Brown ADVISORY
Thoughtful Investing.

Good Preparation Leads to a Good Audit Experience

What to Expect from Your Investment Advisor

Related Resources:

- E&F Overview
- Are Alternatives Right for Our Organization?
- Beyond Investing: Strategic Advice for Nonprofits

After an extended period of strong returns that began in 2009, many not-for-profit (NFP) organizations find themselves increasingly challenged to earn the traditional target of an inflation-adjusted 5% annual spending rate. To help meet this return objective, we find that our clients' investment portfolios are becoming increasingly complex as a result of their reliance on private equity, real estate and other less liquid "alternatives" to sustain their growth objectives and, ultimately, their charitable objectives.[1]

For NFPs of all kinds, collaborating effectively with your investment advisor is a critical component to managing this complexity when preparing for your annual audit. In a rapidly evolving investment and financial reporting landscape, NFPs can benefit from a thorough and thoughtful process of advance audit preparation. Good preparation is key to a successful audit.

Clarify roles and expectations in advance to help ensure success. Before embarking on the annual auditing process, it is beneficial to define the roles of everyone who will be involved. This is true across the NFP sector, from large organizations with investment portfolios in the tens to hundreds of millions of dollars under the aegis of a CFO backed by their own internal accounting staff, to those that work with an outsourced chief investment officer, to smaller, largely volunteer-run groups relying on a part-time bookkeeper. Regardless of an entity's scale, proactively defined audit requirements set mutual expectations for advisor and client alike, helping to ensure efficient and effective goal setting and communication.

Confirm the role of your board of directors. Your board is, of course, the governance mechanism that holds the fiduciary responsibility for overseeing and ensuring your organization's financial integrity. While some boards delegate the audit oversight function to their executive committee, at Brown Advisory, we believe that maintaining a dedicated standing audit committee is a key aspect of board governance best practices. In either case, it is always a best practice to separate finance committee and audit committee functions to help ensure proper segregation of duties and oversight. Since these two committees may not interact frequently throughout the fiscal year, it is essential that your investment advisor can communicate effectively with both.

Assess—or reassess—the role of your staff. Inevitably, your team will be responsible for validating all the information your organization provides to the auditor. It is essential for your leadership to reemphasize the importance of developing a close relationship with your investment advisor. This way, they can best support your staff, maintain proactive communication and timely responsiveness to inquiries and requests, and assure the accuracy of all information provided. Preparing for an audit offers an excellent opportunity to build partnership and strengthen the trust between staff and advisor.

Securities Fair Value Leveling: A Four-Step Approach

Liquidity is always a key metric for an NFP, as it helps ensure available cash to support portfolio distributions to the organization. The ambiguity surrounding securities levels is sometimes a point of frustration for NFP staff, especially in the valuing of less liquid, harder-to-ascertain level 2 and 3 assets. To help efficiently support the leveling process, we recommend a four-step process:

1. Define the type of investments involved, (e.g., bonds, stocks, mutual funds, limited partnerships).
2. Determine categorizations: level 1, 2, 3 or NAV.
3. Draft descriptions of the investment pools or alternative investments.
4. Explain the timing difference and cutoff on valuations. Provide additional context and detail on leveling and the new NAV category.

Leverage your auditor's independence. An independent auditor can offer value in many ways. The process toward achieving an unmodified opinion can help:

- Enhance trust among the constituencies your organization serves, like your donor pool.
- Build the capacities and capabilities of your professional staff.
- Offer constructive feedback. An auditor is often most concerned with point-in-time valuations and keenly focused on financial controls, especially the nuances of the accounting rules regarding liquidity (e.g., securities' fair value hierarchy leveling).

Consider how your investment advisor will partner with your auditor and staff. Ideally, an investment advisor should serve as co-fiduciary to your organization's investment committee and as an extension of your staff. In choosing an advisor, look for an ability to articulate the mission and value alignment of your portfolio, and provide documentation and mandatory disclosures on the investment and operational due diligence process.

The Uniform Prudent Management of Institutional Funds Act (UPMIFA),[2] approved by the National Conference of Commissioners on Uniform State Laws in 2006, has had important effects on how charitable organizations manage their investment and endowment spending, with important considerations come audit time. (For more details on the act, see below.) At Brown Advisory, we believe strongly in helping NFPs build their portfolio as prudent investors in accordance with the spirit of UPMIFA. The legislation's rules and standards have significant effects on all charitable organizations that maintain endowment funds.

Disclosures of the type of investments that an NFP holds and how they are valued are, of course, a fundamental part of audit process. Yet you should be able to expect more from your investment advisor at audit time than just regulatory compliance and a checklist for your CFO on investment levels, lockup and liquidity. Alternative investments, if you hold them, can cause discomfort for auditors unfamiliar with them, even leading them to request information that is not necessary, which draws your staff's attention away from where it should be focused. Ideally, your investment advisor will be skilled in taking on a discretely educational role for you as a client and for your auditor when necessary, keeping you both up to date with reporting requirements.

Specific audit information for investments that an advisor should provide includes:

- A manager due diligence package, including valuation methodology, audited financials, redemption and subscription details
- An analysis of the fair value hierarchy (see sidebar) of underlying assets in the portfolio, with a breakdown by level 1, 2, 3 or NAV
- A description of investment assets as required by FASB ASC 820–Fair Value Measurement[3]
- An alternative investment schedule, including allowable redemption frequency, days' notice for redemption and unfunded commitments[1]

FOUR-STEP PROCESS

We support our NFP clients and their auditors through their annual audit using a multistep process:

1. During the onboarding process, we make sure to understand your specific audit requirements.
2. In the pre-audit planning meeting with you and your auditor, we detail our investment process.
3. During audit fieldwork, we collect all necessary information and prepare to provide it to your auditor in the correct form.
4. Post-audit fieldwork, we facilitate the process of translating your portfolio data from investment language into audit language, and we support your team in drafting your audited financials.

BROWN ADVISORY CAN HELP

We strive to help our clients educate themselves about the evolving investment landscape and to learn from every client and their auditors. And when an NFP experiences turnover in key staff members that affects the audit process, including the CFO, we strive to function as your vault of institutional knowledge.

With the necessary back-office infrastructure in place, an annual audit does not have to be a long or painful process.

Clear, proactive communication among your professional staff, auditor and advisor will go a long way to help make the process manageable, efficient and effective.

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Basis of Paper
In August 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-14, Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities ("ASU 2016-14").

[1]Alternative investments may be available for accredited investors and qualified purchasers only. Please see the end of this presentation for important disclosures.

[2]**UPMIFA.** The Uniform Prudent Management of Institutional Funds Act ("UPMIFA" or "the Act") was adopted in 2006 by the National Conference of Commissioners on Uniform State Laws, as the successor to the Uniform Management of Institutional Funds Act (UMIFA), and has (at 1/1/2017) been enacted in every state except Pennsylvania. UPMIFA provides guidance and authority to charitable organizations concerning the management and investment of charitable funds and for endowment spending.

UPMIFA contains rules and standards for their application across three broad areas of importance to charitable organizations, members of their fiduciary boards and their advisors, if those organizations hold donor-restricted endowments. UPMIFA also addresses rules for the delegation of management and investment functions, and for the release or modification of restrictions contained in gift instruments.

UPMIFA applies to any institution, which can be a charitable trust or a nonprofit corporation, holding funds for charitable purposes subject to restrictions imposed by a donor in a gift instrument, including endowment funds.

[3]**Fair Value Measurement.** FASB ASC 820–Fair Value Measurement establishes a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. ASC 820 classifies assets based on their level of liquidity. The more liquid an asset, the easier it is to determine its value. Level 1 assets are the most liquid, while level 3 assets are the least liquid. Alternative or partnership investments generally fall outside of the level 1, 2 or 3 framework and are presented at net asset value (NAV).