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On the 2019 higher education audit committee agenda

Audit committees will again be challenged to effectively oversee their institutions' financial reporting (which for most will reflect the significant changes to be implemented in fiscal 2019 statements) and related risks, as well as other risk-driven agenda items such as cybersecurity and compliance with laws and regulations. As if that wasn't enough, we are seeing some audit committees assigned the responsibility for oversight of institutional culture, which the National Association of Corporate Directors said "should be among the top governance imperatives for every board, regardless of its size or sector."[1] Drawing on insights from our work and interactions 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 2019 agendas.

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

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 2014-09, *Revenue From Contracts with Customers*; ASU 2018-08, *Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made* (discussed last year as a proposed ASU and finalized in June 2018); and ASU 2016-02, *Leases*.

The *Presentation* standard, which is much more about financial reporting than the underlying accounting, is effective for most private not-for-profit colleges and universities for fiscal 2019 statements. The overwhelming majority of institutions have chosen not to early adopt the standard and may benefit from referencing the financial statements and disclosures of early adopters, which include some of our country's largest research institutions as well as smaller schools.

The adoption of the *Presentation* standard provides an opportunity to consider other areas where financial statements and/or disclosures might be modified. For management responsible for the preparation of the institution's financial statements and related disclosures as well as board members providing valuable oversight, it may be useful to approach a fresh look with an understanding of the objectives of general purpose financial reporting, which is intended to meet the needs of a broad range of external users. General purpose financial statements of colleges and universities should provide information that assists existing and potential resource providers and other users in making decisions about providing resources to the institution and in assessing the services the institution provides, as well as its ability to continue to provide those services. The expectation that general purpose financial statements provide insight into an institution's ability to continue to carry out its mission

[1] NACD, *Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset* (Washington, DC: NACD, 2017), p. 7.

has garnered significant attention in the face of a growing number of college closings and mergers. While nowhere near the numbers predicted in some of the more dire forecasts with respect to small, private college closures, there has been an increase in the closure rate (a July 2018 report from Moody's puts the current rate at about 11 closures annually—versus three to five pre-financial crisis) and growing anxiety about viability and the impact of "surprise" closures on consumers as well as faculty and other employees.

The fresh look at the financial statements and disclosures may warrant consideration of materiality in assessing whether the financial story is told without superfluous information. The FASB's recent discussions regarding materiality emphasize that it is entity specific and that materiality judgements need to consider quantitative and qualitative factors. The omission of immaterial information is unlikely to change or influence the judgment of a reasonable person relying upon the statements or disclosures, while the inclusion of immaterial information may distract readers and divert their focus from more important information. There is also cost—both time and money—associated with presenting immaterial information.

As anticipated, the quantitative and qualitative disclosures with respect to liquidity and availability have been identified by many early adopters as the most demanding aspect of implementation. Preparers should consider liquidity-related information already in the footnotes, information previously provided to credit rating agencies, banks or others as well as the disclosures of early adopters. It is important the audit committee understands that the required quantitative information focuses on the availability of financial *assets* at the balance sheet date, rather than *net assets* which recognize existing liabilities. This is particularly important at institutions with limited financial flexibility. In assessing the message conveyed to financial statement users and consistent with its approach to review of the audited financial statements as a whole, the audit committee should be satisfied that the information is consistent with information known to committee members and conveys well meaningful liquidity information, as well as any availability limitations, such as donor restrictions or board designations. To give the audit committee time to consider and offer input with respect to this important new disclosure, management should consider providing a draft of the note in advance of the fiscal 2019 year-end using 2018 data. 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." Recognizing that board designations of net assets will now attain greater significance in financial statements, the AICPA issued guidance in June 2018, "Board Designations and Delegations: Important Considerations and Sample Policies." In light of new reporting requirements, boards may want to reconsider whether formal designations are even necessary.

For most private institutions, the *Revenue* standard will also be effective for fiscal 2019. While the impact of this standard on colleges and universities—after management has thoroughly analyzed revenue streams potentially in scope—may prove to be immaterial for some institutions, the new guidance requires attention, particularly with respect to tuition and housing revenue streams. Questions surrounding contract existence, refund policy, collectibility, transaction price, and summer sessions may need to be addressed.

When the *Revenue* standard was released, much of the attention from colleges and universities was related to government-sourced grants and contracts. As noted above, there are other revenue streams subject to the standard, but most federal research grants and contracts are now deemed to be conditional contributions covered instead by the more recent *Contributions* standard and outside the *Revenue* standard's scope. As to this revenue stream, the impact of the *Contributions* standard might be muted for most colleges and universities as they may continue to recognize revenue as allowable costs are incurred. However, the terms of agreements with all sources, including foundations and corporate sponsors, will need to be evaluated in order to determine whether the transaction is an exchange or a contribution, as well as whether a contribution is conditional.

Most colleges and universities have until fiscal 2020 to implement the *Leases* standard—arguably the most complex of the new standards that will impact higher education. For those with significant lease agreements (as lessee, lessor, or both) or difficulty identifying all leasing transactions in a decentralized campus environment, implementation may be challenging and audit committees should continue to monitor management's progress.

Public universities will also have some significant financial statement changes to address, including GASB Statement No. 87, *Leases*, and GASB Statement No. 84, *Fiduciary Activities*. *Leases*, which is effective for most in fiscal 2021, will likely require the greatest effort. Ensuring the identification of the population of potential leasing arrangements, including embedded leases, through the institution or system is a critical starting point and may present significant challenges. *Fiduciary Activities*, which is effective for most in fiscal 2020, will require fiduciary activities—including, for example, pension and postretirement plans administered through a trust—to be reported in separate fiduciary fund financial statements.

Other standards that public universities will need to address include GASB Statement No. 83, *Certain Asset Retirement Obligations*, and GASB Statement No. 88, *Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements*, which are effective for most in fiscal 2019, as well as GASB Statement No. 89, *Accounting for Interest Cost Before the End of a Construction Period*, which is effective for most in fiscal 2021. Looking at some other areas of GASB focus, a final statement on Conduit Debt and an exposure draft on Public Private Partnerships are expected to be issued in the first half of 2019.

Enterprise risk management (ERM)

Our own experience continues to confirm that a large majority of institutions have assigned responsibility for oversight of risk management *processes* to the audit committee. This oversight role and discussions with respect to the specific risks assigned to the audit committee typically fill the committee's agenda time available beyond the time devoted to core responsibilities. Often, the time allotted for these issues appropriately exceeds that provided for core matters. With respect to process oversight, the committee should help ensure that the institution understands and leverages the strategic value of risk management activities. Leveraging risk management as a strategic tool to improve decision making hinges on having a common (and current) understanding of the institution's risk profile and philosophy: How do we think about risk and reward? What risks are acceptable, and how do they align with strategy? What are the issues where we won't compromise, no matter how low the probability of an adverse outcome? How is leadership—in the C-suite and the boardroom—keeping pace with developments in the operating environment, including those outside higher education, that could impact colleges and universities?

A risk area that is not abating and more often than not deemed to be within the purview of the audit committee is cybersecurity and data privacy. Audit committee discussions are moving beyond prevention to *detection*, *containment*, and *response*—and to addressing these risks as an enterprise-wide business issue that affects strategy, compliance, and relationships with vendors, suppliers, employees, and students. A robust and frank boardroom dialogue is vital to helping the institution learn to live with cyber risk and making cybersecurity a competency across the organization. Audit committees need to understand how the institution is keeping up with regulatory changes and new legal requirements. In our 2017 and 2018 Agenda papers, we discussed the U.S. Department of Education's (ED) interest in institutional compliance with respect to data security regulations. That interest has not lessened, and ED is now expected to require auditors to perform procedures to assess certain aspects of institutional compliance as soon as in 2019 Single Audits.

While ED is (for now) focused on compliance with U.S. laws and regulations, many colleges and universities became subject to European Union (E.U.) law when the General Data Protection Regulation (GDPR) became effective in May 2018. Colleges and universities with operations in the E.U. as well as those which enroll foreign nationals or employ E.U. citizens at U.S. campuses are almost certainly subject to GDPR. Data obtained from potential students or employees may also require protection. While those affected had two years to prepare for the effective date and a good number of schools established task forces to help ready their institutions for compliance, many institutions may not be ready for stepped up E.U. enforcement. A November 2018 *Inside Higher Ed* article, "With E.U. slow to enforce new data privacy laws, colleges told not to panic about lack of compliance," highlighted some of the perspectives offered in a session at Educause's annual conference in October 2018. A key message was that while E.U. data protection authorities are developing enforcement strategies and no U.S. universities had yet to be fined, institutions should not be complacent about compliance.

Headlines of sexual harassment and other wrongdoing—with institutional culture as the culprit—have put boards squarely in the spotlight: Where was the board? And what is it doing to fix the culture? While oversight of institutional culture may be seen as a full board responsibility because of its connection to strategy, risk and performance, some audit committees have been delegated this specific risk area as an extension of their oversight of risk management processes, the control environment, the results of internal audits, compliance, or hotline reports. As with other risks, each board should decide where to assign oversight for culture risk.

For a 2017 edition of *Global Boardroom Insights*, KPMG's Audit Committee Institute interviewed directors and subject matter experts to gather their perspectives on this issue. Takeaways included: Culture should start at the top and cascade down through all levels of the organization; in addition to its monitoring role, the board should model the behavior leadership wants to drive; the board should ensure it is getting an unfiltered view of culture, including information from all levels of the organization; and internal audit should be leveraged to help assess and monitor culture.

One area that touches both culture and compliance risk, and which is often assigned to the audit committee, is intercollegiate athletics. In September 2018, the Association of Governing Boards of Universities and Colleges (AGB) issued its *Board of Directors' Statement on Governing Boards' Responsibilities for Intercollegiate Athletics*. The Statement acknowledges the increasing challenges associated with college sports, including growing costs, student-athlete academic performance, and health and safety risks, as well as high-profile scandals and ethical violations. The Statement presents three principles (including Principle 2: "The governing board must accept responsibility for upholding the integrity of the athletics program and ensuring it advances the institution's educational mission.") The Statement recognizes that "administrative or managerial oversight alone is not sufficient to counter the forces that cause athletics to equal and even overshadow the academic purposes of an institution," and urges boards to grasp the responsibility, emphasizing that "attention by higher education's fiduciaries to the challenges of intercollegiate athletics is essential."

Final thoughts

In previous papers, we have commented on the importance of assessing the audit committee's and board's performance. AGB also recently issued a publication, *Assessing Board Performance: A Practical Guide For College, University, System, and Foundation Boards*, which asserts that "board assessment is an essential element of good governance" and also recognizes that "the work of boards should be grounded in the work of their committees." AGB recommends that the board periodically evaluate overall committee structure and that each committee regularly assess its own performance. We believe that audit committee self-assessment should be tailored to meet the needs of the institution and that a constructive assessment process depends on the committee's ability to develop a culture of frankness and mutual trust. The audit committee chair, working with the board chair, should establish a process and performance criteria that suit the culture of the institution, ensuring independence, candor and strict confidentiality with respect to each participant's input and feedback. Ultimately the self-assessment should be performed with a view to identify areas where the committee and its processes might be more effective.

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