Grant Thornton

Audit

Not-for-Profit

Audit committee outlook for not-for-profit organizations

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Introduction

Your organization's most valuable asset is its reputation, and that reputation must be able to withstand today's increased scrutiny. As an audit committee member, you are a guardian of that precious asset.

Audit committees exist to help the board maintain the organization's overall integrity, financial credibility and long-term viability. A sharpened focus on accountability, transparency and risk has brought the role of the audit committee into the public eye. A critical responsibility for every audit committee is to ensure that the organization prepares accurate financial statements, exercises responsible financial management, maintains compliance with laws and regulations, and manages operating risks effectively.

Understanding that your role as an audit committee member is both rewarding and challenging, Grant Thornton LLP has created this Audit Committee Outlook, which provides an overview of recent accounting pronouncements and tax regulations with the potential to affect your not-for-profit organization. We have created this guide as a reference to assist you with discharging your critical fiduciary responsibilities.

Additional information about our resources for this sector can be found at gt.com/nfp. We also encourage you to register to join our Board and Executive Institute so you can regularly receive invitations to educational forums and speaking engagements, as well as articles and webcasts on current and emerging issues of interest to not-for-profit leaders.

We are committed to providing outstanding service to meet the audit, tax and advisory needs of our not-for-profit and higher education clients. For more detailed information and answers to your questions, contact our Not-for-Profit and Higher Education professionals.

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Outlook on: Tax reform and the audit committee

President Trump signed into law a major tax overhaul on December 22, 2017. The new law includes provisions of critical interest to not-for-profits. While many of the proposed changes that would have dramatically affected the not-for-profit sector were ultimately dropped from the final bill, there are still significant consequences to the legislation.

U.S. accounting standards require that organizations record the effects of a law change in the period corresponding with enactment of the law. Therefore, the effect of these changes must be reflected in annual financial statements for calendar year 2017. For example, even though the lower corporate tax rate is not effective until tax years beginning after December 31, 2017,

Questions for management

1 What plans or processes are in place to stay aware of new guidance as more information becomes available?

2 What plans or processes are in place for the possibility of lower contribution levels? Have approaches to fundraising been examined and modifications made as appropriate? Have business and contingency planning exercises been performed to prepare for the potential of lower available resources?

3 What plans or processes are in place to prepare for the increased cost of compensating employees earning over $1M? Have deferred compensation and other arrangements that could help minimize taxes been considered?

4 What plans or processes are in place for the taxes on certain college endowments? What steps have been taken to minimize those taxes?

5 What plans or processes are in place for UBI? Has a determination been made if estimated taxes must be paid now or if current estimates need to be revised? Are changes necessary to certain employee benefits that would now be subject to a 21% tax? Has careful consideration been given to expense allocations used to offset UBI, especially where losses from one unrelated trade or business have been used in the past to offset the gains from another so that all indirect costs are fully allocated?

Questions/action items for audit committee discussion

1 Do we have the necessary expertise in both tax and accounting to understand the tax requirements posed by the new law and to evaluate management's judgments related to them?

2 How will the proposed changes impact our financial reporting and business strategy going forward?

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it will impact the calculation of deferred taxes in any quarter that includes the enactment date of December 22, 2017.

The following is a high-level look at just a few of the provisions that may have a pronounced impact on tax accounting. For a comprehensive look at all of the provisions as well as some deeper analysis of specific changes, please see additional information at gt.com/taxreform.

Key points relating to tax-exempt organizations

- **Corporate tax rate.** Effective January 21, 2018, the corporate tax rate is 21%.
- **Net operating loss (NOL).** NOLs have been modified to be aligned with the corporate rules. NOLs are limited to 80% of taxable income. NOLs can no longer be carried back to prior years but may be carried forward indefinitely. Tax-exempt organizations set up as corporations do not need to compute Alternative Minimum Tax (AMT) on Unrelated Business Income (UBI) activities.
- **Unrelated business activities.** Entities created as corporations will be subject to the new 21% corporate income tax rate. There will be no sliding scale rate based on the amount of UBI generated. Tax-exempt organizations will need to treat each unrelated trade or business activity as a separate line of business, effectively creating a separate profit and loss statement for each activity. The losses from one unrelated trade or business cannot offset the gains from another. This treatment places tax-exempt entities at a disadvantage to their for-profit counterparts, which are able to offset profitable lines of business with unprofitable ones.
- **Employee-provided benefits.** The value of certain employee-provided benefits (subsidized parking, transportation, etc.) must be treated as unrelated business income on the Form 990-T if the benefit is not treated as taxable wages to the employee.
- **Excise tax on excess compensation.** The new law includes a provision to assess a 21% excise tax on compensation paid to the top five "covered employees" in excess of $1M (as well as on "excess parachute payments"). Certain employees within the medical profession (doctors, nurses, veterinarians) are excluded from this provision.
- **Excise tax on college endowments.** Private colleges and universities with at least 500 full-time enrolled students and assets greater than $500,000 per student will be subject to a new 1.4% excise tax on their endowment net investment income. It is estimated that fewer than 30 colleges in the U.S. will be impacted by this provision.
- **Charitable contributions.** Changes made to the individual tax rules, many of which may expire in 2025, could have a profound impact on the not-for-profit community.
  - By increasing the standard deduction and limiting itemized deductions (state and local taxes), the new legislation reduced the number of individuals who will choose to itemize deductions on their personal tax returns.
  - The new legislation doubles the exclusion amount for estates and gift tax purposes.
  - For households that still itemize their tax returns, the new legislation increases the percentage limitation on giving to public charities from 50% to 60% of individual adjusted gross income.
  - Specific to higher education institutions is the removal of the law allowing individuals to deduct, as a charitable contribution, 80% of their payment for the right to purchase tickets or seating at athletic events.
- **Qualified moving expenses.** Will now be taxable.
- **One-time transition tax.** The one-time transition tax could impact the repatriation of income, as well as the Base Erosion and Anti-Abuse Tax on certain taxable income for institutions with certain foreign investments.

Outlook on: Accounting for the audit committee

The new lease accounting standard and nonprofit considerations

The technical requirements for accounting and financial reporting are ever changing. Under new lease accounting guidance, lessees will see the greatest change, as the new leasing standard aims to recognize a lessee's financial obligations and related "right-to-use" assets on the balance sheet for leases with lease terms greater than 12 months.

The new standard, required for almost all leases, goes into effect for public companies (including not-for-profits with public debt) in fiscal years starting after December 15, 2018. It goes into effect one year later for private companies and not-for-profits without public debt.

This guidance presents a number of current discussion issues for audit committees to assess whether the organization understands the impact of the leasing standard is prepared for adoption, and can implement it smoothly.

Four key concepts to understand about the new standard

1. **Definition of lease**

   The new standard defines a lease as a contract, or part of a contract, that transfers the right to control use of an identified asset class for a period of time in exchange for consideration.

   A notable change in this standard is that a contract will no longer be deemed a lease simply because a customer has a right to substantially all of an asset's output, if the customer does not obtain control of the asset.

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Questions for management

1 What is the plan for adoption of the leasing and revenue recognition standards? Is there a plan for early adoption? If so, when? If not, has it been considered?

2 Regarding leases:
  a Do legacy accounting systems have a complete inventory of leases, and do they identify and track the lease components necessary to comply with the new rules? If not, can they be upgraded or do they need to be replaced?
  b How are service agreements currently structured in existing leases? Do all current agreements include the information necessary to account separately for lease and nonlease components – including embedded leases?
  c Have policies and procedures been reviewed for the separation of lease and nonlease components within the agreement?
  d Would there be benefit in having a more centralized process for identifying and tracking all lease accounting activity?

3 Regarding revenue recognition:
  a What steps are you taking to make sure everyone is familiar with Topic 606 (e.g. summarizing its key factors, reading relevant commentary from accounting firms, attending technical training, and talking through the new guidance with your auditors)?
  b Has an inventory of revenue streams and those that include contracts with customers been conducted? Has each revenue stream that includes a contract with a customer been further evaluated in accordance with the five-step model? Has particular attention been paid to those contracts where the transaction price may be variable or where multiple deliverables are promised to the customer, including goods, services, options, future discounts, and other rights that the customer would not receive if not entering into the contract?
  c Have the differences between old and new guidance been evaluated? Have the financial implications been determined and the changes communicated? Have the requirements to retrospectively adopt the new guidance been determined?
  d Have any changes in controls that are needed been identified and have policies and procedures been appropriately updated? Have changes been communicated to the staff? Has training been provided?
  e Have changes to the financial statements and related disclosures been determined? Have board members, senior staff, key programmatic stakeholders, contract signers, banks and bondholders been alerted to those changes?

Action items/questions for audit committee discussion

1 With the new standard requiring all leases to be on the balance sheet, how confident are you that all of the organization's lease agreements have been identified and properly accounted for?

2 Does your organization currently have sufficient resources to review all of your lease agreements and extract the necessary data to ensure that the proper accounting treatment has been applied?

3 Will the revised presentation of leases on the balance sheet have an impact on matters such as debt covenants?

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2 Separation of lease and nonlease components

When a lease includes "nonlease" components, such as a service agreement for maintenance of leased equipment, the nonlease costs must be reported separately and not included in the lease figures shown on the balance sheet.

3 Transition relief

The new rules allow several types of relief. A lessor or lessee can elect to not reassess the following on transition, but all three must be elected as a package applied to all leases:

a Whether expired or existing contracts contain leases
b Whether to reclassify any expired or existing leases
c Whether initial direct costs for existing leases should be capitalized under the new standard

As a separate form of relief, lessors and lessees may continue to follow old practices to determine lease terms with respect to renewals and purchase options, and to evaluate impairment of right-of-use assets. This allows organizations, as a practical expedient, to continue to account for leases that began before the effective date of the new standard in accordance with "old" or existing GAAP of today. However, a right-to-use asset and a lease liability for all operating leases must still be recorded at the present value of the remaining minimum rental payments.

4 FASB and IASB differences

Our discussion focuses on FASB standards. If you follow IFRS, the new lease guidance under those standards includes a significant difference for lessees — all leases will be finance leases — which is a change from current IFRS that have both operating and finance leases.

The new revenue recognition standard and its impact on nonprofits

The Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers, Topic 606, applies to all entities, including nonprofits. For nonprofits that have issued, or are conduit bond obligors for, securities traded, listed, or quoted on an exchange or an over-the-counter market, the standard takes effect in annual reporting periods beginning after December 15, 2017. For all other nonprofits, the standard takes effect in annual reporting periods beginning after December 15, 2018.

The core principle of Topic 606 focuses on the contract between the nonprofit and its customers for goods and services, and ultimately, the rights and obligations between the nonprofit and the customer. Common nonprofit revenue streams, such as membership dues, tuition, admission fees, licensing, training fees, trade show registrations, and program fees, will likely be included under this guidance. Topic 606 requires more estimates and greater judgment than prior guidance, and Topic 606 will also require evaluation of the policies, processes, systems and controls by which revenue is recognized and disclosed.

There are a significant number of nonprofit revenue streams that would be covered under a new five-step model governing revenue recognition that is detailed below. Since contributions are both voluntary and nonreciprocal, they do not fall under Topic 606 and would continue to be accounted for under existing guidance.

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ASU 2014-09 escalates the importance of whether grants and contracts are within the scope of Topic 606 and if these contracts are considered to be reciprocal or nonreciprocal. The FASB recognizes the difficulty and diversity in practice among nonprofits in distinguishing between grants as exchange transactions or contributions, and on August 3, 2017, issued an exposure draft ASU intended to clarify and improve the scope and the accounting guidance for contributions received and made.

The five steps below are completed at the contract level, and each contains certain concepts and judgments that will have an impact on the revenue recognition process:

Step 1: Identify the contract with a customer
Step 2: Identify the performance obligations, defined as promises to transfer "distinct" goods or services to a customer
Step 3: Determine the transaction price
Step 4: Allocate the transaction price to the performance obligations
Step 5: Recognize revenue when or as the entity satisfies performance obligations

For many contracts, the identification of the related performance obligations and the transaction price may not be overly complex. However, when the nonprofit is transferring various goods and services at various points in time, careful consideration should be given as to when to recognize revenue for each performance obligation based on an estimated amount per performance obligation as determined by the terms and conditions of the contract.

As your organization embarks on the implementation of Topic 606, keep in mind the importance of developing an implementation plan and understanding how this will affect your organization. Detailed planning, adequate resourcing, and generous lead times are the key elements of smooth implementations. For more insights on accounting updates and changes, please visit gt.com/audit.

Outlook on: The audit committee and risk

Management must constantly weigh the risks of potential actions against the possible benefits that could result from success. Directors carry the responsibility to carefully review the risks that management accepts and the steps taken to minimize risk where possible. The audit committee's focus on the organization's financial position and performance provides a unique viewpoint from which to evaluate its risk management efforts.

To effectively understand and evaluate executive decisions, directors need to have a clear understanding of the organization's cultural values and its risk appetite. Directors need to ask if risks are evaluated and accepted in accordance with the organization's risk tolerance and mission.

Questions for management

(See our Not-for-Profit and Higher Education Audit Committee Guidebooks for further exploration of areas to address)

1. How would we characterize our organization's appetite for risk? How is it communicated/demonstrated throughout the organization? Are we taking the right risks? How do we know?
2. How does our organization:
   a. Prioritize existing risks
   b. Identify emerging risks
   c. Prepare for and manage those risks
3. Is our management team integrating risk management into decision making and ongoing operations? What is our organization's risk management culture? Do all relevant employees understand the role they play in evaluating and managing risk?

Questions/action items for audit committee discussion

1. Are we comfortable that our risk tolerance is aligned with strategic goals?
2. How do we assess the risk management process' soundness and effectiveness?
3. If we asked managers and staff to characterize the organization's approach to risk, would we get the same answer as we did from executives?

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1 Risk 101

Organizations face many common risks every day. The more days that pass without a failure related to a risk, the more likely it is that management and directors might become jaded into complacency. That is why the audit committee, and the board in general, should frequently review the most essential risks to the organization and make sure that adequate identification, monitoring, and prevention/mitigation is in place. Some of these risks in daily operations include:

a **Cybersecurity risk.** This may be the most challenging risk of all. So many people and entities are trying to hack into systems that cybersecurity threats are an ever present danger. Organizations must evaluate the cost of security relative to financial, reputational, and compliance risks and consequences, and they must prepare and maintain an action plan for the steps to take in the event that a breach occurs. (Please see "Reputational risk" below.)

b **Business interruption risk.** This risk can be as large-scale as a hurricane, or as local as a water main break. What level of interruption insurance does your organization need and what does it have in place?

c **Financial error risk.** These risks are on the rise as U.S. accounting standards shift to a model that allows more subjective judgments by management. Changes in revenue recognition and lease accounting, for example, will increase the types of reporting errors that may occur. Changes in tax law will require audit committees to understand the impact of tax provisions.

d **Reputational risk.** Some not-for-profits can go for years without ever facing a crisis that will damage their reputation. But none can afford to assume that they will be that lucky. While it's impossible to anticipate every possible event that could tarnish your reputation, it is critical to map out key reputational risks and strategies to prevent or limit the damage from a negative situation, as well as formulating a response strategy.

2 Opportunity risk

Nonprofits can be overly risk averse, to the point where they miss out on strategic opportunities that may present themselves. It is important to evaluate risk tolerance/appetite and to establish consensus regarding what level of risk is acceptable, so that the organization — both management and the board — is prepared to seize upon new opportunities that can further its mission.

Tax Professional Standards Statement

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