NONPROFIT ORGANIZATIONS: ANNUAL AUDIT SURVIVAL GUIDE

Chenae L. White, CPA, Consultant

Introduction

Many nonprofit organizations are recognized under section 501(c)(3) of the Internal Revenue Code (IRS) and therefore considered exempt from paying federal income taxes. Despite this reprieve, federal and most state governments levy several other "taxes" on nonprofit organizations' resources in the form of financial regulation, including but not limited to the dreaded annual financial statement audit. In the past several years, regulatory bodies have pushed for increased transparency and heightened the level of scrutiny placed on financial statements. Juxtapose this environment with one in which organizational budgets have been slashed from some combination of declining governmental grants and less private donations, along with a reduction in dedicated resources. The difficult macro environment for nonprofits makes it particularly challenging for organizations to pay their non-IRS levied "taxes" while achieving their core mission-driven goals.

AN INDEPENDENT AUDIT ALLOWS A NONPROFIT TO MAINTAIN, OR EVEN ELEVATE, ITS FINANCIAL CREDIBILITY

This white paper will break down the evolving financial reporting landscape for nonprofit organizations and equip nonprofit staff with tools to prepare for their annual financial statement audits, thus aiming to reduce the administrative taxes placed on critical resources that could be focused on fulfilling the organization's mission.

Independent Audits: Why Are They Important?

An independent audit is an examination of the financial records, accounts, business transactions, accounting practices, and internal controls of an organization by an "independent" auditor. To be considered independent, the auditor must not be an employee or related party of the organization whose audit it performs.[1]

Some nonprofits are not required to have an annual independent audit and their peers may tongue-in-cheek refer to them as the fortunate minority. In contrast, most nonprofit organizations are bound by federal, state and local laws as well as financial agreements that require them to produce audited financial statements; therefore, implicitly requiring an annual independent audit. This yearly examination seeks to provide comfort to the organization's stakeholders that the nonprofit's financial statements are fairly stated, in all material respects, and represent the organization's underlying operations as well as cash flows in an appropriate manner. Although painful to experience in many respects, an independent audit allows a nonprofit to maintain, or even elevate, its financial credibility in the eyes of its key stakeholders, particularly its benefactors and creditors. So why aren't annual independent audits welcomed with open arms if their objective is to foster financial goodwill?

Complexity At Its Best – Financial Statement Reporting Guidance

The proverbial bar that nonprofits must reach to successfully navigate their financial statement audit rises consistently despite there being little to no change in the nonprofits' core missions or activities performed to fulfill these missions. Even the most well-informed CFO or controller could find herself confused by the ever changing financial reporting standards.

Nevertheless, guidance on financial statement reporting, crucial for the success of any financial audit, generally comes from a few sources, including but not limited to the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). FASB establishes standards of financial accounting that govern the preparation of financial reports by nongovernmental organizations, including but not limited to private university endowments, private foundations and healthcare organizations. The GASB has a similar role whereby it establishes accounting standards and financial reporting for US state and local governments (e.g., public universities). Despite being separate organizations, FASB and GASB both seek to provide key stakeholders useful decision making information and are governed by a central body.

ONE CENTRAL AREA HAS GENERATED A SIGNIFICANT AMOUNT OF COMPLEXITY AND CONFUSION WITH ANNUAL AUDITS – FAIR VALUE MEASUREMENT AND DISCLOSURES

As it relates to the investment portfolios of nonprofit organizations, we have found that one central area has generated a significant amount of complexity and confusion with annual audits – fair value measurement and disclosures. FASB issued SFAS 157 Fair Value Measurement (ASC 820) nearly a decade ago to define fair value, establish a framework for measurement of fair value and expand fair value disclosures. In the case of governmental nonprofits, GASB Statement No. 72 was issued in 2015 and is the governing standard. Finance professionals and auditors initially viewed the decade-old fair value standard as a step in the right direction to achieving the goal of increased transparency. However, this view transformed as a result of the piecemeal rollout (herein lies another layer of complexity) of what is today's current fair value measurement standard.

Nevertheless, nonprofit organizations are required to report investment assets at fair value and include a litany of disclosures in the accompanying notes to financial statements. Sometimes, nonprofit finance professionals find determining an investment's fair value rather simple. The price or net asset value may be published publicly (e.g., mutual funds). In other cases, it can be challenging to understand the valuation of private investments as well as appropriately categorize alternative strategies that do not fit neatly in traditional asset classes. Further difficulties arise when preparing the financial statement disclosures and answering the auditor's questions necessary for them to gain comfort that the investments are presented fairly. What level should this investment be categorized as? What process is in place to perform initial due diligence and monitor the investment's valuation on an ongoing basis? What is the liquidity of the investment? This is usually the point where we, as the investment consultant, receive an email entitled "Audit Questions."

How Nonprofit Finance Professionals Can Prepare for the Annual Audit

One of the benefits of having the same auditor year after year is they bring institutional knowledge of the nonprofit and its advisory relationships (e.g. investment consultant). However, the purpose of an independent audit is to objectively examine the internal controls and financial reporting of an organization; thereby implicitly not relying on what happened in the previous year to remain the same in the current year under audit. As such, nonprofits routinely field similar questions from their independent auditor each year. But that's okay! Many of the responses to auditor questions, particularly those related to internal controls, should not change. The auditor simply needs to verify no change has occurred.

Several of these routine questions typically surround the nonprofit organization's process (or internal controls) related to investments (e.g., the initial due diligence, ongoing monitoring, reporting).

THE RESPONSE TO QUESTIONS ABOUT THE INVESTMENT GOVERNANCE PROCESS CAN TRANSFORM INTO A CHECK-THE-BOX EXERCISE

During the annual audit, the auditor is seeking to gain an understanding and, in some instances, test the reasonableness of an organization's procedures to manage the investment program. Some areas of focus include the following:

- Research process for initial due diligence and monitoring of each investment
- The nature of each investment
- Valuation methods used for investments
- The underlying liquidity of and redemption process for each investment (e.g., gates, lock-up periods)
- The performance reporting process

With some limited advance preparation, we have found that the response to questions about the investment governance process can transform into a check-the-box exercise. We recommend nonprofit finance staff obtain a written summary of its investment consultant's research process, including the due diligence of traditional and alternative investments as well as its ongoing monitoring process. On an annual basis, in preparation for the financial audit, nonprofit staff can simply request its investment consultant to provide an updated written summary of its initial due diligence and ongoing monitoring process for investments. This written summary demonstrates nonprofit finance professionals' knowledge of the controls supporting the investment program.

To round out the organization's demonstration of its internal controls, finance professionals should be able to explain the role of the nonprofit organization's broader governance structure, including senior finance professional(s), board of directors, the investment committee and the investment consultant. As a best practice, organizations typically rely on their investment policy statement to memorialize this information in detail. We recommend organizations review their investment policy statement annually to reconfirm goals and the appropriateness of the investment program's governance structure. This yearly review further underscores the robustness of the nonprofit organization's internal controls over the monitoring of its investment program.

Knowledge of Each Investment's Key Characteristics

Having a chief investment officer remains a luxury that many nonprofit organizations cannot afford. According to the 2015 NACUBO-Commonfund Study of Endowments[2], the respondents surveyed had an average of 1.7 full-time equivalent (FTE) staff members to manage the investment function. Further, institutions with $501 million to $1 billion in assets under management had 2.5 FTE staff members while those with less than $500 million had less than 1 FTE staff person on average. Many nonprofit organizations rely on a senior finance professional (e.g., CFO, Treasurer, Controller) to manage the investment program and this role generally represents one of the many hats that this person wears. Anecdotally, it is common for the senior finance professional to have one support person to help with much of the day-to-day heavy lifting for the investment program.

With limited resources, it is critically important for finance professionals to be efficient and inventory key information related to the investment program. Understanding the nature of each investment and formally documenting each one's key characteristics demonstrates the strength of an organization's internal controls. It also enables finance professionals to readily locate important information for monitoring the investment program. The table below highlights key information that should answer many auditor questions.

Investment Specific Items	Organization Specific Items
Name, ticker, ISIN	Investment date
Liquidity, subscription and redemption terms	Asset class
Reporting frequency	Vehicle, share class
Valuation type	Base currency
Custodian/Administrator	Preferred benchmark
Country domiciled	Fee schedule

A good practice is to have these key characteristics at your fingertips in the form of a manager term sheet for each investment. This can also help demonstrate to an auditor a greater level of internal control over the management of the investment program.

Recent Changes to FASB's Disclosure Requirements

Oftentimes the biggest cause of strife between finance professionals and auditors lies in the classification of investments across the fair value leveling hierarchy. Auditors are well versed in this hierarchy as this tends to be a higher risk area and one on which they focus on during the completion of an independent audit. However, as noted earlier, the accounting standards for classifying investments had historically changed often leaving nonprofit finance professionals confused as to the current regulations.

There could be some relief for nonprofit finance professionals on the horizon. FASB heard the chorus of complaints regarding disclosure overload and is in the midst of a holistic review of disclosure requirements for nonprofit organizations, particularly related to fair value disclosures. The comment period for stakeholders to provide feedback ended on February 29, 2016. Knowledge brokers[3] in the accounting industry believes there remains a possibility that FASB will provide some relief in certain areas, which are highlighted in the box below.

- **Level 3 Valuation Process Disclosure**
  Could be eliminated entirely due to lack of benefit to users of financial statements and overlap with overall internal control process
- **Fair Value Level Table Disclosure**
  Could be reconfigured to no longer include investments that use NAV as a practical expedient for fair value
- **Fair Value Asset Transfer Disclosure**
  Could eliminate disclosures describing the transfers between level 1 and level 2 assets due to limited use and misinterpretation

As with many FASB changes, the evaluation process appears to have been robust and the implementation could be staggered over time. Nonprofit finance professionals can expect to hear more details before the end of 2016. Keep in mind any changes would likely be effective for the following fiscal year or at some point thereafter.

How to Eliminate Confusion Despite Differing Perspectives

Auditors and nonprofit finance professionals approach the investment program from two differing perspectives. For example, auditors generally focus on the current year under audit while finance staff tends to share a longer term view given its reliance on profits from the investment program to support the organization's ongoing mission. Moreover, auditors need to understand investment results, but place more emphasis on the investment values at a particular date, generally the financial statement measurement date. They need to gain a certain level of comfort that the valuation of all investments appropriately reflects the assets of the organization. Nonprofit finance staff can avoid the roadblocks associated with differing perspectives by preparing for the auditor's focus areas, namely, by having information on each investment's key characteristics, particularly for new investments and those in which the valuations are not readily available in public markets. This preparation coupled with a foundational understanding of the investments in the portfolio position finance staff to answer many initial audit questions and should reduce the time devoted to the audit process.

Depending on the complexity of the investment program, nonprofit finance staff can spend a significant amount of time classifying investments across the fair value levels. The conversation between auditors and finance professionals can align when both parties silence the noise embedded in classification nomenclature and hone in on the underlying nature of each investment as well as the valuation techniques employed to reach the fair value on the financial statement measurement date. In essence, pay much less attention to whether an investment is considered an absolute return fixed income strategy and focus more on the investment vehicle and process for deriving its valuation.

As a liaison between investment managers and nonprofit staff, the investment consultant can be a resource before and during the audit process. More specifically, they should be able to identify investments where the valuation may be more complex or nuanced (e.g., hedge funds), and answer many investment related questions posed by the auditors. They can provide information on how an investment manager's valuation technique compares with industry practice, or more importantly when it does not align with it.

THE INVESTMENT CONSULTANT CAN BE A RESOURCE BEFORE AND DURING THE AUDIT PROCESS

For many non-traditional investment products, investment consultants perform a litany of detailed due diligence procedures before making a recommendation to their clients. This evaluation is typically memorialized in an investment or operational due diligence memo, which can be shared with nonprofit finance staff and used as a starting point for valuation questions. In many cases, coupling the investment consultant's diligence memo with a follow up conversation or email can result in enough information to answer most valuation-related questions.

Knowledge of Liquidity Profile

One of the primary purposes of a nonprofit organization's financial statements is to provide information about how cash is obtained and spent along with any other factors that may affect the organization's liquidity (e.g., outstanding debts). Therefore, auditors pay special attention to the liquidity profile of a nonprofit. More specifically, the financial statement audit evaluates whether disclosures have provided enough relevant information for key stakeholders. For example, a potential donor would like to know if a nonprofit has enough liquidity to meet its short-term operational needs prior to making a donation. On the other hand, a creditor of a nonprofit wants to be aware of the organization's total debt to understand its probability of being repaid.

FASB defines liquidity as an asset or liability's nearness to cash. Every nonprofit organization has a unique liquidity profile. As such, the amount of liquidity a nonprofit organization maintains varies based on its cash flow needs, size, debt covenants and several other factors. For example, a foundation that spends five percent of assets per year may require more liquidity than a university endowment that spends four percent annually. Similarly, an endowment whose spending is used to support a significant portion of its operating budget may need a higher liquidity profile as compared to an endowment whose spending is an immaterial contributor to its operating budget. The differences in liquidity profiles influence the types of investments a nonprofit will make. Some organizations can tolerate less liquidity in their investment portfolio and may decide to invest in illiquid funds or those with lock-up periods, where access to money invested is limited over a period of time. A nonprofit who needs a high level of liquidity within its portfolio may avoid illiquid investments or those with lock-up periods.

Another best practice for nonprofit finance professionals is to maintain a list of the underlying liquidity of each investment in the organization's portfolio. Having this list at its fingertips allows the organization to quantify what percentage of its investment portfolio can be converted to cash within different time periods. For example, it is useful for finance staff to know what percentage of the portfolio can be converted to cash within thirty days versus those that need more than a year to be converted to cash. This information allows the organization to make decisions about how to use existing cash and when it is appropriate to raise more cash to sustain the organization's mission-oriented goals.

In addition, the importance of the liquidity profile increases when an organization has illiquid investments. Nonprofit finance professionals should not only maintain liquidity information on current investments but also be knowledgeable about unfunded commitments. Cash for private investments is typically called over a period of time in contrast to public investments where all the cash is funded upfront. Therefore, it is important to track how much of the private investment has been funded versus how much remains to be called for funding at an unknown future date. From a financial reporting standpoint, the unfunded commitment could be considered a contingent liability based on its nature and may need to be disclosed separately in an organization's financial statements and accompanying notes. An auditor will inquire about unfunded commitments to gain an understanding of whether or not they should be disclosed.

As mentioned earlier, auditors are typically focused on evaluating the appropriateness of financial information as of the financial statement measurement date. However, the liquidity profile of an investment portfolio is dynamic and can change quickly based on market conditions. For example, a fixed income investment may be considered highly liquid or able to be converted to cash within one week under normal market

NONPROFIT FINANCE PROFESSIONALS SHOULD NOT ONLY MAINTAIN LIQUIDITY INFORMATION ON CURRENT INVESTMENTS BUT ALSO BE KNOWLEDGEABLE ABOUT UNFUNDED COMMITMENTS

conditions and conversely could be considered less liquid in a stressed market environment. As such, nonprofit finance staff should work with their investment consultant to understand how changing market conditions could impact the underlying liquidity of each investment. The cash flow needs of an organization, such as debt repayment and operational expenses, do not disappear when market conditions deteriorate. Therefore, maintaining a robust understanding of the investment portfolio's liquidity in normal and stressed market environments positions a nonprofit organization to balance its short term needs with its long-term goals.

Documentation of the Performance Reporting Process

Nonprofit organizations rely on the investment portfolio to produce returns that support a combination of the organization's mission-driven goals and operational needs. Therefore, key stakeholders of nonprofits monitor the investment portfolio's performance results. As the liaison between the nonprofit organization and fund managers, the investment consultant plays an integral role in compiling and analyzing investment results. Some nonprofit finance organizations supply auditors with a copy of the report generated by the investment consultant for use as a baseline in summarizing the organization's investments. Albeit non-audited, some level of reliance is placed on the accuracy of the investment performance report and the process in place to produce the report.

Evaluating the accuracy of reported investment amounts and assessing the reasonableness of investment valuations are two main areas of focus for financial statement audits. Having adequate controls in place to support the performance process demonstrates the robustness of a nonprofit organization's internal control structure. As a normal part of their business, an investment consultant should document its performance reporting process and be ready to share this information with any nonprofit organization it serves. In addition, the nonprofit organization should receive the same statements and reports from fund managers that its investment consultant receives. This parallel communication structure positions the investment consultant and nonprofit finance staff to both evaluate the reasonableness of results and monitor fund managers.

UNDERSTAND HOW CHANGING MARKET CONDITIONS COULD IMPACT THE LIQUIDITY OF EACH INVESTMENT

Conclusion

Since the global financial crisis, US centric investment programs have benefitted from positive returns on the back of unprecedented monetary policies and low market volatility. However, over the past year, volatility has increased and global markets have exhibited widespread sensitivity to changing monetary policy and macro events (e.g., US Federal Reserve rate increase, China currency devaluation, UK Brexit vote to leave European Union). For the one year ended June 30, 2016, the impact of these market headwinds is embedded in investment program returns.

Finance professionals can use the audit year following the global financial crisis as an example for what they may expect for this year's audit. The increase in market volatility may lead to more questions about investment performance and valuation, particularly with alternative investments. Auditors may take a deeper dive or raise questions challenging the appropriateness of investments given the organization's objectives and risk profile. This stance of professional skepticism remains consistent with the purpose for performing an independent audit.

While the primary goal of an independent audit has not changed in decades, the demands placed on nonprofits' resources continue to increase. Establishing and documenting appropriate policies before the audit best ensures a more comfortable experience. Moreover, maintaining updated records detailing the relevant information for the investment program demonstrates the organization's preparedness. With advanced planning along the lines described in this paper, we believe nonprofit organizations can position themselves to best survive the annual audit process.

References

1. Nonprofit Audit Guide. (2015). Retrieved from https://www.councilofnonprofits.org/nonprofit-audit-guide

2. PricewaterhouseCoopers, 2016. *PwC's Healthcare, Higher Education and Not-for-Profit Webcast Series- Hot topics and technical updates impacting accounting and financial reporting on April 21, 2016 [Webcast].* Retrieved from: https://event.on24.com/eventRegistration/EventLobbyServlet?target=registration.jsp&eventid=1165048&sessionid=1&key=4D34B9A2AB07597673300B6A576B42F5&sourcepage=register

3. National Association of College and University Business Officers (NACUBO) and Commonfund. *2015 NACUBO- Commonfund Study of Endowments*. Rep. February 2016. Print.

Disclaimers and Disclosures

- Past performance is no guarantee of future results.
- The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.
- The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.
- This report contains summary information regarding the investment management approaches described herein but is not a complete description of the investment objectives, portfolio management and research that supports these approaches. This analysis does not constitute a recommendation to implement any of the aforementioned approaches.

255 STATE STREET, BOSTON, MA 02109 | TEL: 617.374.1300 | FAX: 617.374.1313 | www.nepc.com

BOSTON | ATLANTA | CHARLOTTE | CHICAGO | DETROIT | LAS VEGAS | SAN FRANCISCO