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On the 2019 not-for-profit audit committee agenda

Audit committees will again be challenged to effectively oversee their organizations' financial reporting (which for many will reflect the significant changes to be implemented in calendar 2018 or 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 organizational 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 not-for-profit organizations (NFPs), 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. 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 no later than for fiscal 2019 statements. The overwhelming majority of NFPs have chosen not to early adopt the standard and may benefit from referencing the financial statements and disclosures of early adopters, which include organizations across the not-for-profit spectrum.

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 organization'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

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

general purpose financial reporting, which is intended to meet the needs of a broad range of external users. General purpose financial statements should provide information that assists existing and potential resource providers and other users in making decisions about providing resources to the organization and in assessing the services the organization provides and its ability to continue to provide those services.

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 judgments 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.

In our 2017 and 2018 papers, we devoted considerable attention to functional expense reporting, which continues to attract what some would say is excessive attention because expense metrics (e.g., ratio of program expenses to total expenses) are too often a poor substitute for reporting on service accomplishments and impact. Functional expense reporting says nothing about impact. The ability to measure and articulate impact isn't only to support fundraising efforts, as volunteers, staff, and board members get uplifted and motivated by the stories of how a real difference was made—likely what attracted them to the organization in the first place.

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 previously provided to 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 organizations 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 as early as practicable, perhaps using prior year 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.

The *Revenue* standard will be effective for years beginning after December 15, 2018, except for Public NFPs[2], for which the effective date is one year earlier. The impact of this standard—after management has thoroughly analyzed revenue streams potentially in scope—may prove to be immaterial for some organizations. To assist management of NFPs in applying the *Revenue* standard, the AICPA Not-for-Profit Entities Revenue Recognition Task Force identified implementation issues and provided nonauthoritative guidance with respect to subscriptions and membership dues, as well as tuition and housing revenues. Beyond these areas, many organizations may find that revenue streams requiring attention are exchange transactions not unique to NFPs.

When the *Revenue* standard was released, much of the attention from NFPs was related to government-sourced grants and contracts. As noted above, there are other revenue streams subject to the standard, but most federal 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 many NFPs 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

[2] NFPs that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

the transaction is an exchange or a contribution, as well as whether a contribution is conditional.

Some grants that are considered exchange transactions under current U.S. GAAP will be accounted for as conditional contributions under the new guidance, and some that are now considered unconditional contributions will be deemed conditional under the new guidance. Audit committees will want to understand the financial statement impact, if any, particularly whether implementation of the *Contributions* standard will delay recognition of revenue (recipients) or expenses (resource providers), or have a more muted effect.

The *Contributions* standard will be effective for most NFPs for years beginning after December 15, 2018, but only as to transactions for which the reporting entity is a resource recipient. As to transactions for which the reporting entity is a resource provider, the standard will be effective for most NFPs for years beginning after December 15, 2019. For Public NFPs, these effective dates are for years beginning after June 15, 2018 and December 15, 2018, respectively.

Most NFPs have until calendar 2020 or fiscal 2021 to implement the *Leases* standard—arguably the most complex of the new standards that will impact NFPs. Once again, the effective date is one year earlier for Public NFPs. For those with significant lease agreements (as lessee, lessor, or both) or difficulty identifying all leasing transactions in a decentralized environment, implementation may be challenging and audit committees should continue to monitor management's progress.

Enterprise risk management (ERM)

Our own experience continues to confirm that a majority of organizations 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 organization'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 the not-for-profit sector that could impact the organization?

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 service beneficiaries. A robust and frank boardroom dialogue is vital to helping the organization learn to live with cyber risk and making cybersecurity a competency across the organization. Audit committees need to understand how the organization is keeping up with regulatory changes and new legal requirements.

Many NFPs became subject to European Union (E.U.) law when the General Data Protection Regulation (GDPR) became effective in May 2018. While organizations with operations in the E.U. as well as those which employ E.U. citizens at U.S. offices are almost certainly subject to GDPR, many other NFPs will find that they possess data requiring protection under GDPR. An article authored by Tal Frankfurt, the Founder and CEO of Cloud for Good, provides an excellent introduction to the topic and discusses GDPR's definition of personal data, how such data might be collected by NFPs, and the author's "top nine best practice tips for how your nonprofit can help mitigate some of the risks associated with the GDPR."[3] While those affected had two years to prepare for the effective date and we are not aware of any U.S. NFPs cited or fined for noncompliance, many organizations may not be ready for more rigorous enforcement activity that is likely coming.

Headlines of sexual harassment and other wrongdoing—with organizational 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 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

[3] Frankfurt, Tal. "What Does GDPR Mean for U.S. Based Nonprofits?," Forbes (May 25, 2018).

internal audits, compliance, or hotline reports. As with other risks, each board should decide where to assign oversight for culture risk.

Recognizing that "a company's ability to promote the attitudes and behaviors needed to navigate a much more challenging business terrain will be increasingly important," in January 2019, State Street Global Advisors issued a paper *Aligning Corporate Culture with Long-Term Strategy* to "help guide directors and senior management as they tackle this complex issue." The paper notes that "while senior management plays a more direct and influential role in defining and shaping culture within an organization, board oversight is still needed. Oversight of corporate culture is inherently complicated in that, as an intangible, culture can be difficult to articulate or change."

We too have recognized the importance and challenge of culture oversight. 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.

Final thoughts

In previous papers, we have commented on the importance of assessing the audit committee's and board's performance. The 3rd edition of the AICPA's *Audit Committee Toolkit: Not-for-Profit Entities* recommends an annual self-evaluation and provides a sample questionnaire to be used as a starting point. We believe that audit committee self-assessment should be tailored to meet the needs of the organization 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 organization, 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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