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Perspectives in higher education
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Introduction

The new Presidential administration has introduced a level of uncertainty and anxiousness into the higher education industry. The potential impact of changes in rules, regulations, funding and legislation has fostered significant planning considerations for educational institutions. At the same time, ongoing challenges and demands impacting institutions from parents, donors, federal regulators, state governments, and others are not lessening.

In this edition of "Perspectives in higher education" we have highlighted several of the areas that institutions are focused on and assessing. These areas include evolving practices in enhancing internal controls, enterprise risk management and audit committee governance. We have also provided a framework for assessing and managing cybersecurity risks. Additionally, we highlight the current regulatory environment and new financial reporting standards that will impact educational institutions. The higher education industry has not seen so many significant financial reporting changes since the 1990's.

Looking forward, this edition provides an outlook on potential federal legislation and rule changes that may impact the industry. We also offer suggestions in several administrative areas on how institutions are continuing to strive to be organizationally agile and efficient during this dynamic period. Additionally, we provide insights into the evolving and expanding role of the departmental administrator, and certain perspectives on the public role of colleges and universities and the related expectations of their communities.

In this time of significant change, it is important for higher education to stay abreast of changes and pressures within the industry, as well as more globally. Approaching change in a proactive and positive manner will ensure institutional success in the years ahead.

This document was created to share PwC's insights into the key challenges and related opportunities facing colleges and universities, and to offer an informed point of view on how institutions might proactively respond. As a leader in providing audit, tax, and advisory services to the higher education and not-for-profit industry, PwC has been honored to work with many of the nation's premier educational institutions in addressing their most pressing challenges. Our contributors to this paper are working with your peers on regulatory, tax, risk, and operational issues and are in an excellent position to share trends, insights and perspectives.

We hope you use this document as a platform for collaborative discussion on the items most pertinent to your institution. I invite you to contact me at (646) 471-4253 with any questions or comments you may have.

John A. Mattie
National Higher Education and Not-for-Profit Practice Leader

Washington outlook

Background

As the presidency of President Trump evolves, the nation expects to see significant changes take place in nearly every government program. Changes affecting higher education will be no exception. We believe there are key areas where the Trump administration could make changes that will affect students and families, colleges and universities, lenders and servicers, and the higher education operating model for years to come.

Impact on educational institutions

Tax reforms – Affordable Care Act (ACA), charitable giving and endowments

President Trump continues his call for action on ACA repeal and replacement legislation after a House effort in March 2017 failed when a scheduled vote was cancelled due to disagreements among House Republicans. GOP Congressional leaders are relying on a fiscal year 2017 budget resolution that provides budget reconciliation instructions for ACA repeal and replacement legislation. Congressional leaders would like to complete work on ACA legislation before the House and Senate pass a new fiscal year 2018 budget resolution providing instructions for tax reform legislation. This is because approving a new fiscal year 2018 budget resolution would invalidate the fiscal year 2017 reconciliation protections that Senate Republicans are relying on to pass ACA legislation.

The House Republicans have passed a revised ACA repeal and replacement bill, and now Senate Republicans could face their own challenge to secure the votes for a Senate version of such legislation. Both the House and Senate ultimately would need to agree on a final version of ACA repeal and replacement legislation and secure the votes in each chamber to clear a final bill to President Trump. The most recent version of the House ACA repeal and replacement bill (the American Health Care Act) included proposals to repeal most ACA tax provisions, including a tax on health insurance providers, a 2.3% medical device excise tax, a 3.8% net investment income tax, and a 0.9% Medicare health insurance surtax affecting upper-income individuals. Details on the proposed repeal of ACA tax provisions, including effective dates, remain under negotiation.

In April 2017, Treasury Secretary Steven Mnuchin unveiled the Trump Administration principles for tax reform. The principles called for numerous changes to the current federal tax system, including lowering the business tax rate, moving from seven to three individual tax brackets, doubling the standard deduction, eliminating the alternative minimum tax, repealing the estate tax, and expanding tax credits for child and dependent care expenses. The principles also call for moving to a territorial tax system from the current worldwide US tax system, and enacting a one-time repatriation and taxation on the foreign earnings of US companies.

The Trump principles differ in key aspects from the House Republicans "A Better Way" tax reform blueprint ("Blueprint") released in June 2016. That said, both plans focus on lower marginal rates and improving tax positions for business. Both the Blueprint and the Trump principles could directly and indirectly impact the higher education sector. On the campaign trail, President Trump spoke critically of large college endowments, stating that "these huge, multibillion-dollar endowments are tax-free, but too many of these Universities don't use the money to help with the tuition and student debt…" Such statements align to statements by Republican Congressmen such as Peter Roskam (R-IL) and Tom Reed (R-NY) in connection with the House Ways and Means Committee's recent review of the largest university endowments. Representative Reed floated a plan that would require endowments greater than $1 billion to pay out a quarter of their earnings in grants to working-class families or face steep penalties or loss of tax-exempt status.

Proposed changes to personal income tax provisions could also impact charitable giving and the value of the associated charitable deduction. Both the Trump principles and the House Blueprint decrease the individual marginal tax rates. Additionally, both also expand the standard deduction, but retain the charitable deduction for those who itemize. If the value of the charitable contribution decreases and/or fewer taxpayers itemize deductions, higher education institutions could see a decrease in contribution revenue.

Also serving as a resource for potential provisions for comprehensive tax reform is the 2014 Tax Reform Act released in December 2014 by then-Chairman of the House Ways and Means Committee David Camp (R-MI). The Tax Reform Act included several provisions applicable to exempt organizations, such as a proposed excise tax of 1% on the net investment income of private colleges and universities with endowment assets of at least $100,000 per full-time student. Additional provisions affecting higher education institutions include a tax on excess compensation to executives, changes to the charitable deduction rules, limitations on the FICA exemption and housing allowance provisions, and a repeal of certain education incentives for students.

In addition to the specific items noted above, the economic impact of comprehensive tax reform could have a ripple effect that will impact the higher education sector. Changes to taxation of international income and the financial services industry will impact endowment returns and access to capital. President Trump and the Republican-controlled Congress are expected to push for action on comprehensive tax reform. Still, prospects for the enactment of such legislation remain in question, given differences between the White House and the Republican-controlled Congress, as well as differences between the two political parties on fundamental aspects of how to reform the tax system.

Research and development funding

Federal funding for research and development in higher education has been on the decline for the past 15 years, through both the Democratic and Republican administrations. This has been particularly true for biomedical research funding, supported mostly through the National Institutes of Health (NIH). The decline has led to shrinking research portfolios and a reduction in the number of research-based faculty positions.

President Trump's views on climate change have been made clear. Namely, he has expressed skepticism that man-made carbon dioxide emissions have played a role in climate change. President Trump's nominees to the highest levels of office, including Scott Pruitt who heads up the Environmental Protection Agency, have also expressed their disbelief in the concept of man-made global warming. There is speculation that the Administration's view on climate change will lead to reduced funding in the fields of environmental science.

Changes to funding for biomedical research are also unknown. The Trump administration floated a proposal to slash the NIH budget by $1.2 billion for the remainder of this fiscal year. Congress rejected that proposal, and instead recommended a $2 billion increase, with support from both sides of the aisle. Yet President Trump's budget for fiscal year 2018 includes a 20% cut to NIH's budget, reducing funding by $5.8 billion. It remains to be seen if these proposed reductions will become reality.

Campus Based Aid: Federal Supplemental Educational Opportunity Grant and Federal Work-Study

With the release of the President's 2018 budget[1], there were significant changes to two key federal student aid programs. The budget proposes to eliminate the Federal Supplemental Educational Opportunity Grant (FSEOG), a longstanding program to help supplement the Pell Grant and high need students. FSEOG has been discussed for years as potentially being eliminated based on the House Committee on Education and the Workforce goals[2] of "One Grant, One Loan" initiative. The broader concern has not been the elimination of the program, but the lack of redistribution of those funds back into the Pell Grant program or another campus based aid program.

The second impact was the significant reduction to the Federal Work-Study program. In addition to the financial impact to students, institutions greatly benefit from work-study to help with various roles across campus. These roles have provided administrative and front line positions, funded up to 75% by the Department of Education. Institutions will need to be prepared for the financial impact should those positions be eliminated or reduced.

[1] *https://www.whitehouse.gov/sites/whitehouse.gov/files/omb/budget/fy2018/2018_blueprint.pdf*
[2] *https://edworkforce.house.gov/uploadedfiles/hea_whitepaper.pdf*

The federal direct student loan program

Throughout his campaign, President Trump has been clear on his objectives to minimize the role of the federal government and engage the private sector. As one of the nation's largest lenders, disbursing over $100 billion annually to students, federal student aid could be a prime target. Involving other sources of capital from private equity or corporations as a means of reducing the federal student loan financing burden, is not out of the question. In addition, the federal government could reconstitute a modified Federal Family Education Loan Program (FFELP) and bring private banks back into the equation to originate federal aid. These options align with President Trump's objectives and signal change on how institutions disburse student loans today.

Changes from direct loans could influence the Pell Grant program in future years. In 2010, with the mandate for 100% of federally guaranteed student and parents loans to be originated by federal student aid, the Obama Administration's goal was to redirect FFELP subsidies (formerly paid to banks), to fund Pell Grants more fully, and to create a consistent source of revenue to help stabilize the government's primary education grant program. The reintroduction of the private markets could impact these grants going forward.

Finally, while the President's proposed budget does signal a desire to keep the Pell Grant program funded, changes could occur with the Republican Congress. With the potential changes to the Pell Grant program comes potential decreases to enrollment or increases to institutional dollars subsidizing the deficit for needy students. Colleges and universities will need to be strategic in budget planning, ensuring the changes to the program will not negatively influence their financial model.

Risk-based lending

With student debt levels increasing, there continue to be calls for more accountability from all stakeholders. This includes students needing to be more accountable for their course of study and ability to repay, schools needing to be more accountable for the value they are offering in their curriculum and in achieving gainful employment, and federal student aid needing to be more accountable for underwriting its loans.

In April, Sam Clovis, advisor to President Trump on higher education policy, shared the concept of risk-based lending, where the degree a student chooses to pursue may influence their interest rate. For example, if a student with a degree in biochemistry can reasonably be expected to earn $60,000 upon graduation, that student may receive a lower interest rate than a student with a fine arts degree. Clearly this method can be considered controversial, yet it is not out of the realm of possibility.

In concert with the borrower impact, there could be an impact on the colleges and universities offering the degrees. Should programs be found to be financially unproductive for a student, it could result in an institution being "on the hook" for a certain level of defaults. This course of action could influence institutions, specifically admissions practices, if there is the perception that a student may not be able to repay their loans based on their desired course of study. These changes could signal a significant shift in how colleges admit students and operate today.

CFPB and the For-Profit sector

The future and authority of the Consumer Finance Protection Bureau (CFPB) under the Trump administration is an open question. While the agency has been associated with review of large financial institutions, including student lenders, their role in the closure of certain for-profit higher education institutions has been conspicuous and high profile. Under the Obama administration, the for-profit education sector experienced a significant decline. Institutions not only received scrutiny from the Department of Education, but also suffered fines levied upon them from the CFPB for lack of disclosure and false advertising of institutional private student loans.

Republicans have been vocal in their criticism of the borrower defense and gainful employment rules. Recently, the Education Secretary announced the Administration's intent to block rules set to take effect in July and establish rulemaking committees to establish more clear and fair guidance while still protecting students. This process will include public hearings in July and provides a renewed opportunity for impacted institutions on both sides of the issue to insert their views.

This could signal regulatory scrutiny relief for certain institutions. With continued focus on the desired outcome of an education - gainful employment and the focus on infrastructure and job retraining with the Administration - there is clearly a place for vocationally oriented for-profit institutions.

Our perspective

While it is difficult to predict what change may ultimately come in the form of new regulation and legislation under the new Administration, institutions will need to be vocal in asserting their views on the impacts of proposed changes. Institutions should also ensure they have a consistent message regarding the value they provide.

Colleges and universities will also need to be vigilant in their analysis of potential impacts and be able to make more rapid decisions. Potential changes to funding, including federal financial aid programs, research funding or donor giving, should be factored into financial planning and analysis. Related to research, institutions should continue to consider alternative sources outside of federal awards, including partnerships with private industry and other organizations.

Boards and leadership should discuss and have a common understanding of the following:

- What is the potential impact of proposed legislation and how should the institution respond?
- What is the institution's government relations or similar function doing to understand potential changes and educate the public and legislators?
- Which industry associations is the institution collaborating with to ensure its voice is heard?
- How is the institution communicating views and actions with stakeholders?

Audit committee governance

Background

The higher education industry continues to be challenged by significant external pressures and an ever accelerating pace of change. As noted throughout this document, institutions are impacted by changes to the regulatory environment, economic and political uncertainty, and increased pressures to manage costs. Constant external changes and uncertainty can make even the strongest institutions feel reactionary and challenged to stay informed. The board's role and perspective is critical to ensuring institutions balance their commitment to meeting requirements and responsibilities while continuing to position their institution for long-term success and fulfillment of their mission. As a result, audit committees and trustees continue to implement practices to understand and clarify their responsibilities, maximize their effectiveness and keep pace.

Impact on educational institutions

With the increased demands on trustees, leading boards are taking the necessary time to periodically reflect on their roles to not only ensure they are properly discharging their fiduciary responsibilities to their institution and relevant stakeholders, but also proactively addressing strategic risks. This requires a greater depth and range of skills and experience, as well as views and perspectives to succeed in the dynamic environment.

Traditional roles and responsibilities of audit committees, including oversight of external reporting and compliance remain critical. There are significant new accounting and reporting standards that will impact financial statements more than at any time in the last 20 years, and the resources necessary to properly implement them should not be underestimated. This includes a new not-for-profit reporting standard that will likely include multiple phases of changes, including information about institutions' liquidity and how it manages its resources. The new leasing standard will require organizations to gather data from across the organization, coordinate with multiple departments, and consider the sufficiency of existing systems to capture necessary data.

Additionally, the breadth of risks and compliance matters brought to the audit committee continues to grow with increased external regulation as well as the evolution of audit, risk and compliance professionals. As these risk discussions have consumed more time on the agenda, prioritization and time allocation have been necessary. This includes the assumption that members have read in advance information provided, so discussions at meetings are limited to questions or clarifications.

The number and background of members on audit committees also continues to be important. Many audit committees are re-assessing their required composition, including the definition of a financial expert, and incorporating elements of institutional risk and compliance. Increasingly, a greater number of audit committee members possess a broad knowledge of accounting, financial reporting, regulatory, and risk and compliance to ensure they understand not only the financial reporting process and financial statements, but also the related business and industry issues and associated risks.

Our perspective

While there are governance related questions on the IRS Form 990 and periodic inquiries from the government, there are currently no regulations dictating specific elements of audit committee performance. The higher education environment is complex, requiring members to bring relevant best practices from their positions on public company boards and other roles external to the higher education industry. Leading audit committees are setting a strong tone at the top, owning their agenda, building strong relationships with internal and external auditors and compliance offices, and evaluating their informational needs and their own performance.

Several audit committees have incorporated risk and compliance into their names and charters to explicitly recognize the increased responsibilities regarding risk assessment and accountability for mitigation and institutional compliance. Many institutions also continue to evolve their enterprise risk management ("ERM") activities. It is important to make sure the proper governance structure exists to ensure risk programs receive the appropriate amount of time and attention. The specific role of the board, standing board committees, and the audit committee in the ERM structure must be well-defined.

Given the increased demands and expectations being placed on audit committees, it is more important than ever to ensure the audit committee charter is updated periodically and explicitly states the responsibilities of the committee. Increasingly, a greater number of audit committee charters are including more risk related topics, including reviewing the results of compliance and regulatory audits conducted by third parties, security assessments, hotline call activity including ensuring appropriate disposition of hotline calls, and reviewing the compliance office's (or equivalent) risk assessment and annual plan.

In assessing opportunities for success, audit committees should periodically consider the following:

- Does the audit committee charter reflect the current or expected roles and responsibilities of the committee? Are responsibilities clearly defined for key risk areas between the audit committee and other board committees, including oversight of information technology and related risks?
- Do audit committee members have the appropriate skills and experience relative to current issues? Is succession planning and diversity part of the assessment?
- Have materials evolved to use data visualization and other tools to better summarize data and information, and allow for more focus on key issues?
- Does the audit committee perform robust, periodic self-assessments and take quick action relative to areas for improvement?
- Is education regarding current or evolving industry and institutional issues a part of each agenda?

The state of enterprise risk management

Background

Many believe that higher education as an industry is entering an era of unprecedented change. The new presidential administration, potential legislative changes, and a series of highly publicized events have prompted executive leaders across academia to assess the potential impacts on their institutions. As a result of these changes and continued uncertainty, leaders of many enterprise risk management (ERM) programs are finding themselves in a heightened position of analyzing, interpreting and mitigating risk and related opportunities. Recognizing this time of change, risk program leaders have been working to increase the ERM profile, its standing and the related reach of their risk organizations. In many cases, this has meant openly sharing information about the risk organization, what it does and how it operates.

The profile of enterprise risk management activities continues to expand, resulting in increased expectations. Board members, many of whom have first-hand external experience with risk management techniques, are asking probing questions, reviewing risk reports and requesting in-depth discussions on specialized risk topics. Many risk programs have responded with self-assessing the current state of their risk activities to determine if they are meeting their original expectations, as well as attempting to identify opportunities to improve the overall evolution of their programs. Increasingly, key stakeholders are inquiring about the effectiveness and value of risk activities, the structure and positioning of their programs, and how best to involve key resources.

Despite the increase in profile for ERM, there remains a wide range of disparity related to risk management concepts and their application. Many institutions report that they have either recently launched their risk program efforts or remain in a basic state of existence – either unable or slow to advance - beyond the initial risk identification phase.

Impact on educational institutions

With increased visibility of ERM, institutions have continued to enhance the structure and organization of their programs. Leading practices that have been implemented or are being considered include the following items:

Formalization of enterprise risk management: A movement toward more organized enterprise risk management is occurring. Many institutions have conducted risk identification exercises and assigned dedicated risk officer and manager responsibilities, and in many cases, have established standing enterprise risk committees. With structures being assembled to support risk management activities, there has been an increase in the awareness and stature of risk programs.

Recognition of the "power" of organized ERM: As risk management groups have taken on more responsibility, they are entering into new areas that may have been previously considered "off-limits". These include strategic planning, new ventures, investment decisions, and externally-facing activities in which institutions engage. In recent years, executive leaders and governance members have taken notice of the capabilities and contributive powers of an effective ERM program, which can provide a foundation to assess new risks and opportunities. In response, executive leaders are positioning their ERM programs as "first responders" to high-profile and new risk topics.

Integration of ERM across the institution: ERM programs have worked to collaborate with, and in some cases integrate with, other functions and departments across an institution. Some institutions have established dedicated risk management functions or have assembled risk management committees consisting of a number of representatives from across campus. With either structure, natural synergies exist between various governance, risk and compliance-oriented groups. Often, collaboration has resulted between risk management, internal audit and compliance. Leading risk programs have found ways to penetrate different aspects of the organization by holding sessions on risk, participating in standing committee meetings, and through individualized meetings with functional leads.

Risk facilitation: ERM program leaders and members typically possess a wide range of skill sets related to information gathering, risk identification, analysis, reporting, and group facilitation. In certain cases, faculty, staff and dedicated risk owners may require assistance in identifying the various risk and opportunity areas that affect their particular area of responsibility. At some institutions, risk program members have helped to conduct targeted risk assessments designed to pinpoint individualized risks affecting a specialized area such as facilities, information technology, student life, and external regulatory compliance. Results are typically summarized and consolidated at an enterprise level.

Risk advisor: ERM leaders have assisted "risk owners" in the evaluation of risk mitigation options and the development of formalized risk mitigation plans. The ultimate goal of formalized risk mitigation plans is to support the ongoing tracking of risk management activities and to promote accountability throughout the institution for active risk management.

Strategy linkage: An effective ERM program is grounded in the overall organization strategy. This helps to ensure that key risk topics are prioritized and to provide management with a means of allocating resources to those areas that matter most. Leading institutions' ERM programs are directly involved in strategic planning exercises.

Methodology-based: Certain institutions are also beginning to assess the potential impacts of the COSO Risk Framework. The Risk Framework suggests that elevating risk discussions from core risk groups to executive leadership, formalizing the connection between risk and strategy, and assessing the design and effectiveness of mitigation plans and internal controls are primary areas of opportunity.

Where practical, many colleges and universities are seeking to incorporate these and other leading practices. Additional practices include ensuring that risk activities are supported by the board of trustees and leadership, developing impactful executive reporting methods, providing ongoing risk training and "all-hands" sessions to promote risk program awareness across an institution, and engaging regularly to understand the current state of each key risk area and its associated risk mitigation plans and actions.

Our perspective

Every institution has an interest in providing a safe and rewarding learning atmosphere, complying with applicable laws and regulations, maintaining a sustainable financial model, protecting an institution's brand, and creating practices that lay the foundation for the achievement of strategic goals. Many leading risk programs categorize these objectives and risk topics according to reputation, financial, compliance, operations and strategy. It is imperative that the risk programs develop a mechanism to identify new and emerging risk topics that include such items as crisis management, effective resource utilization, cybersecurity, student activism, student outcomes, and accommodating new and different needs from an increasingly diverse student body.

With increased expectations, it becomes even more important for risk program leaders to be clear on roles and responsibilities, especially related to what constitutes a formalized "risk owner." It is also important to be clear on what a risk program is, as well as what it can and cannot do for an organization. A well thought-out communications strategy, regular trainings, and risk updates to a broader group assists in establishing and reinforcing expectations.

There remain a core set of ERM practices that are critical to ensuring continued success. These include such items as the ongoing engagement of key stakeholders, driving awareness across the institution, providing succinct and effective executive reporting, and linking risk to strategy. Additionally, ERM programs should make sure new and emerging risk topics are evaluated in a timely manner and that risk program efforts are integrated into other governance, risk and compliance objectives. Leading risk programs also periodically evaluate their programs to assess whether there are opportunities to further incorporate leading practices. This evaluation includes asking the following key questions:

- What constitutes an effective ERM structure for the institution?
- Who "owns" ERM?
- What type of information flow is required among key stakeholders?
- How is ERM program value measured at the institution?
- How is the ERM program sustained?

Many institutions have made strides related to some of these leading practices outlined previously. Others have adopted certain best practices but continue to struggle with a number of challenges. Institutions continue to report that competing priorities, lack of dedicated resources and divergent views from stakeholders on the objectives, structure and output to be impediments. Further, many risk managers note that continued interest and support from leadership can be a challenge, and that maintaining momentum and keeping risk programs functioning requires continued focus.

Despite the current state of any given risk program, and its position along the maturity curve, it is widely recognized that continued care and nurturing is required to maintain overall program momentum and to ensure that the impact of the risk program is commensurate with the associated investments, expectations and overall needs and interests of the institution and its broad array of constituents.

Regulatory environment

Background

As a result of the Presidential and Congressional election outcomes, the tax and regulatory environment for educational institutions is in a significant state of flux and uncertainty. Educational leaders continue to seek information on where the regulatory environment will ultimately land over the next several years. Ongoing monitoring and dialogue with federal committees who ultimately determine the direction and extent of regulatory change are important in this dynamic environment.

Impact on educational institutions

The following is a high-level summary of selected regulatory matters upon which educational institutions are currently focusing their attention.

Internal Revenue Service

Modifications to IRS partnership audit rules: Institutions that hold partnership interests, including endowment investments in limited partnerships, should be aware of the modifications to the IRS rules governing audits of partnership entities. Recently enacted legislation - generally effective for tax years beginning after 2017 - can impose partnership-level liability for IRS adjustments to income tax liability. As such, the rules can effectively shift the tax burden from institutions who were partners in the year to which the adjustment relates to institutions who are partners in the year in which the adjustment is finalized. Tax-exempt partners should consider the various procedural rules, exceptions, and elections under the new rules and should understand the approach their partnerships will take to these issues. For instance, some partnerships may be eligible to opt out of the new rules, and partnerships may elect to push out liability to persons who were partners in the year to which the adjustment relates. Either of these approaches may be advantageous for tax-exempt partners. Tax-exempt partners should consider whether the partnership agreement addresses how decisions around these and other issues will be made.

Tax reform proposals: Although the prospects for tax reform are uncertain in the current climate, there are a number of proposed changes to the tax code that institutions should be monitoring, including the following:

- Impact on charitable contributions:
  - Tax rate reductions would decrease the value of charitable contributions
  - Increase in the standard deduction and caps on itemized deductions would limit incentives for making charitable contributions
- Continued focus on college and university endowments:
  - Various recent proposals that would impact endowments, including an excise tax on net investment income, minimum payout requirements, limiting charitable contribution deductions for gifts to endowments, and changing the tax rules relating to offshore investments
  - December 2016, proposed legislation, "Reducing Excessive Debt and Unfair Costs of Education Act", would require institutions with endowments over $1 billion to spend 25% of investment gains to reduce the cost of attendance for students from middle income and working class families

IRS audits – recent activities: The IRS Exempt Organizations Examinations office conducts audits of tax-exempt organizations to enforce compliance with the tax laws. In fiscal year 2016, Exempt Organizations Examinations implemented a case selection process using data modelling based on information from IRS Forms 990 and other tax and information returns aimed at identifying risk factors for noncompliance. The IRS indicated that as of September 2016, it had closed 203 audits selected through this process. The IRS has indicated that it will continue to utilize data-driven decisions in identifying audit targets and will introduce newly developed analytic models in 2017. The IRS also identifies audit targets through referrals from the public, random selection, information in the press, and other means. Areas that IRS audits recently have focused on include:

- Diversion of assets - a newspaper article that analyzed information disclosed in Forms 990 filed by numerous organizations drew the IRS' attention to this issue, resulting in multiple examinations
- Compensation - worker classification matters, fringe benefits, and deferred compensation
- Form 990 inconsistencies - missing or inconsistent information on the return
- Tax-exempt bonds - post issuance compliance
- Unrelated business income - activities that consistently generate losses, identification of income, and allocation of expense
- Pension and retirement plans - plan compliance, nondiscrimination rules, and contribution limits

Federally sponsored research

On December 26, 2013, the Office of Management and Budget ("OMB") published its "Sweeping Reform" guidance, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (the "Uniform Guidance"). Many organizations had grants audited under the Uniform Guidance in the previous year, but during the current audit cycle more grants will be subjected to these rules. For years ending December 31, 2016 and later, the compliance portion of the annual Single Audit will be subjected to several revised compliance audit requirements.

From an audit perspective, the objective of the changes was to focus on higher expenditure dollar volumes and a more streamlined risk assessment process related to the selection of award programs for testing and thus to reduce both administrative burden and the risk of fraud, waste and abuse. These changes will allow the federal government to maintain a significant amount of audit coverage with respect to the total volume of federal awards issued, while it will also allow smaller organizations to be eliminated from the mandatory audit rule. In addition to the audit requirements, other aspects of compliance rule changes that were made in the Uniform Guidance that organizations must continue to focus on include the following items:

Internal controls: Under the Uniform Guidance, organizations are required to have an effective system of internal controls. Two frameworks that are provided as examples to follow include the "Green Book" (issued by the Comptroller General of the United States) and the "Internal Control Integrated Framework" (issued by COSO). While there is no current expectation or requirement to document or evaluate internal controls prescriptively in accordance with the frameworks above, organizations should consider their current controls and documentation in relation to the recommended frameworks and assess whether there are any gaps to be remediated.

Many institutions are using this requirement as an opportunity to improve their internal controls over the compliance areas that carry higher risk and more judgement. Federal agencies are also developing their viewpoint as to what internal controls should be in place. Audits and reviews of programs conducted by federal agencies include consideration of the adequacy of internal control over each compliance objective. OMB is currently revising the internal control section of its annual Compliance Supplement to be more in line with COSO.

Subrecipient monitoring: Organizations that pass federal money through to subrecipients have more prescriptive requirements to follow, including evaluating each subrecipient's risk of noncompliance. A risk assessment should be completed and documented, the results of which should drive an organization's monitoring of each subrecipient.

Many institutions have a large volume of subrecipients, and thus much attention is being devoted to the extent and form of risk assessment documentation to maintain. Now that Uniform Guidance audit reports will be included on the federal clearinghouse website, access to the reports will no longer be a hindrance to using the subrecipient Uniform Guidance reports as a starting point for the risk assessment process.

Effort reporting*:* The Uniform Guidance clearly states that effort reporting certifications are no longer required. However, what continues to be required is that controls must be in place to ensure complete and accurate distribution of compensation to each recipient function and to each federal award when applicable. The trend has been thus far for institutions to continue use of "effort" certifications, perhaps less frequently, as the primary control to ensure appropriate salary distribution. Institutions, however, are also now beginning to explore what they might do to replace the effort reporting certification process with other internal controls. Federal pilot studies at four universities, along with a study being sponsored by the National Council of Research Administrators, are producing results that may become alternatives to the traditional effort certification process.

Procurement: Procurement regulations have recently been delayed for a third full fiscal year after the effective date of the Uniform Guidance. However, given the potential impact, organizations should not lose sight of the changes that will be required in this area. There are five methods of procurement prescribed under the Uniform Guidance, including micro-purchases, small purchases, sealed bids, competitive proposals, and non-competitive proposals. In December 2016, Congress passed a National Defense Act which allows for increasing the micro-purchase threshold to $10,000 for the Department of Defense and a few other agencies. OMB plans to issue in the federal register an amendment to the Uniform Guidance to adopt the revised threshold. However, due to President Trump's focus on reducing burdensome regulations, issuance of this amendment notice has been delayed. The Uniform Guidance procurement regulations, with the postponement for a third year, is applicable to institutions starting in fiscal years beginning on or after December 26, 2017.

Required written documentation: The Uniform Guidance requires written policies in the following areas: cash management, procurement, subrecipient monitoring, conflicts of interest, and time and effort reporting. Institutions should ensure these policies are formally documented.

Institutions should continue their efforts to implement Uniform Guidance and work with their auditor and industry associations to stay abreast of best practices that are developing in each of the Uniform Guidance areas discussed previously, as well as other aspects of the Uniform Guidance. It is likely that a smaller program that has not been audited in the past will come into scope in 2017, if not already in scope in 2016. Institutions should work with the faculty, investigators and administrators on the selected award to familiarize them with the audit process. Additionally, institutions should continue to focus on the training of both financial and compliance administrators, as well as the faculty and investigators who carry out the work of the federal awards.

Municipal securities

SEC enforcement actions

Most institutions finance their capital needs with long-term debt. Typical financing strategies include issuance of tax-exempt or taxable municipal securities (directly or through a conduit borrowing arrangement). While the SEC cannot directly regulate the content of disclosure documents provided to potential investors, it can and does undertake enforcement actions against municipal bond issuers and conduit borrowers for violations of the federal securities statutes' antifraud provisions.

In 2016, the first-ever criminal prosecution of individuals by the Department of Justice in connection with a municipal bond offering occurred, providing further evidence that federal agencies are paying close attention to the municipal market. Such proceedings serve as a reminder that whenever higher education institutions "speak to the markets" through their offering documents and continuing disclosure filings, they must devote the necessary time and effort in the preparation and review of disclosure documents.

During 2016 and 2017, compliance with "continuing disclosure agreements" (CDAs) continued to be an area of SEC enforcement focus. In order to use an underwriter to market their bonds in offerings to the public, borrowers must sign CDAs promising to supply investors with annual financial and operational reports throughout the life of the bond issue and to provide notice within 10 days regarding the occurrence of certain events which could materially affect the bond issue. Any failure to comply with a CDA (such as missing a filing deadline) must be disclosed in future offerings; failing to disclose such information is a violation of the antifraud laws.

During 2016, the SEC announced enforcement actions against 71 entities, including several public and private higher education institutions, for erroneously stating in bond offerings that they had complied with CDAs when in fact they had not (or for failing to disclose a failure to comply). These cases arose from the SEC's 2014 Municipalities Continuing Disclosure Cooperation initiative, which promised more lenient settlement terms to underwriters and issuers that self-reported instances where offering documents had incorrectly portrayed the issuer's history of past compliance. The SEC reaffirmed that entities that are found to have violated securities laws in the past that did not participate in the voluntary reporting program will be subject to more onerous sanctions. In addition, they have left open the possibility of taking enforcement actions against individuals related to the disclosure failures.

Proposed new event notices

In early 2017, the SEC issued a proposed rule that would add two new event notices to the list of 14 for which disclosure must be made within 10 days.

The proposal arose from concerns about the increasing frequency with which borrowers are turning to private placements of their municipal securities with banks ("direct purchases") or bank loans structured and negotiated by investment bankers as an alternative to traditional public offerings of municipal securities. At present, no federal securities laws or regulations would require entities with publicly-traded municipal bonds to immediately disclose information about these transactions. However, information about the incurrence of non-publicly offered debt is important to the entity's other bondholders, who have complained to the SEC that they should not have to wait for issuance of annual audited financial statements or an offering document to discover their investee's involvement in such activity.

The scope of the proposed amendments is directed to "financial obligations," which goes well beyond the private placements and bank loans. The proposal defines the financial obligations as debt obligations, leases, guarantees, derivatives, and monetary obligations resulting from judicial, administrative or arbitration proceedings, and makes clear that broad interpretation is expected. During the comment period, many respondents expressed concern that the definition is too broad and would require consideration of many types of financings and financial obligations that are part of day-to-day operations and would not affect an entity's ability to repay its public debt. Examples cited include financial aid contracts, health insurance contracts, food service contracts, labor agreements, student housing leases, research agreements, management contracts, sports venue contracts, copier equipment and other routine operating leases, and similar items.

The volume of such transactions and their decentralized administration would up the ante for potential violations of CDAs, as it would potentially require institutions to identify, summarize, disclose, track, and analyze – within the tight 10 day time-frame – a far broader range of financial obligations than they do today. The comment period ended in May, and the estimated timetable for final rulemaking is not yet known.

New rules for auditor involvement in municipal offerings

Beginning in mid-2018, the AICPA's Auditing Standards Board will impose new requirements on CPA firms whose audit opinions accompany audited financial statements included in municipal bond offerings (and other exempt securities and franchise offerings). Potential investors in exempt securities offerings (that is, where either the entity or the security itself is exempt from the SEC's registration requirements) may not be aware that the rules for auditor involvement in those offerings differ from the requirements for registered offerings.

In registered offerings, companies must obtain an auditor's permission before including the auditor's opinion in the offering materials. Prior to granting consent, the auditor performs certain procedures to ensure that the opinion rendered on the registrant's financial statements is still appropriate at the time the offering goes to market. Potential investors typically derive some comfort from knowing that the auditor has been involved in this manner.

In exempt offerings, inclusion of an auditor's report in the offering document is no guarantee that the auditor has performed the customary procedures and granted permission to use the report. In fact, auditors frequently are unaware that their reports are included in exempt offerings. The new standard will help to narrow the expectation gap. Going forward, if an institution makes certain requests of the auditor in connection with an exempt offering, the auditor must perform the customary procedures. The procedures include the auditor reading the offering document to assess whether any of the information it contains contradicts the knowledge obtained during the course of the audit. In addition, the auditor would evaluate whether any events have occurred since issuance of the opinion that, if known at the time the report was issued, might have resulted in a different opinion.

The new standard establishes minimum requirements based solely on the occurrence of a request to the auditor. As a matter of professional risk management, certain audit engagement letters require that the auditing firm be notified and permitted to perform the customary procedures if an institution wishes to use their report in connection with selling securities. Institutions that have not historically involved their auditors in bond offerings may find that they will need to coordinate with auditors in ways they may not have done in past offerings. The new rules will take effect for securities offerings undertaken on or after June 15, 2018.

Our perspective

It is difficult to say with certainty what tax and regulatory modifications will be made over the next year. The many non-educational related issues in the spotlight may result in several of the regulatory changes that impact higher education being placed on hold. Given the potential impact to an institution, areas where educational leaders should focus include:

- Gift deduction limitations
- Taxes on endowments greater than $1 billion
- Research funding cuts across federal agencies
- Application of private foundation rules to higher education institutions
- Affordable Care Act reforms

As it relates to municipal bonds and related SEC enforcements, institutions should ensure they are performing appropriate due diligence as it relates to their respective CDA requirements. This is an area where institutions may not have been performing all of their duties outlined in their municipal bond agreements.

When the opportunity arises, institutions should continue to be visible and vocal with regulatory bodies and political leaders as to their perspectives on proposed changes and the regulatory cost associated with them.

Shared services

Background

Significant economic, societal, political and other events continue to shape higher education operating models. Over the past decade, increased competition, rising student debt, a tightening regulatory landscape, reduced research funding, and unstable state economies have posed significant challenges to many higher education institutions. Mergers, consolidations, and closures have also spread concern throughout the industry. In response to the changing landscape, both public and private institutions have increasingly sought to reduce expenses and improve operating efficiency. "Shared service" type operating models have been a strategy institutions have utilized to mitigate risk, standardize processes, improve productivity, and provide incremental cost savings.

The traditional organizational structure of an institution is born from a faculty tenure system that benefits from a measure of independent governance. This drive toward autonomy has led to the splitting of universities into separate departments, schools, or colleges with each housing a full administrative support system. Functions are often ripe for the kinds of financial and strategic benefits that operational centralization offers. Areas to reduce costs and increase efficiencies may include, but are not limited to human resources, information technology, procurement, and research.

The shared services approach has been gaining momentum in the higher education industry. The most successful efforts have occurred in larger academic organizations that have implemented proactive models designed to gain buy-in and leverage institutional knowledge. Proper application of change management techniques have been critical to this process. Institutions who have implemented effective shared service approaches have demonstrated the opportunity to realize benefits, with many looking to reinvest savings into strategic initiatives and core missions such as education, research and student services.

Impact on educational institutions

Implementation of shared services has primarily occurred through either the "lift and shift" or "clean and bring" methodologies. For certain institutions focused on achieving rapid cost savings, the "lift and shift" approach provides the quickest path to immediate results. "Lift and shift" involves first consolidating common administrative functions from individual departments into a central unit which then serves multiple colleges across an institution. This centralization of services often leads to quickly realized cost savings related to a reduction or replacement of higher cost full-time equivalents. "Lift and shift" does not, however, immediately address the potential inefficiencies that might accompany the legacy processes being imported, nor does it provide ready solutions for loss of business-line specialization skills that is likely to occur with the centralization of services. Phase two of a "lift and shift" implementation often focuses on process improvement and training.

For other institutions focused on improving functional expertise and sharpening compliance, the "clean and bring" approach offers a path that emphasizes the streamlining of internal controls. "Clean and bring" first focuses on optimizing and standardizing policies and procedures into a common framework before centralizing functions. While cost savings could be a part of these process improvements, "clean and bring" may not provide as much immediate financial benefit as the quick reductions of the "lift and shift" approach.

The ultimate structure of a shared services center is often a key consideration of institutions. The structure can define both the level of efficiency achieved and the amount of autonomy and flexibility allowed. Taking a more decentralized approach, certain colleges and departments form integrated business units that share common business and administrative functions such as research, human resources, or procurement. This more autonomous model provides flexibility to customize which integrated functions might best serve the particular needs of individual academic units. On the other end of the spectrum, institutions that have adopted a more centralized approach consolidate common administrative processes and functions into a single shared services entity that serves the entire institution, allowing for standardization and optimization.

Regardless of the approach, the structure of an institution calls for a degree of flexibility in a shared services center. Models have ranged from a single shared services entity for a network of institutions (a state system or institutions with multiple campuses over a large geography), to multiple shared services hubs covering a single institution (grouping colleges or departments across an institution).

Our perspective

Irrespective of the driving reasons or chosen structure, key aspects of a shared services approach will continue to bring operational and strategic value to an institution. In addition to efficiency and standardization, the ability to scale and shift operations according to business needs provides a powerful lever to institutions dealing with a landscape transforming before their eyes. The greater subject matter expertise generated by allowing staff to concentrate on a specific area rather than diluting focus across general departmental functions can lead to improvements in both administrative support and job satisfaction. The more successful shared service model implementations have focused on the following before and during implementation:

- **Culture:** Institutional culture is a critical consideration in a shared services model. Improvements should be led and communicated by faculty. Using a data driven approach focused on benchmarking can be used to determine where to improve, and can help eliminate "sacred cows" that could cause unintended challenges to an implementation.
- **Workforce:** Focus should be on the depth of functional and business expertise and allow for mobility within the shared services model. Changes should focus less on staff reductions and more around desired process efficiencies.
- **Governance and leadership**: Focus should include the importance of relationships and common agreements of the end goal. Defining clear accountabilities with a focus on strategy, tactics and operational approach is important. A clear communications plan and transparency help to build trust, and reduce inaccurate or incomplete assumptions to be drawn by relevant stakeholders. Support and buy-in from senior leadership is imperative to a successful shared services implementation.
- **Technology:** Consistently leveraging ERP technologies should occur to allow faculty and staff more thorough access to information required to fulfill their professional obligations. Additionally, utilization of new technologies such as robotic process automation to change manual review processes can help re-distribute human resources to student services and further focus on the institutional mission.

As with any large scale reorganization, it is essential to take a pro-active approach to managing change when embarking upon a shared services implementation. From design through implementation, stakeholder engagement must be a central focus. Staff led committees can contribute to the design of future-state processes, technology requirements, standard operating procedures, work flows, and tools. An effective communications and training program consisting of leadership mobilization workshops and the establishment of a change agent network can accelerate cultural and behavioral change management across an institution.

Big data also offers promises for shared services. Every transaction processed through the central shared services repository offers a potential input that might be aggregated and analyzed, potentially leading to further value attained through better process efficiency, trend prediction, and performance improvement. The data flowing through shared services centers provides a myriad of opportunities for colleges and universities – from better enrollment management to faculty utilization, research funding efficacy, and more. In addition, automation can lead to increased quality control, efficiencies, and cost savings. Higher education institutions can also benefit strategically from such automation as traditional workers are able to refocus on more customer centric and business development tasks.

Shared services is only beginning to demonstrate the array of solutions it can offer higher education institutions. Institutional leaders should consider how this multi-faceted model might help them compliment their strategic priorities in an industry that is certain to remain in flux for the foreseeable future.

Economic and social impact

Background

The public role of colleges and universities and contributions they make to their communities has generated debate for decades. The government continues to raise questions regarding the responsibility of institutions to the public good. There has been heightened scrutiny in recent years, particularly around tax incentives for higher education, arising from concerns regarding increasing college tuition costs, student debt levels and unemployment among college students. Compounding these trends are federal and municipal budget shortfalls gaining the attention of politicians and policy makers who are re-examining public subsidies for educational institutions.

Endowment policies and property tax exemptions were two of the major subjects of the recent joint letter to 56 colleges and universities from the Senate Committee on Finance and the House Committee on Ways and Means and its Oversight Subcommittee. The government asked for detailed information on use of endowments as well as tax-exempt properties and the extent to which institutions were making payments in lieu of taxes to their local communities to help meet the public cost of supplying police, fire and other municipal services to the institutions.

Impact on educational institutions

For these and many other reasons, institutions have analyzed their performance through different lenses. Some have conducted economic impact studies to examine the effect they have on their communities, primarily in terms of financial costs and contributions. These economic impact studies are also a means of communicating the institution's economic and social value to local communities, public officials, policy makers and other government agencies. Economic impact studies typically provide measures on how institutional spending flows through its surrounding local and regional economies using metrics that translate into economic activity that includes the following:

- **Workforce impact**: The number of employees and salaries and wages paid directly to employees in the surrounding local and regional areas
- **Capital investment impact**: Building and infrastructure spending, construction related jobs and wages, and inclusion of women and minority construction businesses
- **Innovation and investment impact**: Federal and private sponsored research awards, technological development with private industry through licensing, commercialization and new ventures
- **Purchasing of goods, supplies and services**: Amounts spent with local and regional businesses, channeling purchasing to minority and women owned businesses, student and visitor spending and generating local and regional jobs
- **Community engagement impact**: Investment in community building projects, local initiatives, home ownership, and community partnerships

Institutions play an important role in their surrounding communities and the commitment to increase engagement has continued to grow over the last decade. Many believe that colleges and universities should benefit their communities in additional ways in recognition of the substantial tax benefits they receive. Institutions have responded by broadening their outreach and programs aimed at stimulating the economic and social value provided to the community.

Many institutions have created offices of community and civic responsibility that form community partnerships and create programs and initiatives to address social issues, economic problems and community needs. These community partnerships and programs focus on a range of efforts including:

- Linking theory with applications to solve community and real-world problems, such as college access, career readiness, job training, business opportunities and anti-poverty initiatives
- Connecting faculty and students with community and not-for-profit organizations and civic and government groups to address community needs

- Raising funds to invest in partner neighborhoods and to support affordable housing and community health centers
- Providing community-based service learning opportunities for students as part of integrating the concepts and missions of service into formal education
- Providing community benefit packages, including free community services and infrastructure improvements in conjunction with campus expansions

Benchmarking data on community engagement of colleges and universities is not standardized or readily available for the higher education industry. The Carnegie Foundation Community Engagement Classification, which was initiated in 2005, is a framework that recognizes higher education's commitment to community engagement. Participation over the years has grown and in 2015, The Carnegie Foundation recognized 361 campuses in its 2015 Community Engagement Classification. Some institutions see the classification as an opportunity for national recognition and a way to communicate to local communities and governments the efforts they are making on community engagement.

As not-for-profits are tax-exempt and do not pay tax on property used for charitable purposes, local governments often ask not-for-profits to make voluntary payments in lieu of taxes (known as PILOTs). These PILOT programs help to offset the cost of essential public services provided by local governments, such as fire and police services, and road maintenance. PILOTs do not equate to what would be owed if the property were paying taxes, but do help cover the costs of public services and help to benefit the community. According to the Lincoln Institute of Land Policy, institutions of higher education account for approximately 67% of total PILOT revenues and represent approximately 24% of all not-for-profits making PILOTs.[3]

PILOT programs have continued to gain traction as local governments look for alternative revenue sources to alleviate budget issues and deal with declining property tax revenues. The question of whether PILOT programs are sizeable enough to make up for lost tax revenue continues to be debated. Several states are considering whether to eliminate the property tax exemption altogether. According to a report by the Lincoln Institute of Land Policy, local governments lose out on average 4% to 8% of total property tax revenue each year due to the exemption.[4]

Our perspective

More and more, colleges and universities are looked upon to justify their tax-exempt status and to increase their contribution to the public good. Unlike not-for-profit hospitals, colleges and universities are not required to calculate their community benefits as a condition of receiving federal tax-exempt status, so estimating the value of college and university benefits does not allow for easy cost-benefit analysis or comparability between institutions. As many politicians and policymakers are raising issues surrounding the use of endowment funds and tax incentives as part of a broader agenda for potential sources of revenue, the question of the social impact that colleges and universities have on the communities is becoming increasingly important.

Although defining and measuring the value colleges and universities have on their surrounding communities is difficult, the communication of value through greater transparency and awareness is becoming increasingly important. While economic impact studies are useful tools, communication of the many intangible civic, social and cultural benefits that colleges and universities provide are critical to the debate. Certain institutions are providing reports to the public, local governments and communities on how they engage with the local community and the ways they are contributing. These reports include detailed data on the following:

- Voluntary cash contributions to municipalities
- Voluntary tax payments
- Contributions to community organizations and outreach programs
- Services that are free to the public, including educational and cultural programs, and community events
- Institutions are also starting to expand disclosures in their Form 990 to help tell their story and are providing community benefit information on programs and initiatives they provide to the public and surrounding communities

[3] *Source: Langley, Kenyon and Bailin (2012)*

[4] *Exempts' Tax Status Under Scrutiny as States Feel Money Woes, Bloomberg BNA, Colleen Murphy, August 19, 2016*

Institutions should evaluate their process for publicly reporting their goals and related achievements, consider how that data is accumulated and presented, and increase transparency of the community benefits they provide and their related impact to local, regional and national communities. Doing so can be an important means of increasing public understanding and further shaping the public debate. Outreach and communication with government officials and congressional leaders is important for colleges and universities to provide policymakers with the proper context, and to educate and enhance the understanding of higher education industry topics.

As trustees and administrators look to enhancing disclosure and communication of the benefits provided, questions to be considered include:

- How is the institution articulating its role in the community, and is it well defined?
- For academic medical centers, are the community benefit disclosures aligned with the broader academic strategy?
- Is the level of public disclosure and communication appropriate?
- How is the public disclosure and communication effort supported within the institution?
- Is there a process in place to review current data in the public domain?

Cybersecurity

Background

Cybersecurity, and the management of business relevant cyber risks, continues to challenge organizations of all sizes and in all sectors. Stories seem to emerge daily regarding breaches, including thefts of personal, sensitive corporate and government information, ransom attacks and other cyber-attacks. In response, threat intelligence continues to mature and evolve.

A new model of cybersecurity is evolving that is agile, capable of acting on analytic inputs and adaptive to evolving risks and threats. At the core of this new approach are solutions like data analytics and real-time monitoring, managed security services, advanced authentication and open-source software. Predictive analytics and artificial intelligence to allow for real-time responses to vulnerabilities, may not be far off. This rapid technological advancement has resulted in increased investment in monitoring and use of third-party vendors.

While colleges and universities are focused on the threat and are making investments to protect their institutions, including insurance, security assessments and intrusion detection tools, many continue to adopt a defense-first posture, viewing cybersecurity as a necessary investment to protect information assets. Regulatory requirements and reputational considerations continue to be primary forces compelling institutional behavior in the protection of data.

Impact on educational institutions

Colleges and universities are complex, decentralized organizations with varied business elements making standardization of systems and security procedures more challenging. These conditions make higher education a target for criminal activity. Data breaches at institutions of higher education accounted for 17% percent of all reported incidents, second only to the health industry with 27% of reported incidents.[5] With many institutions turning over their student body once every four years, the amount of valuable information available to a malicious person can be substantial.

While interconnected digital ecosystems and the threats they generate are driving changes in cybersecurity measures, these technology advances are also creating rapid and significant regulatory change around the world. The legislative churn is paving the way for record levels of enforcement actions, class-action lawsuits and regulatory scrutiny. For higher education, regulatory pressures can be felt in research, teaching hospitals, and administration functions. Protection of parent and student personally identifiable information (PII) is mandated by 48 of the 50 states, each with a unique approach to managing the privacy of PII. Industry standards, such as the Payment Card Industry's (PCI) Data Security Standard governing protection of consumer credit card information, will additionally influence an institution's approach to cybersecurity. Finally, federal regulations also require an institution to have appropriate policies and procedures including the following:

- Higher Education Act (HEA)
- Family Educational Rights and Privacy Act (FERPA)
- Student Aid Internet Gateway (SAIG) Enrollment Agreement
- Gramm-Leach-Bliley Act (GLBA) as required by the Department of Education Program Participation Agreements (Dear Colleague Letters GEN-16-12, GEN-15-18)
- Federal Information Security Management Act (FISMA) – NIST 800-53
- Health Insurance Portability and Accountability Act (HIPAA)

Addressing the business impacts of cyber risks, as well as the plethora of regulatory requirements, is a challenge every institution must address. Good governance is a key aspect of a successful strategy.

[5] *Privacy Rights Clearinghouse, 2005-2014*

Our perspective

Effective cybersecurity risk mitigation begins with a detailed understanding of risk and related impacts. Many institutions have developed cybersecurity programs with an unbalanced focus on technology solutions and cyber control operations. The focus on these programs is based on mandates levied by third parties impacting different aspects of an institution. This reactive approach can result in an institution spending limited resources on controls and technologies which are not directly tied to relevant business risks.

A holistic approach to managing cybersecurity risks should include the following structural elements:

- **Annual risk assessment**: The risk assessment is an activity best led by functional and departmental unit leaders. Many organizations lead with an IT risk perspective, which limits an institution's ability to gain insight into the potential impacts to the business in the event of a cyber incident. A successful incident response, and therefore an appropriate plan, incorporates elements beyond IT, such as general counsel, business operators, risk, privacy, compliance, audit and communications. The assessment also needs to consider the proliferation of activities being outsourced to third-party vendors.
- **Data inventory and data lifecycle management**: Before considering what cyber controls require implementation, an institution must first understand what types of information assets – also known as data elements – are critical to the business. Questions that should be asked include:

    - What is the organization's most sensitive data?
    - Who needs access to the data?
    - What recovery timeline is acceptable?

  For organizations conducting research, as well as educating and engaging in clinical activities across geographies, education of employees is critical as data and devices move regularly between platforms and locations. A thorough understanding of the lifecycle of those information assets within an institution should be developed.
- **Align cyber control to risks**: Once an institution has developed a comprehensive, business-centric view of cyber risks and understands how affected information assets are managed within the environment, it can then start to measure its residual risk profile. As an organization develops an understanding of where residual risk remains unacceptably high, a roadmap of cyber controls can be developed and implemented in an orderly manner. Actions that can be taken to mitigate threats should be in place, communicated and tested.
- **Measure compliance and monitor progress**: The primary focus of the cyber program for many institutions is compliance. While ensuring compliance is critical, too narrow of a focus can leave larger business risks unaddressed. A comprehensive cybersecurity program will effectively manage business risk as well as meet regulatory obligations. As a final step in the construction of a cybersecurity controls portfolio, risk mitigation techniques should be compared against known regulatory requirements and potential gaps should be identified. Data analytics and reporting should be utilized to identify and monitor vulnerabilities and threats. Regular reporting of progress against goals should occur within operations and with the audit committee or other governing body at least annually.

An effective approach to managing cybersecurity risk should consider risks through the view of what is most critical to the business, and should comprise a formal infrastructure and discipline around regular reassessment, monitoring and reporting on progress.

Research administration

Background

The state of the research administration enterprise has evolved significantly over the last 20 years. Research universities, academic medical centers, and research hospitals have all invested in staff, systems, and learning development programs. Some institutions have created a detailed workforce roadmap for their staff to define career ladders through targeted trainings used to supplement their daily work experience. Other institutions are seeking changes in their research administration model.

These changes are being driven by several items. First, research organizations continue to face immense cost uncertainties. Federal budget constraints will likely pressure indirect cost recovery and provide less reimbursement for the direct costs of research. As such, the extent to which an institution 'subsidizes' research will likely increase over the next several years. Second, executive awareness of the state of research administration performance has increased, as senior leadership teams have become better informed of the total cost of the research mission.

The third major change driver relates to staffing gaps that remain in research administration, with high variability in regulatory and operational knowledge, and delivery of support services. In addition, there are frequently poorly documented roles and responsibilities within research administration. A fourth issue relates to the decentralized nature of research data. Data is often found across multiple systems with minimal interfaces, meaning that operational data needed for executive reporting has to be pulled from disparate sources with different data governance rules.

The last two change drivers relate to institutional strategic trends. Many institutions are continuing to push their faculty for increased research productivity. This requires a research administration enterprise that is built to facilitate principal investigators winning and managing more grant and other funding activity. Finally, internal and external research collaboration continues to grow as 'team science' drives increased research results. The administrative operations need to be aligned to these industry trends, which may break down the traditional departmental research administration structure.

Impact on educational institutions

Significant constraints in net revenue growth, increasingly complex regulatory costs, growth in activities that depend on subsidies, and emerging competitive modes of education all point to the need to improve both the effectiveness and efficiency of a research organization's business operations. To address these challenges, institutions are experiencing a shift in current paradigms around administrative structures and are seeking to design innovative approaches to reduce administrative costs, improve operating performance, and achieve financial stability without jeopardizing academic integrity and research excellence. To accomplish this, many institutions are undertaking initiatives to assess service models and to design a change management process that builds community consensus and results that are aligned with the existing approach to administrative support.

Many research organizations are often reluctant to change. In many institutions, research administration is still synonymous with compliance. In addition, research administration functions are spread across the research enterprise, creating multiple stakeholders that have to be linked together. Attempts to develop centralized administrative functions are usually hybridized to retain a high degree of center, department, or institutional control. Thus, the theoretical efficiencies of a shared services model are rarely achieved in practice.

To address this, institutions are developing business cases to move forward with change. These business cases include early engagement with the research community and other stakeholders to demonstrate the benefits of revisiting their current operating model and have included the following priorities and practices:

- Reducing the administrative burden on principal investigators by using automated processes
- Developing effective governance, policies, management and operational procedures for collaboration within and across institutions

- Devising performance metrics for research management that are accepted by academic faculty and are actionable
- Providing senior leadership access to management information which lies across numerous systems and organizational boundaries

Our perspective

Given the current federal funding outlook, research organizations are unable to sit back and wait for funding to support the old operating models. At the same time, faculty are expecting an increased level of service in the research administration enterprise. Several institutions are seeking to create a shared service center model, or a new operating model in order to drive success and enable research organizations to improve financial performance. Institutions' appetite for a shared services model vary. For those institutions looking to make enhancements to research administration without creating a shared service center, there are additional practices and policies that can be initiated to create streamlined processes, leverage economies of scale and increase the service quality of back-office functions. These include the following:

Roles and responsibilities must be clearly defined: The first step any organization should take when revisiting its research administration operating model is to define clear roles and responsibilities across all tasks within the research lifecycle. Leading practices include forming working groups to discuss and clarify roles and responsibilities within research administration in an effort to realize greater efficiency. These members should identify operational activities and assign them to specific key offices or personnel who should have the primary responsibility for the specific task. A roles and responsibilities matrix should identify supporting policies and procedures, along with the supporting technology.

Policies and procedures should be updated to support the new operating model: Organizational change requires departments to review their supporting policies and procedures for completeness and accuracy to support the new operating model. This is also an ideal opportunity to benchmark the current policies and procedures to leading universities, academic medical centers, or other comparable organizations to identify any gaps. After gaps are identified, an institution should prioritize the population to develop primary and secondary items to be communicated to the research community. Given the new operating environment, institutions may also develop checklists that show a list of activities that must be completed for a given activity and job aides that show the detailed process to complete a task.

Training programs should be developed and aligned to create a consistent level of performance: Few institutions offer structured research administration training programs for principal investigators, central research administrators, departmental staff, or supporting offices. The depth and breadth of training should vary based on a research organization's size or structure. Regardless, there should be four primary levels of research administration training. Level 1 should focus on prerequisites or fundamentals training, providing a high level overview to the research community. Level 2 training should focus on processes, providing an understanding of what exists or has changed in the processes. Transactional training should be the focus of Level 3, with hands-on and real world exercises. Finally, Level 4 should be self-service focused performance support, typically managed through a desk manual or job aide.

For each level of training, the institution should determine the frequency of the program, whether the program is presented live or online, the duration, and the required participants. Many institutions are moving to mandated training for faculty and staff, to cover research compliance issues and basic pre- and post-award administration activities. Major regulatory changes should also be considered as part of an institution's annual compliance training.

Key performance indicators for research administration should be monitored and reported to identify performance opportunities: Sustainable success requires the incorporation of key performance indicators (KPIs). Examples of KPIs in research administration include the number of proposals submitted by pre-award FTE or total number of accounts managed by post-award FTE. There are five primary considerations for metrics development: (1) data should be readily available without manual data collection, (2) there should be regular intervals for monitoring, (3) data should be reliable, accurate, and consistently defined, (4) the rationale for the metric should be understandable with actionable intervention to impact performance, and (5) the metric should be within the purview of operating group leadership with direct ability to influence performance.

Service level agreements should be documented, formally rolled out, measured and reported on: Service level agreements (SLAs) that incorporate KPIs provide accountability to any customer service organization. Within research organizations, SLAs have typically resided within the information technology group or human resources. Within the last few years, more organizations are embracing SLAs to hold the research enterprise accountable. Service level agreements should define a series of categories such as specific functions performed, services provided, central or shared service responsibilities, customer responsibilities, complaint and follow-up procedures, and routine service level review processes.

Research organizations must manage change: A structured change program will facilitate staff capability and desire to work in the new environment, reduce costs and improve service levels. Change should focus on creating a clear vision to propel stakeholder energy while aligning leaders around the vision and work plan. Frequent communication is vital to clarify expectations, issues and benefits. There is also a cultural component that must be managed in the transition to any new operating model. This program should implement a workforce transition plan that supports new ways of operating in the new structure.

It is important that institutions stay current on research administration and the numerous changes impacting federal grants and compliance matters. Designing models, programs, and procedures that allow for institutions to be nimble, cost effective and compliant is not easy, but is necessary in the current regulatory environment. Developing a solid framework designed for the institution that ensures faculty and staff are appropriately trained is the cornerstone to being successful with research administration.

The role of the departmental administrator

Background

The role of the departmental administrator (i.e., a manager in an institution's school or department that supports deans and faculty) takes on various forms and definitions depending on the institution and department where the administrator resides. The role frequently focuses on the business aspects of a specific individual school or department, but can also include a vast array of other tasks including admissions, budgets, grants management, financial aid, alumni development, and oversight of compliance requirements. The role has been an important one for deans, faculty, and principal investigators. Academic leaders see value in the role as a way to effectively oversee the day-to-day operations within a school or department. The position is also viewed as a knowledge source for administrative tasks and a way for departments to be efficiently supported. However, over the course of time, departmental administrators have experienced increased and more diverse workloads as more has become expected of them by their school or department, as well as from central institutional leaders.

A complicating factor is that often departmental administrators report to a dean who oversees an entire school or department. As a result, departmental administrators may not have a direct reporting line to central administration. This structure can cause a lack of standardized training and the inconsistent application of institutional policies and practices. Given this decentralized hierarchy, central administration is often required to interact with a much broader group of individuals, including the deans of each school and each departmental administrator, to obtain necessary information for central institutional decision making and reporting. This model can lead to inconsistencies in reporting, inefficient practices, and prolonged decision making.

The departmental administrator position has evolved to include many responsibilities and unique tasks. Certain decentralized institutions have seen approximately equal numbers of faculty and departmental administrators, and in some cases, less than one full-time faculty member for every departmental administrator. These numbers highlight the increased prevalence of the role. Given that financial and human capital resources within higher education are in high demand and budget pressures continue, institutions are faced with the question of whether the current role of the departmental administrator is appropriate, whether it should be adjusted to one that is more centralized, or whether a hybrid model should be developed. Regardless of the structure, institutions are considering how to implement more consistent, institution-wide policies and procedures, as well as fostering greater alignment between centralized and decentralized functions and activities.

Impact on educational institutions

Departmental administrators typically report to a dean who relies heavily on the administrator for business and other administrative aspects of the department. This reporting structure can result in siloed policies, inconsistencies in training, and individualized skills which can lead to potential non-compliance with institutional policies, inconsistent application of controls, and unmet service expectations.

In many cases, administrators have a background in teaching and education. Given their role can be heavily focused on business and management functions, this is a cause for discussion regarding the necessary skill sets of individuals in this position. Administrators without a business background may not fully appreciate controls, the importance of standardized reporting, and the significance of certain regulatory compliance matters. Additionally, given the predominant reporting structure, many departmental administrators are handling financial matters at their school or department but do not have formal interaction with central university finance and other functional leaders.

In order to address the fact that many institutions have decentralized structures, certain institutions have employed individuals within central administration who ensure departments are provided with consistent training programs and support services. This includes guiding the application of similar policies, procedures and controls. By implementing a more centralized approach, institutions are looking to design a clear reporting structure and standardized procedures between the schools and departments, and more specifically, between the departmental administrator and central administration. This centralized approach allows for enhanced monitoring of controls and reduces the risk of non-compliance.

As a result of potential inconsistencies across departments, many institutions have also started to consider a shared services model, which involves a consolidation of routine support and administrative functions. By consolidating such functions, institutions can work toward developing central groups to support the needs of the campus, as opposed to individual employees for each department or school. Although a shared services model is a considerable adjustment, institutions are viewing this as a way to better define the roles within their organization. This model can also create efficiencies and a clearer line to central administration.

Our perspective

Considerations needed when evaluating the role of the departmental administrator include defining what the role should be and what support needs to be in place at the institution to ensure consistent policies, procedures and controls are implemented. In contemplating certain priorities, institutions will want to understand the needs of their organization, the appropriate level of influence and involvement from the departmental administrator, and how to provide the best service to academic leaders in a cost-effective manner. More specifically, executive leadership is assessing how many administrators are needed and how they can be aligned in a way that brings standardization, cost savings and greater efficiency to their institutional processes. The following steps should be considered by institutions in their evaluation:

- Institutions should explore formally aligning roles and responsibilities of the departmental administrator with operational functions and activities (such as finance and human resources), as opposed to specific schools or departments. This can create more centralized alignment that provides support to multiple departments and could allow for cost savings and more consistent policies and procedures. Additionally, a determination should be made as to whether it is essential to have an individual administrator at each school or department.
- Adequate and consistent training to departmental administrators by members of central administration should be in place to ensure those in the role receive appropriate support and maintain the required skill sets
- Consideration should be given to having dual reporting lines to both the dean of a school or department and to central administration

With unstructured training programs and indirect or informal lineage between departmental administrators and central administration, the ability for a departmental administrator to stay current on all aspects of their duties is becoming increasingly more difficult. As such, institutions must look for ways to support the individual departments and schools in an efficient and cost-effective manner. In doing so, the role of the departmental administrator will become more clearly defined and as a result, more effective within an institution.

Financial reporting

Background

The standard setting authorities for financial statements of higher education institutions is divided between the Financial Accounting Standards Board (FASB) for private institutions and the Governmental Accounting Standards Board (GASB) for public institutions. Roughly half of the National Association of College and University Business Officers (NACUBO) member institutions follow FASB and half are subject to GASB.

Regardless of whether an institution applies FASB or GASB, there is no escaping the volume of new accounting pronouncements that will take effect over the next several years. Some of these standards may require significant effort to implement. Institutions have started to evaluate the level of effort that will be required and assess whether additional human capital will be needed. Institutional leadership must be mindful of the impact that new accounting and reporting standards have on financial reporting systems and internal controls.

Impact on educational institutions and our perspective

There are four primary accounting pronouncements impacting private higher education institutions. They include three that impact all organizations, including the long awaited lease accounting rules, revenue recognition, and presentation of net benefit costs. The fourth pronouncement relates to the most significant change to not-for-profit financial reporting since the 1990's. The new financial reporting format will impact both presentation of the income statement and disclosures in the footnotes.

For public institutions, the GASB board is also focused on three interrelated projects to significantly enhance financial reporting, including potential changes to the reporting model and revenue and expense recognition, as well as modifications to existing footnote disclosures.

FASB and GASB developments:

New lease accounting rules

By now, all institutions should be engaged in planning for the adoption of new lease accounting rules issued by both the FASB and GASB (note that GASB's new rules will be issued in the summer of 2017). FASB institutions with public debt (such as tax-exempt bonds) must implement the new rules in fiscal 2020 (calendar 2019). Other FASB institutions and all GASB entities will make the changes in fiscal 2021 (calendar 2020).

The most significant changes involve operating leases. Today, lessees report operating leases off-balance sheet; lease payments are shown as operating expenses in the income statement and as operating outflows in the cash flow statement. Under the new rules, FASB and GASB institutions will bring nearly all operating leases onto the balance sheet, recognizing both a liability (the obligation to make lease payments) and an asset (the right to use the leased item). This is consistent with the accounting used for capital leases (now called financing leases) today.

Beyond that commonality, substantive differences exist between the FASB and GASB models. The FASB designed its new rules to be as neutral as possible to organizations' financial results by maintaining the dividing line between operating leases and financing leases. By and large, this approach confines the changes to the balance sheet. Operating lease liabilities are considered long-term operating obligations, not debt. The corresponding assets will amortize into expense in a pattern that increases over time, keeping the carrying value of the assets roughly consistent with the balances owed. In the income and cash flow statements, lease-related operating expenses and cash flows will continue to be reflected as they are today. While the definition of an "operating lease" generally remains the same, targeted changes in certain areas could result in some reclassifications.

The GASB took a different approach. Its new model eradicates all distinctions between capital and operating leases, instead viewing all leases as financing transactions. As a result, operating lease liabilities are considered long-term debt, and lease payments are treated as capital financing outflows in the cash flow statement. In the income statement, public institutions will recognize amortization of the asset along with interest expense, as they do for capital leases today.

Bringing additional liabilities onto the balance sheet automatically raises concerns about debt covenants and ratios used to monitor financial strength. Institutions should be inventorying the covenants associated with their debt and debt-related agreements in order to assess and plan for any potential impact. The extent to which an individual entity is affected largely depends on which standard-setter it follows, the nature of its covenants, and whether its debt agreements contain "frozen" or "semi-frozen" GAAP clauses (where covenant compliance is assessed based on accounting principles existing when the agreement arose, or which require good faith renegotiation if a technical default arises from new GAAP).

Generally speaking, the FASB's new rules are not expected to have a widespread impact on private sector institutions' debt covenants, primarily because the additional liabilities are characterized as "operating obligations" rather than debt. However, whether lenders will actually view those liabilities as "debt" remains to be seen. The impact of the GASB's new rules on public sector institutions is expected to be more profound and pervasive, and NACUBO has expressed concern that the characterization of all leases as long-term debt heightens the risk of covenant violations.

The accounting changes could also have consequences for grant funding. Granting agencies often treat capital leases and operating leases differently, and some do not provide funding for debt service costs. The FASB's decision to retain the status quo regarding presentation of operating lease expenses will allow mechanisms such as indirect cost rates to continue unchanged. However, the GASB's decision to treat operating leases as financings raises a number of questions that federal agencies have not yet weighed in on. Similarly, the Department of Education has not yet communicated whether the new operating lease assets and liabilities will be included in calculating private institutions' Title IV financial-responsibility composite scores. However, because FASB's model keeps the asset and liability in sync, the impact would likely be neutral.

The effort required to implement the new standards is expected to be substantial. For institutions that present comparative financial statements, work must begin a year sooner, as both standard-setters require retroactive application to the earliest period presented. While the financial statement changes are the most obvious impact, institutions will also need to analyze how the new frameworks will affect current business activities, debt covenants, contract negotiations, budgeting, key metrics, systems, and business processes. For decentralized institutions with significant lease portfolios, the ability to gather the required information on existing operating leases and capture data on new leases at the outset will be critical to an orderly transition. This may result in the need for new systems, controls, and processes.

FASB developments:

Revenue recognition

The FASB's landmark new revenue recognition standard will take effect in fiscal 2020 (calendar 2019) for institutions with public debt. Other FASB institutions will adopt the changes in fiscal 2021 (calendar 2020).

Overall, the new standard is not likely to have a significant impact on amounts of revenue recognized for short-term contracts such as tuition, housing, and fees. Tuition revenue continues to be recognized pro rata over the duration of the course, but will be reported net of expected refunds to withdrawing students. Academic medical centers may see a significant shift in how certain types of patient service revenues are recognized and measured, with potential reductions in net patient service revenue and the related bad debt expenses. Revenue recognition for licenses of intellectual property will differ depending on whether the IP is "symbolic" (e.g. a school's logo) or "functional" (e.g. a drug compound). A new concept -- "breakage" – would apply to unexercised rights that expire, such as unused balances on nonrefundable meal plans.

More significant changes may result from a related project that arose from concerns about applying the new revenue standard to grants, particularly those from the federal government. By and large, today federal grants are typically considered exchange transactions by both not-for-profits and for-profits. Based on deliberations in this project, that may be changing soon. The FASB has tentatively concluded that grants from governmental entities to not-for-profits are typically arrangements where "funds are provided to fulfill mutually agreeable goals that are in keeping with the institution's mission," which is incompatible with the revenue standard's scope. For example, the objective of a sponsored research arrangement is the performance of research, not the creation of an output with commercial value. Thus, it appears likely that not-for-profits will not apply the new revenue standard to federal grants, but would instead account for them as contributions. The project appears to be moving quickly, with an exposure draft expected in the summer of 2017. FASB's goal is to issue a standard that would be effective at the same time as the revenue standard.

Not-for-profit financial statement presentation

As key users of financial statements, governing boards will be impacted by the FASB's recent changes to the not-for-profit financial reporting model. These changes represent the first phase of a larger project which could potentially result in more widespread changes to the overarching model used by for-profit and not-for-profit entities alike.

The most obvious changes involve net asset classifications. The three classes used today (unrestricted, temporarily restricted, and permanently restricted) will be replaced by two classes: with donor restrictions and without donor restrictions. Details about the nature of restrictions must still be provided.

Boards may interested in the new standard's emphasis on information about liquidity and availability of resources. The rules will emphasize disclosure of information about limitations on use of an institution's financial assets that arise from laws, contractual provisions, donor restrictions, and governing board decisions. Information about significant restrictions or limitations on the use of specific assets must be apparent either on the face of the balance sheet or in the notes, and a new mandatory disclosure will focus on communicating the amount of net financial assets available for current period spending. Such changes are expected to mitigate some of the difficulties associated with assessing not-for-profit liquidity when a non-classified balance sheet format is used.

Presentation of net employee benefit costs

Boards also may be interested in recent changes to rules regarding the presentation of pension and other post-employment benefit (OPEB) expenses in the income statement. Going forward, these costs will be divided between the operating and nonoperating sections reported by most institutions. Operating expenses should include the portion of net benefit costs related to benefits earned by employees during the current period; other components (for example, return on plan assets) will be presented as nonoperating activity. These changes will be effective for not-for-profit institutions in fiscal 2019 (calendar 2018). For many institutions, this will have a positive impact on results of operations and as a result, some institutions are considering early adoption.

GASB developments

Liabilities: a recurring theme

Over the next few years, leaders of public sector entities will likely be focused on challenges associated with bringing additional liabilities onto the balance sheet. For example:

- In fiscal 2018, institutions will adopt GASB's new OPEB reporting rules, and in doing so will be required to report the full unfunded liability for other post-employment benefits provided. Since these rules conceptually resemble the pension changes a few years ago, institutions should strive to take advantage of lessons learned from implementing those earlier changes. The impact, which may be significant, will depend on the nature of the benefits provided and the extent to which dedicated resources have been set aside to fund the liabilities.
- Some institutions have capital assets that, upon retirement, will have environmental consequences that must be remediated. In fiscal 2019, those entities will be required to recognize and record a liability for the eventual retirement of the capital assets. For institutions with research reactors or academic medical centers that have diagnostic imaging equipment, these numbers may be material.

In addition to planning the implementation efforts that will be required for each of these new standards, boards and management should strive to keep the big picture in mind when evaluating the impact on an institution's net position, financial ratios, and covenants.

The "Big Three"

The GASB is working on three interrelated projects – referred to collectively as the "Big Three" – that taken together, will be a comprehensive re-look at governmental financial reporting.

The first is a re-examination of the overall governmental financial reporting model, including the requirements for standalone Business-Type Activities (BTAs) like higher education institutions and hospitals. Today, institutions report using requirements developed for revenue-generating activities conducted by general purpose governments. The focus is on the recovery of costs, and the extent to which the fund's operations are subsidized by (or contribute to) the government's resources. Higher education institutions have long maintained that this model is not particularly useful for a freestanding business organization. A more flexible approach similar to that used by private sector institutions would allow entities to better tell their story.

The second project will consider how revenues and expenses should be recognized within that model. The goal is to develop a comprehensive recognition model that would apply to exchange, nonexchange, and "exchange-like" transactions. Today, governmental entities typically apply concepts adopted from the private sector when recognizing revenue from exchange transactions. Issuance of the FASB's new revenue standard project provides the GASB with an opportunity to consider whether a "performance obligation" approach should also apply to governmental exchange transactions. The project would also reconsider GASB's existing revenue recognition model for nonexchange transactions.

The final project will consider the sufficiency of existing note disclosure requirements. The time horizon for completion of these efforts is relatively lengthy (2021 and after).

Internal controls

Background

Since the Sarbanes Oxley Act of 2002, public companies have been required to document and test key financial reporting controls within their internal control environment. While not-for-profit organizations continue to be excluded from these regulatory requirements, they have been cognizant of what constitutes an effective internal control structure and how it can be assessed. Updates to the internal control reporting framework and recent changes to federal Uniform Guidance rules have resulted in not-for-profit organizations revisiting their internal control initiatives.

The Committee of Sponsoring Organizations (COSO), which was formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting (known as the Treadway Commission), continues to be dedicated to enhancing the quality of financial reporting. COSO developed a common definition of internal controls that provides a standard against which all organizations can assess their controls. Internal control is defined as:

"A process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations"[6]

In 2013, COSO published an update to its *Internal Control - Integrated Framework (Framework)*, which was originally published in 1992. The 2013 revision did not change the definition of internal control; rather, the intent was to (1) clarify the requirements for effective internal control, (2) address changes in business that introduce or elevate risk of achieving entity objectives, and (3) encourage users to apply internal control to additional entity objectives (such as regulatory reporting, operations and compliance).

The 2013 revision to COSO included the articulation of 17 individual principles that have been embedded within the original five COSO components. This provides a more detailed framework which can be used to assess an organization's internal controls across the COSO components.

When public companies were required to implement the Sarbanes Oxley Act of 2002, specifically Section 404, Management Assessment of Internal Control, COSO was viewed as the framework which enabled public companies to ensure financial reporting controls were in place and operating effectively. Not-for-profit institutions, although excluded from the requirements of Sarbanes Oxley, have embarked on various initiatives over the years to enhance their own internal control environments.

A number of fundamental questions still exist in the not-for-profit industry that entities should be cognizant of as they consider enhancements to their internal control structure, including, but not limited to:

- What constitutes an effective internal control structure?
- What are the expectations to demonstrate an appropriate internal control structure?
- How do trustees assess the effectiveness of the institution's internal control structure?
- What is the role of internal audit in ensuring an effective internal control structure?

Impact on educational institutions

Not-for-profit institutions have continued to remain exempt from the financial reporting internal controls certification and attestation requirements of the Sarbanes Oxley Act imposed on SEC registrants over a decade ago. However, the federal Uniform Guidance rules include requirements to maintain a system of internal controls over federal award compliance requirements.

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[6] *Internal Control - Integrated Framework, www.coso.org*

The Uniform Guidance internal control requirement applicable to federal award compliance requirements states the following: "The non-Federal entity must: (a) Establish and maintain an effective internal control over the Federal award that provides reasonable assurance that the non-Federal entity is managing the Federal Award in compliance with Federal statutes, regulations, and the terms and conditions of the Federal award. These internal controls should be in compliance with guidance in "Standards for Internal Control in the Federal Government" issued by the Comptroller General of the United States or the "Internal Control Integrated Framework", issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."[7] However, the Uniform Guidance is very specific in its requirement that the institution's internal control system provides for only a few specific items: 1) compliance with federal statutes, regulations and terms and conditions of each federal award, 2) evaluation and monitoring of compliance with those items, 3) take prompt action when noncompliance is found; and 4) take reasonable measures to safeguard protected personally identifiable information and other sensitive information.

Notwithstanding the lack of a formal requirement to document and test internal controls with the same level of rigor that is required under Section 404 of the Sarbanes Oxley Act for public companies, educational institutions have continued to make progress on their overall control environment particularly in the following areas:

- Formalizing university-wide enterprise risk management initiatives
- Refreshing existing policies and procedures and related documentation
- Ensuring controls are designed appropriately and operating effectively, with particular focus on compliance controls
- Taking advantage of system implementations and new Uniform Guidance compliance rules as an opportunity to refresh policies and procedures
- Ensuring cyber risks, including the protection of personally identifiable information and other sensitive information associated with new implementations, as well as existing systems, are remediated to the extent possible by internal controls
- Driving consistency of processes throughout the institution
- Ensuring existing internal controls in place are replicated at international and other locations
- Reviewing third-party outsourced arrangements to understand internal controls in place at the organization
- Utilizing the COSO framework to aid in the risk assessment process by internal audit functions in the development of their internal audit plans
- Assessing the role of internal audit versus the finance organization with regard to the implementation and testing of internal controls

From a governance perspective, audit committee practices have evolved to incorporate some of the leading practices of public company audit committees, including financial expertise within the membership, increasing the number and length of meetings, responsibilities for the external audit relationship, and responsibilities for the internal audit function.

Our perspective

The system of internal controls of most educational institutions is likely to be somewhere on a continuum between "informal," and "standardized." Specifically, this means that institutions are likely to have control activities in place, such as required approvals and verifications, but the documentation supporting the control activity may not always be at a level it would be if the institution were a public company. The controls are likely to be "people dependent" and not standardized across the institution. This is particularly evident in decentralized environments. This poses challenges when individuals change jobs or retire and do not train their successors on procedural control responsibilities.

There are a number of factors that should be considered as an institution initiates a process to enhance its internal controls. These factors include its size, the extent to which it is decentralized or centralized in its business operations, the degree to which policies and procedures are already well defined, documented, and communicated, whether any business functions are outsourced to external providers, and whether federal funding is received subject to the Uniform Guidance requirements. In addition, federal agencies are increasingly focusing on internal

[7] *Title 2 U.S. Code of Federal Regulations Part 200, Subpart D, Section 303*

controls when performing reviews of federal program compliance at not-for-profit institutions.

Several of the significant steps that might be put in place to advance the institution's internal controls along the internal control continuum include:

- Documenting and assessing the design of the controls already in place, including the comparison to the COSO 17 principles. Specifically, focusing on compliance controls may be a good place to begin to ensure the spirit of the Uniform Guidance is being followed.
- Refreshing the institution's risk assessment to identify key risks and controls in place to mitigate these risks. For those areas identified where the control operation is not mitigating the risk to an acceptable level, consider the existence of other compensating controls.
- Documenting the key risks and controls and linking to the various facets of the COSO framework and considering any necessary control modifications or enhancements to appropriately address the risks identified.
- Considering the potential for a reduction of control processes if there are identified redundancies in the performance controls, or if controls are not mitigating the intended risk.

A critical review of the control environment is a prudent exercise for institutions to undertake to ensure proper controls are in place. The COSO Framework provides an outline to evaluate internal controls and simplify processes. The Framework can also lead to improvements in operations, compliance and reporting. Institutions with effective and efficient controls, a strong reporting and compliance framework and proper governance and oversight are better positioned to support their mission and achieve strategic goals.

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