (i) cyber risk is managed as a business or enterprise risk – not simply an IT risk – and (ii) awareness of and accountability for cybersecurity permeates the institution, with a security mind-set, proper training, and preparation for incident response.

Focus internal audit on key areas of risk and the adequacy of the institution's risk management *processes*.

Internal audit is most effective when it is focused on the critical risks to the business, including key operational risks and related controls, not just compliance and financial reporting risks. Help define the scope of internal audit's coverage and, if necessary, redefine internal audit's role. Is the audit plan risk-based and flexible, and does it adjust to changing business and risk conditions? What has changed in the operating environment? What are the risks posed by a decentralized environment, including international operations? For academic medical centers, governance, risk and compliance pose unique challenges which internal audit may help address. Set clear expectations and make sure internal audit has the resources, skills, and expertise to succeed. Help maximize collaboration between internal and external auditors. As internal audit moves to a higher value-added model, it should become an increasingly valuable resource for the audit committee.

Other useful resources:

— KPMG Global Audit Committee Pulse Survey
https://boardleadership.kpmg.us/content/dam/blc/pdfs/2017/2017-global-audit-committee-pulse-survey.pdf

— On the 2016 Higher Education Audit Committee Agenda
http://www.kpmg-institutes.com/content/dam/kpmg/governmentinstitute/pdf/2016/2016-highered-agenda.pdf

— On the 2015 Higher Education Audit Committee Agenda
http://www.kpmg-institutes.com/content/dam/kpmg/governmentinstitute/pdf/2015/higher-ed-agenda.pdf

— KPMG Audit Committee Guide
https://boardleadership.kpmg.us/content/dam/blc/pdfs/2016/kpmg-audit-committee-guide-2016.pdf

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