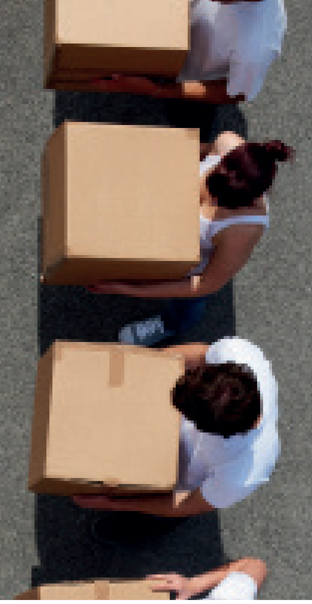

On the 2017 not-for-profit audit committee agenda

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 not-for-profit organizations (NFPs), we have 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 NFP 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 NFP audit committees over the next year. Among those likely to receive emphasis are:

- Compliance and control programs amid fast-changing, uncertain federal landscape
- Preparedness for new FASB financial reporting and accounting standards
- 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
- 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
- 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 NFPs 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 (voluntary health and welfare organizations have historically been required to present this information in a statement of functional expenses but will now have the same reporting requirement—and the same presentation flexibility—as all other NFPs);

— 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 NFPs to understand and implement. One of the major objectives of the standard was to improve the quality of information users have to assess an organization's liquidity and availability of resources. We recommend that when preparing these disclosures, organizations 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 qualitative 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 NFPs the opportunity to reassess their financial statements and note disclosures and consider changes that might be made to better tell their financial story. Given continuing sensitivities around the emphasis by donors on NFP overhead—and despite recent efforts made by GuideStar and other industry organizations to debunk the "overhead myth" (Source: overheadmyth.com)—NFPs will want to focus particularly on the ASU's changes with respect to functional expenses. Prompted by concerns over diversity in NFP cost allocations, the ASU requires new qualitative disclosures about methodologies used by the organization to allocate expenses attributable to more than one *program* or *supporting* activity. Additionally, in an effort to increase clarity and promote consistency and comparability among NFPs, the ASU redefines *management and general* expenses as "supporting activities that are not directly identifiable with one or more program, fundraising, or membership-development activities." Clearly, the enhanced level of transparency and new detailed guidance for allocating costs will necessitate a fresh look by NFPs at how they allocate and present expenses in their financial statements. 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 organizations implement the new standard in their financial statements no later than for calendar 2018 or fiscal years 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 NFPs 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 government grants and contracts will be considered outside the scope of the new revenue standard (effective for most NFPs for years beginning after December 15, 2018). Under the new lease standard (effective for most NFPs for years beginning after December 15, 2019), 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 NFPs—remains mostly unchanged but was updated to better align with changes in both lessee accounting and revenue recognition. For those NFPs with public or conduit debt, the effective dates of both ASU 2014-09 and ASU 2016-02 are one year earlier than indicated above.

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.

Quality financial reporting starts with the CFO and the 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.

In October 2015, The Stanford Social Innovation Review included an article, *The Nonprofit Leadership Development Deficit*, whose authors wrote, "In more than a decade of research on nonprofit leadership, we at The Bridgespan Group have observed little change in the No. 1 organizational concern expressed by boards and CEOs: succession planning… Our most recent research provides a clue as to why. Only 30% of C-suite roles in the nonprofit sector were filled by internal promotion in the past two years… Even more concerning, this low promotion rate did not vary by the size of the organization: larger organizations, which should have more opportunities to promote internal talent, are not doing so."

Reflecting the high priority placed on the issue of succession planning, there is a great deal of literature on the subject, most often focused on chief executive transition and succession planning. BoardSource's January 2015 *Leading With Intent: A National Index of Nonprofit Board Practices* reported that "only 34 percent of boards have a written CEO succession plan." It is safe to assume that far fewer NFPs have written plans in place for CFO succession. For example, a 2016 survey focused on colleges and universities found that less than 3% of respondents were employed at institutions with formal written CFO succession strategies (Source: NACUBO's *2016 National Profile of Higher Education Chief Business Officers*).

Much of the literature on succession planning associates that planning with talent management and places emphasis on identifying and nurturing internal leaders. Yet, The Bridgespan Group authors referred to above wrote that "[survey] respondents said that their organizations lacked the talent management processes to develop staff, and that they had not made staff development a high priority… When we asked respondents what was missing in their development, two themes emerged… a lack of learning and growth… and a lack of mentorship and support… Ultimately, an organization that fails to develop its people will find it more difficult to effectively achieve its goals."

Often, an organization does not have the luxury of someone internally who is prepared to assume, even on an interim basis, the CFO position. Although large organizations may be limited in this regard, bench strength can be even more challenging at mid-sized and small NFPs. The audit committee should have an understanding of the plan 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 NFP 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 attending audit committee meetings.

In January 2017, the National Association of Corporate Directors released its *Director's Handbook Series: Cyber-Risk Oversight*, the introduction to which emphasized that "while some language in the handbook refers to public companies, these principles are applicable to—and important for—all directors, including members of private companies and nonprofit boards. Every organization has valuable data and related assets that are under constant threat from cyber criminals or other adversaries." The threats, scams and techniques faced by not-for-profit organizations are similar to those confronting other sectors. In February 2017, the San Antonio Symphony confirmed a breach in which employee data, including names, addresses, birth dates, and social security numbers, were stolen (Source: San Antonio Express, February 14, 2017). Other not-for-profit organizations have been victimized by phishing scams, suffered the loss of donor and/or customer financial records (including credit or debit card numbers and expiration dates) and, in increasingly prevalent ransomware attacks, the denial of access to their own files and data.

In its May 2016 *Managing Cybersecurity Risk for Nonprofit Organizations: A Fiduciary Duty?*, law firm Patterson Belknap Webb & Tyler LLP stated that "directors and officers of nonprofits should put systems and controls in place to effectively manage the risk of cyberattacks to the level and degree appropriate for their institutions, taking into consideration each institution's own needs, resources, level of risk, and risk tolerance. For most organizations, this will *not* require directors and officers to acquire in-depth technical expertise in information technology (IT) and data security, or to become intimately familiar with the organization's day-to-day IT operations. It *will* mean undertaking reasonable efforts to inform themselves about the corporation's data needs and vulnerability to breach, and taking reasonable steps to protect against such breaches."

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 organization, with a security mind-set, proper training, and preparation for incident response. A key element of education and training initiatives is to ensure that all employees are aware of the specific information to which they have access (that access should be appropriate to their position and job description) and the important role they play in the organization's cybersecurity efforts. Additionally, employees need to understand the nature and dangers of phishing scams and become more suspicious when checking (not simply opening) e-mail. With respect to the risk of ransomware attacks, the committee should gain an understanding of the organization's vulnerability—this includes an assessment of backup files and the ability to avoid business interruption without hostaged information.

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? 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 Not-for-Profit Audit Committee Agenda
http://www.kpmg-institutes.com/institutes/government-institute/articles/2016/04/on-the-2016-not-for-profit-audit-committee-agenda.html

— On the 2015 Not-for-Profit Audit Committee Agenda
http://www.kpmg-institutes.com/institutes/government-institute/articles/2015/04/on-the-2015-not-for-profit-audit-committee-agenda.html

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

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