CASTLETON UNIVERSITY
COMMUNITY COLLEGE OF VERMONT
NORTHERN VERMONT UNIVERSITY
VERMONT TECHNICAL COLLEGE

VERMONT
STATE COLLEGES SYSTEM

OFFICE OF THE CHANCELLOR
PO BOX 7
MONTPELIER, VT 05601
P (802) 224-3000

MEMORANDUM

TO: VSCS Audit Committee
Sue Zeller, Chair
David Silverman, Vice-Chair
Dylan Giambatista
Mary Moran
Shawn Tester

FROM: Sharron R. Scott, Chief Financial and Operating Officer

DATE: October 12, 2020

SUBJECT: Audit Committee Meeting scheduled for October 18, 2021

On October 15, 2021, in compliance with State of Vermont financial reporting requirements, a *draft* version of the FY2021 Audited Financial Statements will be submitted to the State. A copy of the draft statement supplied to the State is included in these materials for your review. Please note that the draft financial statements included herein do not include the Uniform Guidance Single Audit Report and Advisory Comments. We expect that this work will be completed in the coming months and will be shared with this committee at a future meeting.

O'Connor & Drew will join the Audit Committee to review the draft FY2021 Audited Financial Statements and answer any questions you may have regarding the financial statements, progress on uniform guidance, and trends in higher education. O'Connor & Drew is prepared to participate in an optional executive session, should you decide to do so, to discuss any confidential matters pertinent to Vermont State Colleges System financial operations.

As with past practice, three articles have been included as part of these materials for review by the Audit Committee in advance of an executive session with the auditors. These include an easy-to-read article regarding the roles and responsibilities of audit committees, an audit committee resource guide authored by Deloitte, and a Higher Education Audit Committee Guidebook authored by Grant Thornton.

The last item on the agenda for this meeting is review and approval of the FY2021 Internal Audit of Payroll and Benefits completed last spring by Berry Dunn. Representatives from Berry Dunn will present a brief overview of their findings and process. They will also be available to answer any questions you may have regarding this internal audit.

Should you have any questions regarding these materials, or any other matter, please contact me at Sharron.Scott@vsc.edu or 802.224.3022.

CC: VSCS Board of Trustees
Council of Presidents
Business Affairs Council

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Vermont State Colleges Board of Trustees
Audit Committee Meeting

October 18, 2021
1:00 p.m. – 2:30 p.m. via Zoom

AGENDA

1. Review Minutes of the April 19, 2021 Meeting of the Audit Committee

2. Review and Approval of FY2021 *Draft* Audited Financial Statements

    a. Presentation of Financial Statements and Discussion with O'Connor & Drew
    b. Possible Executive Session with O'Connor & Drew

3. Review and Approval of *FY2021 Internal Audit of Payroll & Benefits*

    a. Presentation of *Internal Audit of Payroll and Benefits* with Berry Dunn

4. Other Business

5. Public Comment

6. Adjourn

Materials

ITEM 1: Minutes of the April 19, 2021 Audit Committee Meeting

ITEM 2: Financial Statements

- Agenda
- Required Communications
- Draft 6-30-2021 Financial Statements
- Draft Management Letter
- Resolution 2021-023 Approving Financial Statements

ITEM 3: Payroll and Benefits Internal Audit

ITEM 4: Supplemental Information

- Audit Committee Roles and Responsibilities
- Deloitte Resource Guide for Audit Committees
- Grant Thornton Higher Education Audit Committee Guidebook

ITEM 1:

April 19, 2021 Meeting Minutes

Minutes of the VSC Board of Trustees Audit Committee held Monday, April 19, 2021 at 1:00 p.m. via ZOOM -UNAPPROVED

Note: These are unapproved minutes, subject to amendment and/or approval at the subsequent meeting.

The Vermont State Colleges Board of Trustees Audit Committee met on April 19, 2021, via Zoom

Committee members present: Linda Milne (Chair), David Silverman (Vice Chair), Dylan Giambatista, Mary Moran, Shawn Tester

Other Trustees present:	Ryan Cooney, Lynn Dickinson
Presidents:	Elaine Collins, Joyce Judy, Pat Moulton Jonathan Spiro
Chancellor's Office Staff:	Donny Bazluke, Network/Security Analyst Kellie Campbell, Chief Information Officer Tony Hashem, Information Security Officer Tom Maguire, Director of Network Services Michael Martel, Director of Data Center Administration Katrina Meigs, System Director of HR & Benefits Administration Jen Porrier, Administrative Director Sharron Scott, Chief Financial/Operating Officer Patty Turley, General Counsel Meg Walz, Program Manager, Library Coordinator Sophie Zdatny, Chancellor Yasmine Ziesler, Chief Academic Officer
From the Colleges:	Sarah Chambers, Coordinator of Instructional Technology, Castleton University Michael Fox, Dean of Enrollment & Marketing, Northern Vermont University Laura Jakubowski, Chief Budget & Finance Officer, Castleton University Karen Madden, Director of Academic Support Services, Northern Vermont University Toby Stewart, Dean of Administration, Northern Vermont University

Littleton Tyler, Dean of Administration, Vermont Technical College

From the Public: Katharine Balukas, Manager, BerryDunn
Christopher Evans, Audit Senior, O'Connor & Drew
Kieth Goldie, Partner, O'Connor & Drew
Robert Smalley, Engagement Principal, BerryDunn

Chair Milne called the meeting to order at 1:01 p.m.

1. Approval of the Minutes of the February 1, 2021 Meeting of the Audit Committee

Trustee Giambatista moved and Trustee Silverman seconded the approval of the February 1, 2021 meeting minutes. The minutes were approved unanimously.

2. Status Update for FY2020 Uniform Guidance Single Audit Report with O'Connor & Drew

Chief Financial/Operating Officer Sharron Scott welcomed Chris Evans, Audit Supervisor from O'Connor & Drew, who presented the Single Audit Report. Mr. Evans stated that VSCS was given a clean opinion on this audit (the best that can be received). Mr. Evans went on to discuss the findings in the Audit. Chair Milne asked for the Committee to recommend to the Board acceptance of the Single Audit Report.

Trustee Silverman moved and Trustee Tester seconded the motion to recommend to the Board the approval of Resolution 2021-008: Acceptance of the FY2020 Uniform Guidance Single Audit Report. The motion was approved unanimously.

3. Planning for FY2021 Financial Statement and Uniform Guidance Single Audits with O'Connor & Drew

Mr. Evans shared the plan to conduct the field work in a mostly remote fashion during two weeks in August of 2021 with much of the testing occurring in the spring.

4. Status Update for FY2021 Internal Audit Plan: Payroll & Benefits with BerryDunn

CFOO Scott shared, that after a thorough review of more than ten firms, BerryDunn was selected to perform an internal audit of Payroll and Benefits system. BerryDunn's experience auditing regional higher education systems, coupled with their recent experience with a similar audit for another client, made them the right fit for this work.

CFOO Scott introduced Rob Smalley, Engagement Principal, and Katy Balukas, Audit Manager, to the committee. Mr. Smalley shared a project overview with the Committee which included a brief summary of BerryDunn's approach to the project, and then turned the presentation to Ms. Balukas who shared an early view of the four main areas requiring improvement. These areas include:

1) Adjustments to the bi-weekly payroll review; and,
2) Standardization of processes and forms; and,
3) Improvements to the time management process; and,
4) Management of terminated employees

A final draft of the report will be made available to the Vermont State Colleges in early May. CFOO Scott shared that once the report is received from BerryDunn, corrective action plans will be developed by the System.

The final report and corrective action plans will be shared with the Audit Committee no later than the end of May. At the Committee's discretion, an additional meeting with the Audit Committee will be scheduled to review these results.

5. <u>Discussion on Information Technology (IT) Cyber Security Risks</u>

Chair Milne asked Chief Information Officer Kellie Campbell and her team to share information on IT Cyber Security Risks. At the start of her presentation Ms. Campbell introduced Information Security Officer Tony Hashem, Director of Data Center Administration Michael Martel, Director of Network Services Tom Maguire, and Network and Security Analyst Donny Bazluke noting these staff members are integral to the information security.

Mr. Hashem presented a general overview of internal and external cyber risks and threats that face the VSCS, with an assessment of the technology the VSCS is using to protect its environment. Ms. Campbell concluded by sharing that future transformation at VSCS will provide further opportunities for standardizing technology and software and working together to embed security in the infrastructure.

Trustee Silverman requested an annual update on Information Security at Audit Committee. CFOO Scott agreed to add that report to the schedule.

6. Risk Assessment Process / Review Self-Assessment Questionnaire

CFOO Scott shared that since 2014 the colleges have conducted self-assessment questionnaire addressing internal controls. The self-assessment helps to identify areas within departments where required business policies, administrative processes and regulatory compliance are important and then assess the adequacy of those existing policies and procedures and internal controls.

Chair Milne requested that the VSCS include an assessment of overall system-wide risks, such as cyber-security, at a future meeting.

7. Other Business

There was no other business.

8. Public Comment

There was no public comment.

9. Adjourn

Chair Milne adjourned the meeting at 2:35 p.m.

ITEM 2:

Financial Statement Materials

Memorandum

To: Vermont State Colleges – Audit Committee

From: O'Connor and Drew, P.C.

Date: October 18, 2021

Re: Vermont State College 6-30-21 Financial Statement Presentation

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Agenda:

- Introductions
  - Kieth Goldie, Partner - O'Connor & Drew
  - Chris Evans, Audit Supervisor - O'Connor & Drew
- Required Communications
  - Going Concern Considerations
  - Cash Position
  - Other Post Employement Benefits (OPEB) Accrual
  - State Appropriation and Grants Revenue
- Presentation of FY 2021 Draft Financial Statements
  - Management Discussion & Analysis (MD&A) - Unaudited
  - Discussion of Significant Changes over Prior Year on Balance Sheet, Statement of Operations and Statement of Cash Flow.
  - Discussion of Footnotes
    - CARES Act Funding
    - Restricted Cash
    - OPEB
    - Subsequent Events
- DRAFT of Management Letter
- Questions from the Audit Committee
- Board will review and vote whether to approve FY 2021 Audited Financial Statements.

Vermont State Colleges

October 18, 2021

O'Connor & Drew P.C.

Required Communications

AUDITORS' RESPONSIBILITY UNDER GAAS

- We have a responsibility to conduct our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.
- In carrying out this responsibility, we planned and performed the audit to obtain reasonable – not absolute – assurance about whether the basic financial statements are free of material misstatement, whether caused by error or fraud.
  - We issued an unmodified opinion on the financial statements.
- An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Foundation's internal control over financial reporting. Accordingly, we express no such opinion.
  - No material weaknesses/significant deficiencies were noted within the Report on Internal Control over Financial Reporting and on Compliance and Other Matters.

Required Communications - Continued

AUDITORS' RESPONSIBILITY UNDER GAAS - continued

- We are responsible for communicating significant matters related to the financial statement audit that are, in our professional judgement, relevant to the responsibilities of those charged with governance.
- We applied certain limited procedures (such as inquiry of management and comparing for consistency) to the Required Supplementary Information that supplements the financial statements.

Required Communications - Continued

INDEPENDENCE

- We are not aware of any relationships between O'Connor & Drew and the College that in our professional judgment may reasonably impact our independence.
- We are independent with respect to the College within the meaning of the pronouncements of the Independence Standards Board, Government Auditing Standards, and under Rule 101 of the AICPA Code of Professional Conduct.
- No management advisory services were performed by O'Connor & Drew.
- O'Connor & Drew assisted in the preparation of the financial statements and will perform the Single Audit under the guidelines of Subpart F of the OMB Uniform Guidance for Federal Awards; however, these activities do not impact our independence.
  - These non-attest services were supervised by Sharron Scott, Chief Financial and Operating Officer, Toby Stewart Systems Controller (Current), Renee Hunt Systems Controller (Interim).

Required Communications - Continued

MANAGEMENT'S RESPONSIBILITY

- Selection and use of appropriate accounting policies – Significant policies are found in Note 1
  - No new accounting policies were adopted
  - Application of existing policies were not changed during current year
- Selection and use of appropriate accounting estimates – Based on management's knowledge and experience about past and current events and assumptions about future events
  - Allowance for doubtful accounts
  - Depreciation and useful lives
  - Net OPEB liabilities
  - Net position classifications
  - Health insurance reserve

O'Connor & Drew P.C.

Required Communications - Continued

MANAGEMENT'S RESPONSIBILITY – continued

- Accounting for significant and unusual transactions include:
  - $15.6 million in Coronavirus Relief Funds received from the State
  - $36.9 million awarded in Higher Education Emergency Relief Funds.
  - $13.6 million spent in Higher Education Emergency Relief Funds.
- No transactions entered into during the year for which there is a lack of authoritative guidance or consensus.
- All significant transactions have been recognized in the financial statements in the proper period.

Required Communications - Continued

SIGNIFICANT COMMUNICATIONS, FINDINGS OR ISSUES

- There were:
  - N/A
- There were **NO**:
  - Disagreements with management
  - Major issues discussed with management prior to retention
  - Difficulties encountered in performing the audit
  - Uncorrected misstatements or audit adjustments
  - Other findings or issues that are significant or relevant to be communicated to those charged with governance
- Significant written communications between the auditor and management include:
  - Engagement letter
  - Management representation letter
  - Management letter

Required Communications - Continued

FINANCIAL STATEMENT FRAUD RISKS

- No prevalent financial statement fraud risks were identified.
- Specific Risks Presumed by Auditing Standards:
  - Risk of misstatement relating to revenue recognition
  - Risk of misstatement relating to expense recognition
  - Risk of management override of controls
    - Journal entries and adjustments
    - Significant accounting estimates
    - Significant unusual transactions
- Organization-Specific Risks:
  - Implementation of new payroll system
  - Going concern consideration
  - Significant change in management (Chancellor, CFO, and System Controller)

Other Matters

Upcoming GASB Pronouncement – GASB Statement 87 - Leases

- Effective for periods beginning after June 15, 2021
- Requires lessees to recognize on their statement of net position the rights and obligations resulting from leases categorized as operating leases as assets, liabilities, or deferred inflows / outflows of resources
- Provides for an election on leases with terms of less than twelve months to be excluded from this Standard
- College currently holds leases for equipment, software/hardware and building space (primarily CCV locations).

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

FINANCIAL STATEMENTS AND MANAGEMENT'S DISCUSSION AND ANALYSIS

JUNE 30, 2021 and 2020

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Financial Statements and Management's Discussion and Analysis

June 30, 2021 and 2020

C O N T E N T S

INDEPENDENT AUDITORS' REPORT

To the Board of Trustees of
Vermont State Colleges
Montpelier, Vermont

Report on the Financial Statements
We have audited the accompanying financial statements of the Vermont State Colleges (a component unit of the State of Vermont) (the "Colleges"), which comprise the statements of net position as of June 30, 2021 and 2020, the related statements of revenues, expenses and changes in net position, and cash flows for the years then ended, and the related notes to the financial statements, which collectively comprise the Colleges' basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements
Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility
Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Vermont State Colleges at June 30, 2021 and 2020 and the results of their respective changes in financial position and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that management's discussion and analysis on pages 3-21 and the schedule of changes in Total OPEB liability page 63, and their respective notes on pages 64-65 Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated DATE, on our consideration of Vermont State Colleges' internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the College's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

Certified Public Accountants
Braintree, Massachusetts

DATE

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Management's Discussion and Analysis (Unaudited)

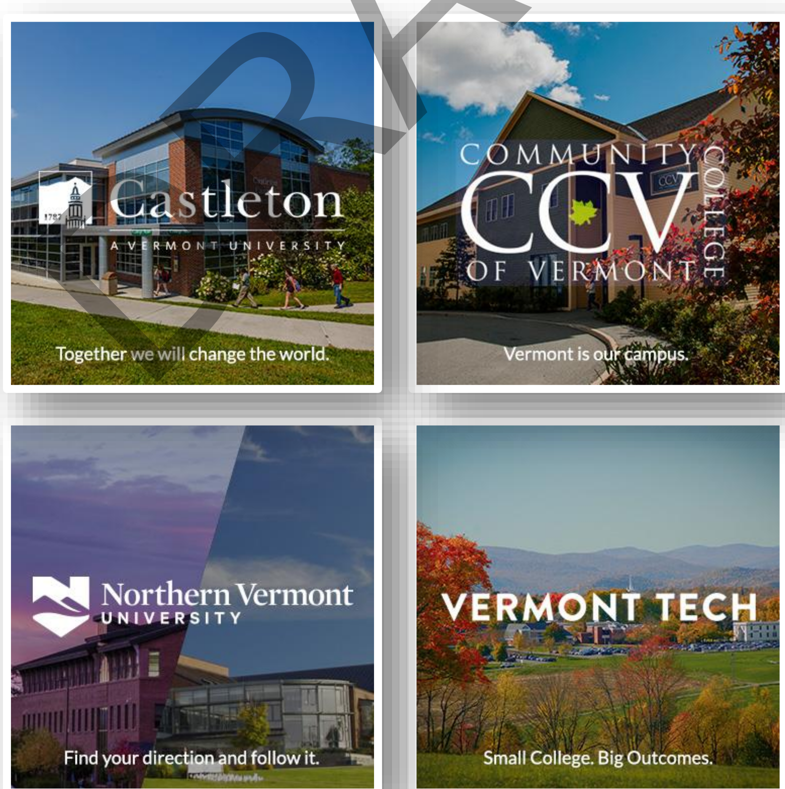
June 30, 2021 and 2020

Introduction

The management of the Vermont State Colleges System (VSCS) has prepared the following unaudited Management's Discussion and Analysis (MD&A), required supplemental information according to the Governmental Accounting Standards Board (GASB). The intent is to contribute to the reader's understanding of the accompanying financial statements and notes. As this MD&A contains highly summarized information, tables and graphs, it should be read in conjunction with the accompanying financial statements and notes.

Vermont State College System

The Vermont State College System is comprised of four public colleges including Community College of Vermont (CCV), Castleton University (CU), Northern Vermont University (NVU), and Vermont Technical College (VTC). The member institutions are united in the common purpose of providing affordable, high quality, student-centered, and accessible education, fully integrating professional, liberal arts, and career study, consistent with student aspirations and regional and state needs.



VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Management's Discussion and Analysis (Unaudited)

June 30, 2021 and 2020

Significant Events Affecting These Financial Statements

Events that affect these statements during the past five years include:

- The pandemic that began in January 2020 touched the Vermont State Colleges System for the first time in March 2020 at which time the VSCS shuttered all face-to-face programs, closed their residence halls to all but those with housing insecurity issues, and conducted all classes remotely. Three of four institutions reopened in Fall 2020 in fully remote or largely remote learning modalities. In Spring 2021, three of four institutions returned to primarily face-to-face instruction. With the exception of Community College of Vermont, all institutions saw lower than prior year enrollment. The result was lower than normal revenue from student tuition, fees, room, and board for both FY2020 and FY2021.

- Pandemic relief in the form of the Higher Education Relief (HEERF) and Coronavirus Relief (CRF) helped the VSCS to conclude fiscal years 2021 and 2020 in a positive position; however, the ongoing pandemic, coupled with the demographics of the Northeast as well as Vermont continues to be a concern.

- For FY2021, the State of Vermont authorized $28.8 million in one-time bridge funding for the Vermont State Colleges. Considered an additional State Appropriation, these funds were authorized to provide the VSCS with additional funding to assist the System with expected revenue loss due to the pandemic.

- A workforce development program for those negatively impacted by the pandemic was created by the State of Vermont and funded by Coronavirus Relief Funds. This program improved tuition revenue by approximately $1 million in FY2021.

- Enrollment trends continue to be a concern for institutions of Higher Education. Nationally, enrollments have declined consistently since 2011. Although a national issue, these challenges to the industry are hitting New England and Vermont especially hard. There are declining numbers of traditional college students and increased competition among colleges for those students. Student preferences and attitudes toward higher education are changing. Historically, Vermont has ranked in the bottom two states supporting higher education. However, recent investments in response to the pandemic and transformation of the Vermont State Colleges has made significant improvements in this arena.

- The other post-employment benefits accrual has a liability of $238 million, an increase of $44 million for FY2021. This accrual is not being pre-funded, but paid when incurred during retirement periods. These programs were closed in 2012 (all staff groups) and 2015 (faculty groups) for all newly hired employees, therefore the liability will reduce over time.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Management's Discussion and Analysis (Unaudited)

June 30, 2021 and 2020

- In FY2020, the System refinanced its 2010B bonds with the issuance of its 2020A bond series. The 2020A bonds are fixed rate, publicly traded, and were issued through the Vermont Municipal Bond Bank under the VSCS Program Resolution, as general obligations of the Bond Bank, secured by a pledge of the 2020 VSCS Bond and the amounts required to be paid by the VSCS to the Bond Bank pursuant to a loan agreement for principal and interest on the 2020 bonds. Additionally, the bonds are secured by appropriations to the VSCS, which may be directed by the State Treasurer to pay principal and interest on the bonds in the event of a default of such payments on the part of the VSCS. In addition to the 2020 bonds, the VSCS debt includes fixed rate, publicly traded general obligation bonds issued in 2013 and 2017.

<u>Using the Financial Statements</u>

The following discussion and analysis provides an overview of the financial statements and activities of the Vermont State Colleges System (VSCS) for the year ended June 30, 2021 and selected comparative information . Since this MD&A is designed to focus on current activities, resulting changes and currently known facts, please read in conjunction with the financial statements and notes that follow this section.

These financial statements have been prepared in accordance with GASB (Government Accounting Standards Board) principles. In June 1999, GASB released Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis*. Changes in Statement No. 34 compared to prior GASB pronouncements require a comprehensive consolidated look at the entity as a whole, as well as capitalization and depreciation of assets. In November 1999, GASB issued Statement No. 35, *Basic Financial Statements and Management's Discussion and Analysis for Public Colleges and Universities*. This essentially applies Statement No. 34 to public colleges and universities. Previously, the financial statements focused on the individual fund groups rather than VSCS as a whole.

A brief explanation of each financial statement required by the GASB reporting model follows:

Financial Statements

The Vermont State College System's financial statements include three primary components:

- Statements of Net Position
- Statements of Revenues, Expenses and Changes in Net Position
- Statements of Cash Flow

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Management's Discussion and Analysis (Unaudited)

June 30, 2021 and 2020

STATEMENT OF NET POSITION

The Statement of Net Position presents the financial position of VSCS at a point in time - June 30, and includes all assets, liabilities, and the net position of the System. Net position represents the residual interest in the System's assets after liabilities are deducted. The change in net position is an indicator of whether the overall financial condition has improved or deteriorated during the year. Table 1 on the next page shows the condensed Statement of Net Position for the past five years.

Assets are items of economic value owed or controlled by an institution. They include capital assets like land, buildings and equipment, cash and investments, and amounts owed to us by students or others. Total assets are categorized as either current or noncurrent.

Current assets are available to satisfy current liabilities, which are those amounts expected to be payable within the next fiscal year. The major components of current assets are cash and accounts receivable, which are primarily funds due to the VSCS by students and granting agencies.

Total assets (including deferred outflows) of $357 million as of the end of the current fiscal year increased by $81 million or 29.7% from prior year, the increase was primarily in cash due to the receipt of $28.8 million one-time bridge funds from the State of Vermont, Higher Education Emergency Relief Funding, and in deferred outflows related to other post-employment benefits (OPEB). Over the 5 years, total assets have increased by $90 million: an increase of $67 million in current assets and investments combined with the $40 million increase in deferred outflows, net of $24 million reduction in capital assets.

Noncurrent assets consist primarily of endowment and other investments, in addition to capital assets. Investments were $55 million at June 30, 2021, $7 million higher than the prior year. Capital Assets continue to decline at relatively the same rate indicating that investments in capital have primarily been at the same level each year and continue to be less than depreciation on an annual basis.

Liabilities are obligations owed by the institutions. They include funds owed to others such as vendors, employees, taxing agencies, and bondholders. Liabilities are classified as current and long-term. Current liabilities are those that due during the next fiscal year.

Current liabilities of $33 million include primarily accounts payable, unearned revenue and principal amounts due on long-term debt related to the next fiscal year. Over this five-year period, current liabilities have been varied dependent upon the timing of deferred revenue and accounts payable transactions. This was especially true for FY2021.

Noncurrent liabilities increased by $39 million to $360 million during FY2021. This increase relates to the actuarial increase in other post-employment benefits.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Management's Discussion and Analysis (Unaudited)

June 30, 2021 and 2020

TABLE 1: Condensed Statement of Net Position as of June 30

($ in millions)

	2021	% change	2020	% change	2019	% change	2018	% change	2017
Current Assets	96	100%	48	45%	33	-6%	35	21%	29
Noncurrent Assets									
Investments	55	15%	48	0%	48	4%	46	0%	46
Capital assets, net	145	-4%	151	-4%	157	-4%	163	-4%	169
Other	4	0%	4	-33%	6	0%	6	0%	6
Deferred outflows/inflows	57	128%	25	0%	25	-11%	28	65%	17
Total Assets and Def'd outflows/inflows	357	29%	276	3%	269	-3%	278	4%	267
Current liabilities	33	22%	27	13%	24	-14%	28	22%	23
Non current liabilities									
Post employm't benefit oblig	238	23%	194	3%	189	1%	188	9%	172
Bonds and Notes payable	114	-3%	118	-1%	119	-2%	121	-3%	125
Other	4	0%	4	-33%	6	-14%	7	17%	6
Deferred outflows/inflows	4	100%	5	100%	5	100%	0		0
Total Liabilities	393	13%	348	1%	343	0%	344	6%	326
Net investment in cap'l assets	41	-11%	46	5%	44	-10%	49	-11%	55
Restricted									
Nonexpendable	21	11%	19	0%	19	6%	18	-5%	19
Expendable	20	54%	13	0%	13	8%	12	9%	11
Unrestricted	-118	-21%	-150	0%	-150	3%	-145	1%	-144
Total Net Position	-36	-50%	-72	-3%	-74	12%	-66	12%	-59
Total Liabilties and Net Position	357	29%	276	3%	269	-3%	278	4%	267

Table 1: Condensed Statement of Net Position as of June 30

Net position is equal to the total assets minus the total liabilities, and represents the residual value of the institution at a point in time for the VSCS as of the financial statements issued each June 30.

Net investment in capital assets represents the historic cost of the System's capital assets reduced by total accumulated depreciation, plus the outstanding principal balances on debt used for the acquisition, construction, or improvement of those assets.

Total net position over the five years reported here has improved $23 million from -59 million in FY2017 to -36 million in FY2021. This improvement is due in large part to one-time bridge funding from the State of Vermont, as well as Higher Education Relief and Coronavirus Relief funds starting in FY2020.

Net investment in capital assets decreased by $5 million from June 30, 2020 to June 30, 2021 due to depreciation, offset partially by reduction in outstanding debt related to capital assets. Net investment in capital assets have steadily decreased over the five-year period reported here.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Management's Discussion and Analysis (Unaudited)

June 30, 2021 and 2020

The restricted nonexpendable portion of the Net Position represents the permanent endowment funds for the system. These are donations to the colleges that cannot be spent without permission of the donor. These are invested; and the earnings are used based on VSCS Board Policy and the instructions of the donor. Most of the earnings on our endowment funds are designated for student scholarships. The increase of $2 million over 5 years is due to gifts received for endowments during this period.

The restricted expendable portion of Net Position includes unexpended restricted gifts and grants, and unexpended endowment appreciation, subject to externally imposed conditions on their use. There was a $7 million increase from June 30, 2020 to June 30, 2021. Over the 5-year period, expendable net assets have increased by $9 million, as earnings have outpaced the 5% spending on endowments permitted by Board policy.

The unrestricted portion of the Net Position is largely affected by general operations, but the most significant impact to date has been the full recognition of future OPEB obligations, which are unfunded. These obligations will erode over time and have a corresponding improvement to unrestricted net position.

Capital Assets and Debt Administration

The System's facilities are critical to accomplishing the mission of the System as they provide the physical framework and environment for education, research, cultural programs, and residential life. However, due to fiscal constraints the VSCS has not been able to invest in its facilities consistent with the decrease in capital assets and consistent with depreciation. This is something the VSCS will be addressing as it completes its system-wide transformation between FY2021 and FY2026. Table 2 below provides detail from the past 5 years related to the Capital Assets held by the System.

Construction in Progress reflects amounts paid for buildings or other assets that were not completed at year-end. When completed and placed in service, the total cost is moved to the appropriate capital asset category. Depreciation of that asset begins the month after it is placed in service. Construction in Progress has remained fairly steady, however, receipt of a Department of Defense Contract for construction of an Advanced Manufacturing Center on the Vermont Technical College campus at Randolph was in progress at the end of FY2021. Building and Improvements remained relatively constant from FY2019 to FY2021 reflecting limited funding for capital improvements. Infrastructure includes water & sewer systems, heating & electrical systems, telecommunication systems, and roads. The increase in infrastructure over the five-year period is due to projects on the campuses as well as enhanced communications systems for the entire System. Table 2 on the next page also includes related information (depreciation expense and outstanding principal on construction loans).

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June 30, 2021 and 2020

Table 2: Capital Assets as of June 30

($ in millions)

	2021	% Change	2020	% Change	2019	% Change	2018	% Change	2017
Land	9	0%	9	0%	9	0%	9	0%	9
Construction in progress	5	67%	3	50%	2	100%	1	0%	1
Infrastructure	42	2%	41	0%	41	3%	40	3%	39
Buildings and improvements	261	0%	262	0%	261	1%	259	1%	257
Leasehold improvements	4	0%	4	0%	4	0%	4	0%	4
Equipment	38	3%	37	3%	36	0%	36	6%	34
Total Capital Assets	359	1%	356	1%	353	1%	349	1%	344
Accumulated Depreciation	-214	4%	-205	5%	-196	5%	-186	6%	-176
Capital Assets, Net	145	-4%	151	-4%	157	-4%	163	-3%	168
Related information									
Depreciation Expense	10	0%	10	0%	10	0%	10	0%	10
Outstanding Principal, Related Loans	118	-2%	120	-1%	121	-3%	125	-3%	129

Table 2: Capital Assets as of June 30

As noted in this table, depreciation continues to outpace the sum of building improvements, infrastructure, and construction in progress.

Statement of Revenues, Expenses, and Changes in Net Position

The Statement of Revenues, Expenses, and Changes in Net Position reports total operating revenues, operating expenses, non-operating revenues and expenses, and other changes in net position, showing the total change in net position for the fiscal year. Table 3 on the next page shows the Condensed Statements of Revenues, Expenses, and Changes in Net Position for the past five fiscal years.

Operating and Non-operating Revenue

Accounting rules require that our audited financials include operating revenues, operating expenses and non-operating revenues and expenses. The following sections provide an analysis of the total operating and non-operating revenues and expenses. In a normal year, the VSCS's primary source of revenue is from student tuition and fees. However, receipt of a one-time bridge appropriation plus Higher Education Emergency Relief and Coronavirus Relief funds, shifted the proportion of total operating and non-operating income attributable to net student revenues to 38%. As shown on Table 3, both Non Capital Appropriations and Federal Grants & Contracts increased $43 million in FY2021.

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Table 3: Condensed Statements of Revenues, Expenses, and Changes in Net Position

($ in millions)

	2021	% Change	2020	% Change	2019	% Change	2018	% Change	2017
Net Student Revenues	87	-13%	100	-7%	107	-1%	108	-4%	112
Grants and contracts	18	13%	16	0%	16	7%	15	7%	14
Other Operating Revenues	8	33%	6	-14%	7	0%	7	0%	7
Operating Revenues	113	-7%	122	-6%	130	0%	130	-2%	133
Operating Expenses	189	3%	183	-2%	186	0%	186	1%	184
Operating Loss	-76	25%	-61	9%	-56	0%	-56	10%	-51
Nonoperating Revenues (Expenses)									
Non Capital Appropriations	61	85%	33	10%	30	0%	30	11%	27
Federal Grants & Contracts	43	54%	28	75%	16	0%	16	0%	16
Gifts currently expendable	3	50%	2	0%	2	-33%	3	50%	2
Investment Income & Interest	7	600%	1	-50%	2	0%	2	-33%	3
Interest Expense	-5	0%	-5	0%	-5	0%	-5	0%	-5
Other nonoperating revenues	0	0%	0	0%	0	0%	0	0%	0
Net Nonoperating Revenues	109	85%	59	31%	45	-2%	46	7%	43
Total Change before other Revenues	33	-1750%	-2	-82%	-11	10%	-10	25%	-8
Other Changes in Net Position									
Capital Appropriation	2	0%	2	-33%	3	0%	3	50%	2
Capital gifts and grants	0	0%	0	0%	0	0%	0	0%	0
Endowment gifts	1	0%	1	0%	0	0%	0	-100%	1
Change in Net Position	36	3500%	1	-114%	-7	0%	-7	40%	-5

Table 3: Condensed Statements of Revenues, Expenses, and Changes in Net Position

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(a Component Unit of the State of Vermont)

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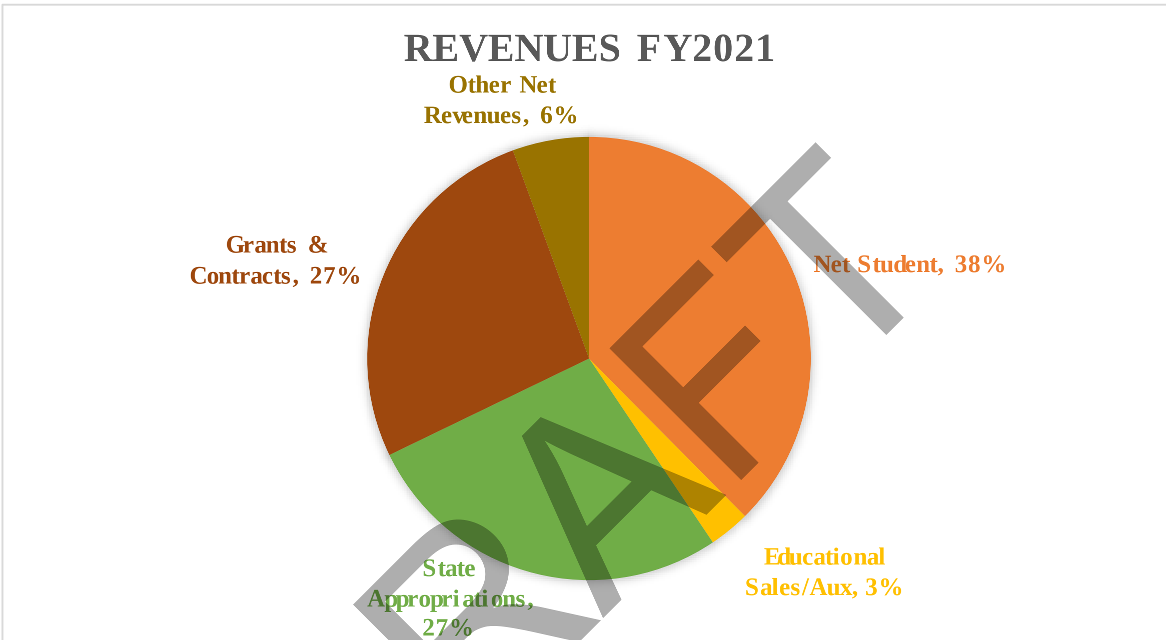
June 30, 2021 and 2020



FY2021 Revenues
($ in thousands)

Net Student	$ 86,514	38%
Educational Sales/Aux	6,880	3%
State Appropriations	62,725	27%
Grants & Contracts	61,188	27%
Other Net Revenues	12,848	6%
TOTAL	$ 230,155	100%

Chart 1: Revenues FY2021

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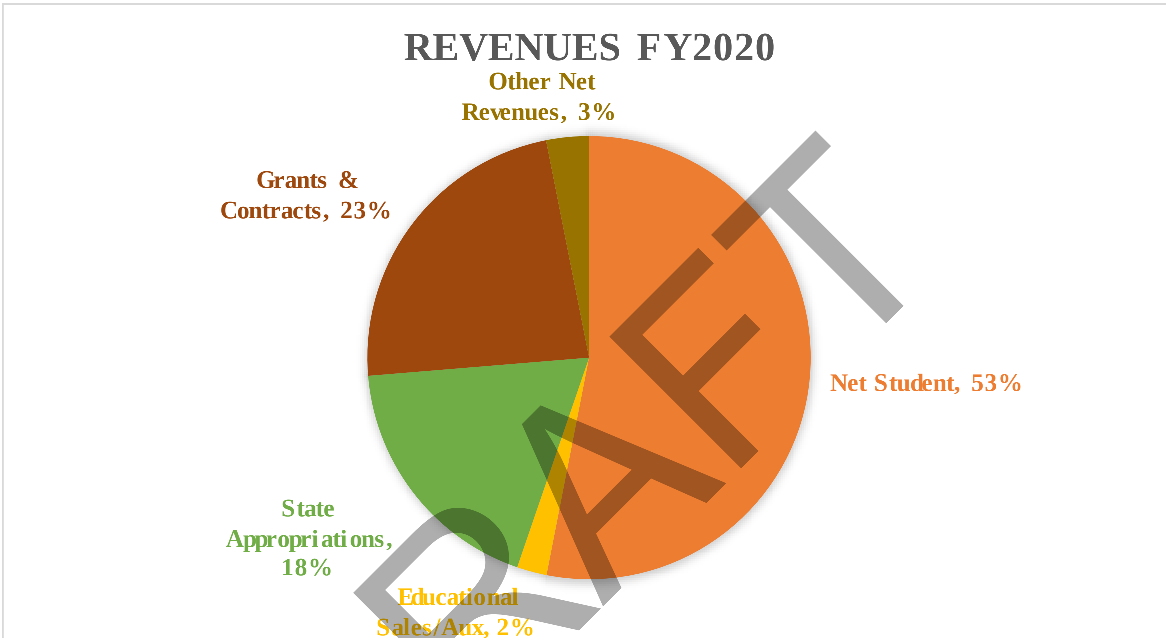

FY2020 Revenues
($ in thousands)

Net Student	$ 100,276	53%
Educational Sales/Aux	4,123	2%
State Appropriations	34,828	18%
Grants & Contracts	43,821	23%
Other Net Revenues	5,882	3%
TOTAL	$ 188,930	100%

Chart 2: Revenues FY2020

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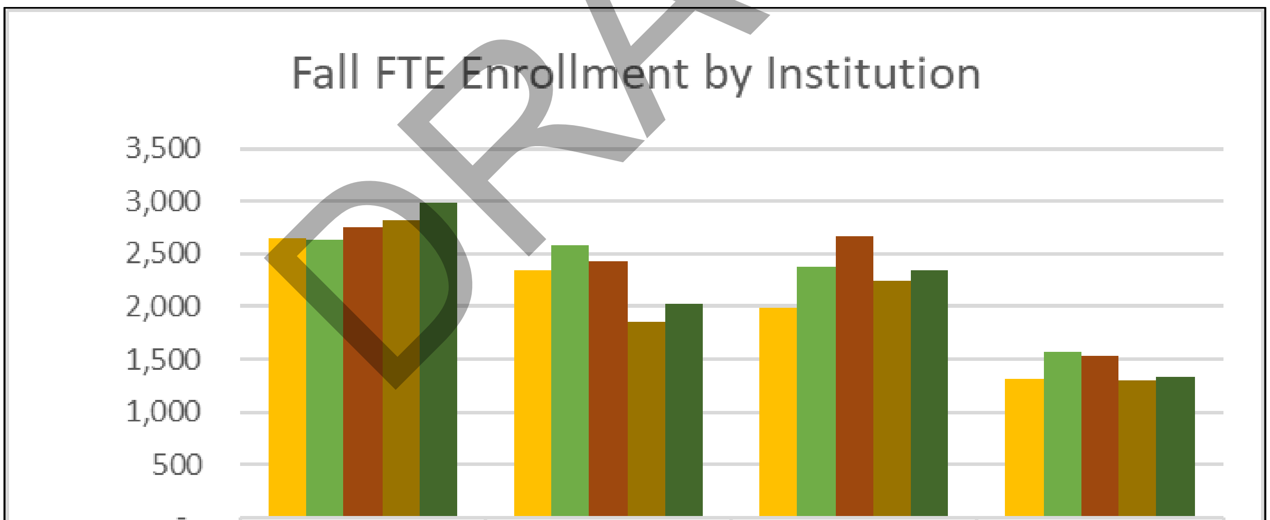
<u>Tuition and Fee Revenue</u>

Net Tuition and fees includes tuition and fees plus residence and dining fees less scholarship allowances. The charts below shows the trend for enrollments and corresponding Tuition and Fee Revenues from FY2017 through FY2021. For the System, student-based revenue has been declining during this five-year period, despite increases in tuition rates for all years. Enrollments, in a time of decreasing high school graduates in the state, coupled with pandemic effects, have created a challenge for the colleges/universities in our system.

Chart 3 displays Full Time Equivalent (FTE) enrollment. The FTE is a reasonable proxy for revenue and reflects the average full-time participation of students. This charts show a general steady decline in enrollment for CCV together with significant volatility for Castleton University, Northern Vermont University, and Vermont Technical College. The volatility at these institutions was exacerbated by the pandemic, while Community College of Vermont held steady with its enrollments due to a pilot program with a local funding agency.



	CCV	CU	NVU	VTC
Fall 2020	2,646	2,345	1,985	1,313
Fall 2019	2,625	2,579	2,385	1,573
Fall 2018	2,754	2,434	2,671	1,533
Fall 2017	2,813	1,851	2,235	1,297
Fall 2016	2,984	2,015	2,338	1,335

Chart 3: Fall FTE Enrollment by Institution

*Please note that the method used for calculating FTE for the VSCS changed for Fall 2018 and restatement of prior years is not feasible, so with exception of CCV, the comparative nature of this chart is somewhat lost for Fall 2018 as compared to prior years.

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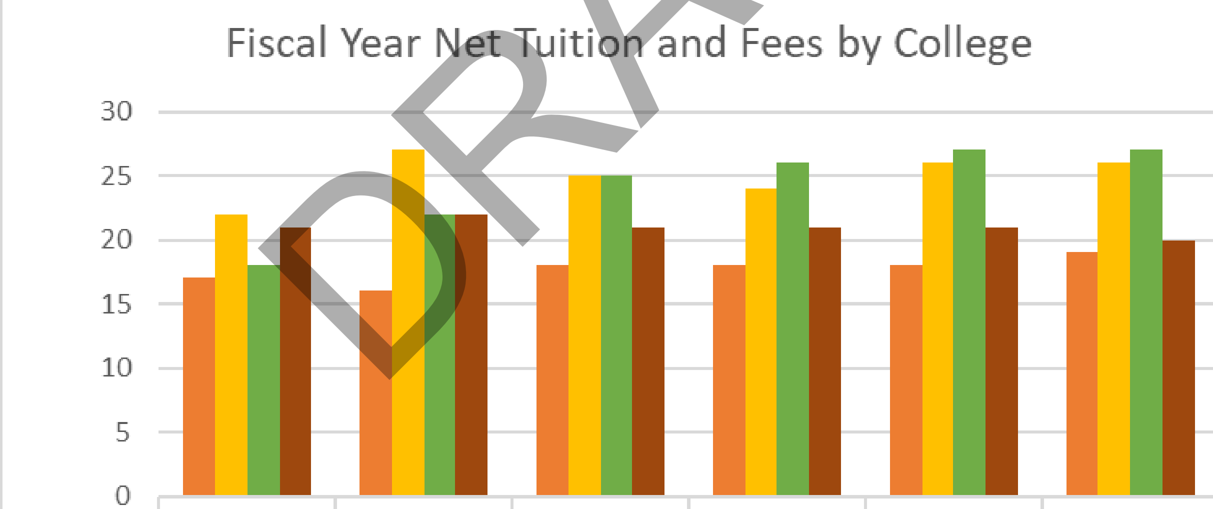
Chart 4 displays Net Tuition and Fees for each college during the five-year period. It is notable that CCV has by far the largest number of students – both FTE and Headcount, but their net tuition is consistently outpaced by the Universities. CCV, as a community college has the lowest tuition cost and charges for courses on a per credit basis, while the residential schools charge a higher tuition rate and on a semester basis.

Over the last five years, enrollment (headcount) has declined across all institutions with the most significant declines occurring at NVU and CCV. Net tuition and fees revenue by institution declined at three of four institutions between FY17 and FY21 with net revenue down between 10% and 33%. NVU's net tuition and fees had been in steady decline until FY2019 at which time enrollments at the NVU-Lyndon campus dipped and greater emphasis was placed on discounting to boost enrollment. CCV, like NVU, experienced a large drop in net tuition and fees between FY2019 and FY2020. With the exception of CCV, net tuition and fee revenue was down in FY2021 due to the pandemic.



	FY21	FY20	FY19	FY18	FY17	FY16
CCV	17	16	18	18	18	19
CU	22	27	25	24	26	26
NVU	18	22	25	26	27	27
VTC	21	22	21	21	21	20

Chart 4: Fiscal year Net Tuition and Fees by Institution

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<u>Operating and Non-operating Expenses</u>

Table 4, below, shows the total Operating and Non-Operating Expenses for the past 5 years and the charts provide a quick view of the percent of expenses by type for FY2021 and FY2020.

The largest percentage of VSCS expenses are for salary and benefits. Over time, these expenses have declined due to staff reductions compounded with a reduction in TIAA employer contribution for all employees beginning in FY2018. Positive trends in health care over the past couple of years have resulted in far less related expense; however, annual accruals related to post-employment benefits are also included in this salary and benefit expense category and have caused fluctuations in the recognized amounts.

Overall expenses have increased over the five years reported driven largely by an increase in scholarship aid. Additionally, supplies and services were notably higher due to required pandemic related spending on supplies, services, and technology. Notably, student aid has increased as the VSCS institutions respond to the national trend towards aggressive discounting as a strategic and necessary response to the current competitive environment.

Table 4: Total Operating and Non-operating Expenses for Years Ended June 30
($ in millions)

	2021	% Change	2020	% Change	2019	% Change	2018	% Change	2017
Operating									
Salaries & Benefits	119	0%	119	-2%	121	-1%	122	1%	121
Utilities	5	-17%	6	-14%	7	17%	6	20%	5
Supplies and Svcs	41	11%	37	-8%	40	0%	40	-2%	41
Depreciation	10	0%	10	0%	10	0%	10	0%	10
Student Aid	13	30%	10	25%	8	14%	7	0%	7
Total Operating	188	3%	182	-2%	186	1%	185	1%	184
Nonoperating									
Interest on Debt	5	0%	5	0%	5	-17%	6	20%	5
TOTAL Expenses	193	3%	187	-2%	191	0%	191	1%	189

Table 4: Total Operating and Non-Operating Expenses for Years Ended June 30

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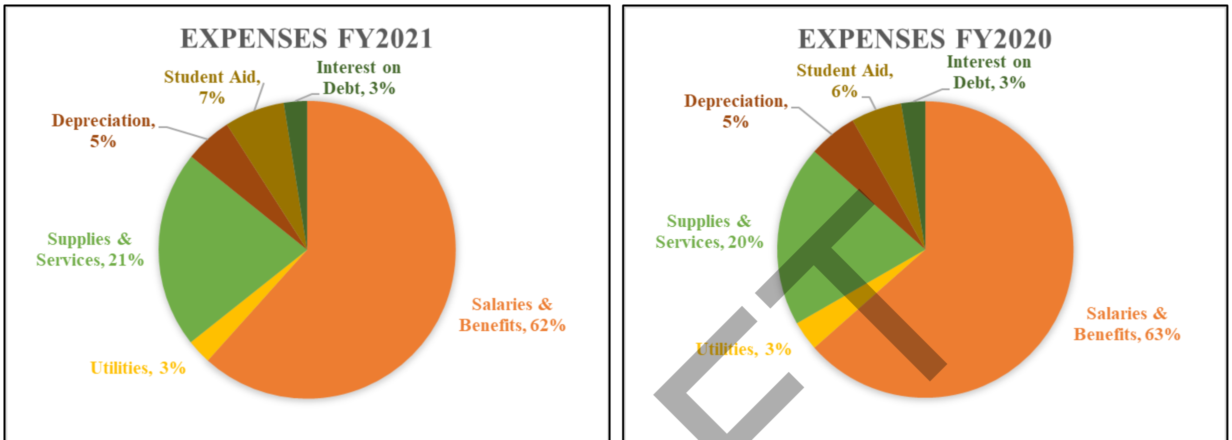

Chart 4: Expenses FY2021 and FY2020 by Major Category

Student Financial Aid

Student financial aid awards are made from a variety of sources including federal, state, private, and system funds. Aid received from third parties is recognized as grants and contracts revenue, and aid funded with endowments are recognized at the initial gift value and adjusted by investment income on the Statements of Revenues, Expenses, and Changes in Net Position while the distribution of aid from all sources is shown as one of two components:

- Scholarship Allowances – financial aid retained by the System to cover students' tuition, fees, and on-campus housing and meals. These amounts are reported as a direct offset to operating revenues.
- Scholarships and Fellowships Expense – financial aid refunded to students to cover off-campus living costs, books, and other personal living expenses. These amounts are reported as operating expense.

Student Financial Aid Trends for Past Five Years
($ in millions)

	FY21	FY20	FY19	FY18	FY17
Scholarship Allowances (included in revenue)	31	32	29	27	25
Scholarship Expenses (included in expenses)	13	10	8	7	7
Total Student Aid	44	42	37	34	32

Table 5: Student Financial Aid Trends for Past Five Years

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June 30, 2021 and 2020

Statement of Cash Flow

The Statement of Cash Flows shows inflows and outflows of cash excluding both revenue and expense that is accrued to comply with accounting rules. The Condensed Statement of Cash Flows for the VSCS is in Table 6.

Cash flows from operating activities

Cash flows from operating activities on the Statement of Cash Flows will always be different from the net operating income or loss on the Statement of Revenues, Expenses, and Changes in Net Position (SRECNP) because of the inclusion of noncash items, such as depreciation expenses on the SRECNP. Also, the SRECNP is prepared on the accrual basis of accounting, meaning that it shows both revenues earned and expenses incurred even if cash has not yet exchanged hands. The primary cash receipts from operating activities consist of tuition and fees, grants and contracts, and auxiliary income from housing and food service operations. Cash outlays include payment of wages and benefits; operating expenses such as utilities, supplies, insurance and repairs; and scholarships awarded to students. Cash flow from operations increased significantly due to significant increases in Operating Grants (CARES, HEERF, CRF).

Consistent with accounting standards, cash flows from state operating appropriations and federal PELL grant revenue are included in noncapital financing activities, even though they provide funding for operating activities. The bottom section of Table 6 shows that with these revenue sources added to the operating cash flows, the result is positive cash flows in all years.

Cash flows from noncapital financing activities

In normal years, there are two primary sources of noncapital financing: state appropriations and non-operating federal grants that fund PELL student grants. Accounting standards require that we reflect these sources of revenue as non-operating, even though each of the colleges depends on them to continue the current level of operations. While this value remained relatively stable between FY2017 and FY2019 large increases were seen in FY2020 and FY2021 due to receipt of federal funding in the form of CARES act, Higher Education Emergency Relief and Coronavirus relief funds. These monies increased the non-operating federal grants line from $28 million to $43 million at the end of FY2021.

Cash flows from capital and related financial activities

Cash flows from capital and related financing activities include all capital plant funds and related long-term debt activities (excluding depreciation and amortization of bond premiums, since these are non-cash transactions), as well as capital gifts, grants, and appropriations. This has remained relatively consistent over the 5-year period presented herein with the exception of both FY2019 and FY2020 as old Bond Series were refinanced at the close of FY2018 and in January of 2020,

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Management's Discussion and Analysis (Unaudited)

June 30, 2021 and 2020

so there was a smaller amount paid on deposit with the bond trustee in both fiscal years, it is expected that this value will remain constant for several more years.

Cash flows from investing activities

Purchase or sale of investments and income earned on investments are included in cash flows from investing activities. An item on the cash flow statement belongs in the investing activities section if it results from any purchases or sales and gains (or losses) from investments in financial markets and operating subsidies. In FY2021 there were minimal cash changes due to investing activities.

Table 6: Condensed Statement of Cash Flows as of June 30
($ in millions)

Cash flows from:	2021	% Change	2020	% Change	2019	2018	2017
Operating	-50	6%	-47	9%	-43	-34	-35
Non capital financing	107	62%	66	38%	48	49	45
Capital and related financing	-6	0%	-6	-25%	-8	-10	-10
Investing	0	-100%	1	-200%	-1	2	0
Net increase (decrease)	52	247%	15	-475%	-4	7	0
Cash, Beginning of Year	29	107%	14	-22%	18	11	11
Cash, End of Year	81	179%	29	107%	14	18	11
Operating cash flows if noncapital appropriations and non-operating grants were included							
Operating	-50	6%	-47	9%	-43	-34	-35
Non capital appropriations	61		33		30	30	27
Non operating grants	43		28		16	16	16
Operating cash flows with non-operating additions	54	286%	14	367%	3	12	8

Table 6: Condensed Statement of Cash Flows

Economic Factors That Will Affect the Future

Pandemic Impacts

The worldwide pandemic of the novel coronavirus COVID-19 hit the higher education sector especially hard. In March of 2020 all VSCS institutions, like much of the higher education market, closed its residence halls and moved to remote instruction. This teaching modality persisted through the summer 2020 term, and disrupted summer camps and conferences. Three of four institutions remained in a fully remote fashion through the fall semester, with minimal on campus activities at Castleton University, Vermont Technical College, and Community College of

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June 30, 2021 and 2020

Vermont. In Spring 2021, all three residential communities returned to face-to-face instruction, though enrollment drops persisted.

Due to the pandemic, admissions recruiting activities were largely virtual throughout much of FY2021. This, coupled with smaller incoming classes in Fall 2020, will likely have lingering revenue implications for the next three to four years. As of the writing of this Management Discussion and Analysis, all four VSCS communities have returned to face-to-face instruction with full residential activities.

Several pilot scholarship programs, launched by State of Vermont, are likely to have a positive impact on student revenue for FY2022 and beyond. These scholarships, funded in part by the American Rescue Plan Act, focus attention on critical occupations, degree completers, and Vermonters transferring from out-of-state institution to return home to complete their education. The results from these pilots will be used to assess how what works to acquire and retain students in critical programs.

Structural Difficulties

Consistent with national trends, Vermont continues to experience a demographic decline in the overall number of graduating high school students. This is expected to last for the foreseeable future and likely result in permanently lower enrollments going forward. In fact, the number of births in Vermont in 2015 was the lowest since before the Civil War and continues to shrink. Additionally, free college initiatives in neighboring states and online education are increasing the competitive landscape and forcing aggressive discounting strategies to ensure VSCS enrollments. All the institutions have adopted programs and implemented strategies to better recruit in this shrinking market.

In August 2019, the VSCS Office of the Chancellor published a white paper titled "Serving Vermont's Students by Securing the Future of the Vermont State Colleges System." The intent was to set the foundation for consideration of concrete, strategic actions that the Vermont State College System could take to secure its mission in an increasingly challenging and rapidly changing higher education environment. The paper highlighted the demographic challenges facing Vermont, New England, and the Northeast, as well as pointed to challenges with respect to the structure and nature of the VSCS.

In late March/early April 2020, the combined effects of the pandemic and the VSCS's structural issues became clear. In response, the former Chancellor proposed shuttering the residential campuses of Northern Vermont University and the Randolph Center location of Vermont Technical College. The proposal was intended to alter the structure and shape of the Vermont State Colleges System to stabilize the system in response to the demographic challenges facing the region. Due to considerable public and legislative outcry, the proposal was withdrawn by the former Chancellor before being placed for a vote.

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Legislative Evaluation and Support

At the request of the Vermont Legislature, two separate financial evaluations of the Vermont State Colleges were undertaken in May 2020. The first, conducted by Vermont State Treasurer Beth Pearce,[1] evaluated the financial health of the VSCS to determine the extent of the VSCS's demographic and funding challenges. The second evaluation, organized by the Joint Fiscal Office of the Vermont State Legislature and conducted by Mr. James Page,[2] former chancellor of the University of Maine System, evaluated the overall financial condition of the VSCS, its current demographic and pandemic related enrollment challenges. Both studies concluded that the VSCS was accurately reflecting its financial situation and that an infusion of cash from the State would be necessary to support the transformation of the VSCS into a leaner, more nimble and financially-sustainable organization. The Legislature also created the *Select Committee on the Future of Public Higher Education in Vermont* to develop a path forward.

Since creation of the *Select Committee*, several key actions have been taken that will have a positive impact on the financial health of the VSCS moving forward:

- The Select Complete completed its interim and final reports with final recommendations available in a report to the Joint Fiscal Office of the Vermont Legislature in April 2021.[3]
- The Board of Trustees of the Vermont State Colleges endorsed the recommendations of the Select Committee at its February 22, 2021 meeting to (a) bring together Castleton University, Northern Vermont University, and Vermont Technical College to create one new university, and (b) consolidate administrative functions and business processes system-wide.[4]
- Act 74 of the Vermont Legislature was enacted mandating system transformation and integration. This mandate requires the Vermont State Colleges to "establish policies and procedures to implement the Board approved transformation plan as developed by the Select Committee on Higher Education."[5]
- To oversee the transformation process, a Director of Transformation Projects was hired to establish the critical project management infrastructure necessary to retool the Vermont State Colleges into the system of the future.
- An experienced government relations professional was hired to oversee the relationship between the Vermont State Colleges and State and Federal officials.
- A strategic financial plan and capital expenditures plan is being developed to shore up the balance sheet of the Vermont State Colleges and reduce the structural deficit of the system by $25 million over five years.

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[1] https://ljfo.vermont.gov/assets/Subjects/Higher-Education/a824553cd8/Treasurer-VSC-Report-Final.pdf
[2] https://ljfo.vermont.gov/assets/Subjects/Higher-Education/f13fd8d299/Report-on-Funding-for-the-Vermont-State-Colleges-System-FY-2020-and-FY-2021.pdf
[3] https://ljfo.vermont.gov/assets/Uploads/c2ef482057/Final-Report-of-the-Select-Committee-on-the-Future-of-Public-Higher-Education-in-Vermont-Submitted.pdf
[4] https://www.vsc.edu/wp-content/uploads/2021/04/2021-02-22-Board-of-Trustees-Minutes-APPROVED.pdf
[5] https://legislature.vermont.gov/Documents/2022/Docs/ACTS/ACT074/ACT074%20As%20Enacted.pdf p. 177-182

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- A series of transformation initiatives is being executed to merge Vermont Technical College, Castleton University, and Northern Vermont University into a singly accredited institution launching July 2023.

Vermont State Appropriations

In FY2021 the Vermont State Colleges received $28.8 million in one-time bridge funding from the State of Vermont in the form of an additional appropriation. Additionally, the State provided more than $22 million in Coronavirus Relief funds and $2.3 million to support education for unemployed and under employed Vermonters who were negatively impacted by the pandemic.

Throughout the Legislative session, the Chancellor and senior team worked closely with the Legislature to provide the necessary background to support the recommendations of the *Select Committee on the Future of Public Higher Education in Vermont*. These recommendations included a $17.5 increase to the System's annual operating appropriation over four years, and supporting bridge funds in excess of $60 million over five years, plus funding to support transformation activities.

With the conclusion of the 2021 Legislative session, the VSCS received a $5 million increase to its base appropriation, a $21 million one-time economic support grant for bridge funding, $20 million in funding for transformation activities, and more than $15 million in scholarship programs. While there are no guarantees that Vermont will be able to continue to increase the VSCS's base appropriation or support additional bridge activities, we have been generously supported to date and will continue to work closely with the Governor, and legislative leadership in the House and Senate.

Employee and Contractual Obligations

The VSCS employs more than two thousand people annually, the majority of whom are covered by collective bargaining agreements. Wages and benefits are the single biggest expense of the VSCS, with more than 62% of all expenses related to employees.

The VSCS has seven collective bargaining units. Three of the collective bargaining agreements expired on June 30, 2020. Due to the pandemic, labor and management agreed to one-year extensions for these units for FY2020 and FY2021 with modest adjustments to the terms. Two additional agreements with part-time faculty expired on June 30, 2021 and are currently under negotiation. One contract with a newly-formed bargaining unit completed negotiation prior to June 2021. The remaining agreement for full-time faculty, will expire on June 30, 2022. All expired agreements will undergo negotiation in FY2022.

VERMONT STATE COLLEGES

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Statements of Net Position

June 30,

Assets and Deferred Outflows of Resources

	2021	2020
Current Assets:		
Cash and equivalents (Note 2)	**$ 75,370,827**	$ 22,432,987
Restricted cash and equivalents	**4,655,455**	5,940,335
Accounts receivable, net (Note 3)	**12,887,694**	17,174,731
Deposit with bond trustees (Note 2)	**1,068,825**	1,061,784
Other current assets	**1,906,174**	1,458,477
Total Current Assets	**95,888,975**	48,068,314
Non-Current Assets:		
Cash and equivalents (Note 2)	**936,856**	963,686
Long-term investments (Note 2)	**54,904,256**	48,091,685
Notes receivable, net (Note 3)	**3,279,122**	3,488,786
Other assets	**99,207**	61,683
Capital assets, net (Note 11)	**144,743,671**	150,979,076
Total Non-Current Assets	**203,963,112**	203,584,916
Total Assets	**299,852,087**	251,653,230
Deferred Outflows of Resources:		
Deferred loss on debt refunding (Note 5)	**7,525,847**	8,570,206
OPEB (Note 9)	**50,006,413**	16,151,177
Total Deferred Outflows of Resources	**57,532,260**	24,721,383
Total Assets and Deferred Outflows of Resources	**$ 357,384,347**	$ 276,374,613

The accompanying notes are an integral part of these financial statements.

Liabilities, Deferred Inflows of Resources and Net Position

	2021	2020
Current Liabilities:		
Accounts payable and accrued liabilities (Note 12)	**$ 16,251,717**	$ 13,402,712
Unearned revenue and deposits	**12,856,448**	12,187,617
Current portion of long-term debt (Note 4)	**4,258,454**	1,613,454
Total Current Liabilities	**33,366,619**	27,203,783
Non-Current Liabilities:		
Other liabilities	**142,476**	244,435
Refundable grants	**4,029,353**	4,751,397
Post-employment benefit obligations (Note 9)	**238,004,492**	194,057,554
Long-term debt, excluding current portion (Note 4)	**113,702,457**	117,960,911
Total Non-Current Liabilities	**355,878,778**	317,014,297
Total Liabilities	**389,245,397**	344,218,080
Deferred Inflows of Resources:		
OPEB (Note 9)	**3,876,310**	4,548,824
Net Position:		
Net investment in capital assets	**41,191,698**	45,779,424
Restricted - nonexpendable	**20,782,281**	19,157,254
Restricted - expendable	**20,122,013**	12,639,185
Unrestricted	**(117,833,352)**	(149,968,154)
Total Net Position	**(35,737,360)**	(72,392,291)
Total Liabilities, Deferred Inflows of Resources and Net Position	**$ 357,384,347**	$ 276,374,613

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Statements of Revenues, Expenses and Changes in Net Position

For the Years Ended June 30,

	2021	2020
Operating Revenues:		
Tuition and fees	**$ 109,090,525**	$ 119,193,554
Residence and dining	**8,753,469**	13,080,067
Less: scholarship allowances	**(31,329,730)**	(31,997,371)
Net Tuition, Fees, and Residence and Dining Revenue	**86,514,264**	100,276,250
Federal grants and contracts	**14,521,551**	12,607,232
State and local grants and contracts	**2,035,581**	2,384,119
Non-governmental grants and contracts	**1,882,074**	940,145
Interest income	**117,412**	84,052
Sales and services of educational activities	**6,879,828**	4,123,603
Other operating revenues	**778,761**	1,285,806
Total Operating Revenues	**112,729,471**	121,701,207
Operating Expenses (Notes 6, 10 and 12):		
Salaries and wages	**73,287,378**	77,863,880
Employee benefits (Notes 8 and 9)	**46,023,515**	41,202,655
Scholarships and fellowships	**12,688,211**	10,369,849
Supplies and other services	**41,461,945**	37,107,026
Utilities	**5,183,184**	6,080,442
Depreciation (Note 11)	**9,973,768**	9,999,987
Total Operating Expenses	**188,618,001**	182,623,839
Net Operating Loss	**(75,888,530)**	(60,922,632)
Non-Operating Revenues (Expenses):		
State appropriations (Note 7)	**60,725,199**	32,754,092
Federal grants and contracts	**42,749,079**	27,890,446
Gifts	**3,473,800**	2,197,466
Investment income, net of expenses (Note 2)	**6,915,624**	1,322,745
Interest expense on capital debt	**(4,882,621)**	(4,944,172)
Other non-operating revenues (expenses)	**168,820**	(18,971)
Net Non-Operating Revenues	**109,149,901**	59,201,606
Increase (Decrease) in Net Position Before Other Revenues	**33,261,371**	(1,721,026)
Other Revenues:		
State appropriations for capital expenditures (Note 7)	**2,000,000**	2,074,056
Capital grants and gifts	**32,438**	405,759
Additions to non-expendable assets	**1,361,122**	604,785
Increase (Decrease) in Net Position	**36,654,931**	1,363,574
Net Position, Beginning of Year	**(72,392,291)**	(73,755,865)
Net Position, End of Year	**$ (35,737,360)**	$ (72,392,291)

The accompanying notes are an integral part of these financial statements.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Statements of Cash Flows

For the Years Ended June 30,

	2021	2020
Cash Flows from Operating Activities:		
Tuition and fees	**$ 74,734,760**	$ 90,171,996
Grants and contracts	**19,864,627**	14,888,434
Sales and services of educational activities	**9,070,503**	4,049,903
Interest received	**117,412**	84,052
Payments to suppliers	**(44,323,893)**	(43,905,043)
Payments to employees	**(110,503,485)**	(113,910,231)
Collection of loan payments	**209,664**	696,442
Other cash receipts	**778,761**	1,285,806
Net Cash Applied to Operating Activities	**(50,051,651)**	(46,638,641)
Cash Flows from Non-Capital Financing Activities:		
State appropriations	**60,725,199**	32,754,092
Non-operating federal grants	**44,113,650**	31,181,335
Gifts and grants	**2,540,294**	2,252,201
Net Cash Provided by Non-Capital Financing Activities	**107,379,143**	66,187,628
Cash Flows from Capital and Related Financing Activities:		
Capital and non-expendable grants and gifts	**1,393,560**	1,010,544
Capital appropriations	**2,000,000**	2,074,056
Purchase of capital assets	**(5,407,875)**	(3,897,495)
Change in deposits with bond trustee	**(7,041)**	2,086,205
Proceeds from sale of capital assets	**1,669,512**	23,141
Proceeds from issuance of bonds	**-**	28,723,755
Payments on capital debt	**(780,000)**	(30,299,155)
Interest expense on capital debt	**(4,841,391)**	(5,208,599)
Other receipts	**168,820**	(18,971)
Net Cash Applied to Capital and Related Financing Activities	**(5,804,415)**	(5,506,519)

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Statements of Cash Flows - Continued

For the Years Ended June 30,

	2021	2020
Cash Flows from Investing Activities:		
Proceeds from sales and maturities of investments	**$ 4,801,103**	$ 5,448,756
Purchase of investments	**(5,696,780)**	(5,502,982)
Interest and dividends received on investments	**998,730**	1,263,407
Net Cash Provided by Investing Activities	**103,053**	1,209,181
Net Increase in Cash and Equivalents	**51,626,130**	15,251,649
Cash and Equivalents, Beginning of Year	**29,337,008**	14,085,359
Cash and Equivalents, End of Year	**$ 80,963,138**	$ 29,337,008
Reconciliation of Operating Loss to Net Cash Applied to Operating Activities:		
Operating loss	**$ (75,888,530)**	$ (60,922,632)
Adjustments to reconcile operating loss to net cash applied to operating activities:		
Depreciation	**9,973,768**	9,999,987
Bad debts	**542,474**	796,980
OPEB activity	**(34,527,750)**	376,643
Changes in assets and liabilities:		
Accounts receivable	**1,745,117**	(708,867)
Other assets	**(485,221)**	833,085
Notes receivable	**209,664**	696,442
Accounts payable and accrued liabilities	**3,018,680**	(559,225)
Unearned revenues, deposits and refundable grants	**1,413,209**	(2,205,058)
Post-employment benefit obligations	**43,946,938**	5,054,004
Net Cash Applied to Operating Activities	**$ (50,051,651)**	$ (46,638,641)
Non-Cash Transactions:		
Unrealized gains (losses)	**$ 5,916,894**	$ (1,119,070)
Donation of stock	**$ 952,750**	$ 403,259
Net gain on disposal of capital assets	**$ 168,339**	$ -

The accompanying notes are an integral part of these financial statements.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements

June 30, 2021 and 2020

Note 1 - **Summary of Significant Accounting Policies**

Organization
Vermont State Colleges include the following entities: System Office and Services, Community College of Vermont ("CCV"), Castleton University ("CU"), Northern Vermont University ("NVU"), Vermont Technical College ("VTC"), Vermont Manufacturing Extension Center ("VMEC"), Small Business Development Center ("SBDC"), and Vermont Tech Office of Continuing Education and Workforce Development ("TED").

On March 11, 2020, the World Health Organization declared the global outbreak of the novel coronavirus (COVID-19) as a pandemic. During the year ended June 30, 2021, COVID-19 had a significant effect on the College's operations in response to government requirements and observing safety measures. As a result, the College's housing's maximum capacity decreased significantly in the 2020-2021 academic year.

In response to the pandemic, the Federal government provided to the College Higher Education Emergency Relief Funds (HEERF) and funds for the Strengthening Institution Program (SIP) under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, Coronavirus Response and Relief Supplemental Appropriations Act (CRRSAA), and American Rescue Plan Act (ARPA). The HEERF consisted of the student aid award and the institutional award. Each Act requires a minimum amount to be spent on student aid.

The student aid award is required to be distributed to students as emergency grants for their expenses related to the disruption of campus operations due to coronavirus. The institutional award and the SIP can be used to cover any costs associated with significant changes to the delivery of instruction. Unless an extension is approved by the Department of Education, the student aid award and the institutional award and SIP funding must be spent by May 2022.
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VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

The Colleges have been awarded the following HEERF and SIP funds as of June 30, 2021:

	Student Aid Award	Institutional Award	Strengthening Institution Program	Total
CARES	$ 3,070,616	$ 3,070,616	$ 302,823	$ 6,444,055
CRRSAA	3,070,616	9,914,094	542,363	13,527,073
ARPA	11,630,099	10,880,450	834,626	23,345,175
Total	$ 17,771,331	$ 23,865,160	$ 1,679,812	$ 43,316,303

The College have recognized the following funds as non-operating Federal grants for the years ended June 30, 2021, and 2020:

For the Year Ended June 30, 2021	Student Aid Award	Institutional Award	Strengthening Institution Program	Total
CARES	$ 421,170	$ 421,170	$ 74,672	$ 917,012
CRRSAA	3,070,616	9,093,217	542,363	12,706,196
ARPA	-	-	-	-
Total	$ 3,491,786	$ 9,514,387	$ 617,035	$ 13,623,208

For the Year Ended June 30, 2020	Student Aid Award	Institutional Award	Strengthening Institution Program	Total
CARES	$ 2,649,446	$ 2,649,446	$ 228,151	$ 5,527,043
CRRSAA	-	-	-	-
ARPA	-	-	-	-
Total	$ 2,649,446	$ 2,649,446	$ 228,151	$ 5,527,043

The CARES act also created the Coronavirus Relief Fund ("CRF") which was awarded to the State. As of June 30, 2021, the State has allocated at total of approximately $26,900,000 to the Colleges for expenses incurred due to the public health emergency with respect to the coronavirus. During the fiscal years ended June 30, 2021 and 2020, the Colleges expended $15,679,159 and $6,575,165 and recognized $15,679,159 and $6,575,165, respectively in non-operating Federal grants revenue. The remaining unexpended balance of $4,655,455 and $5,940,335 is included in unearned income and deposits in the statement of net position as of June 30, 2021 and 2020, respectively. The Colleges must expend this award by December 30, 2021.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

The accounting policies and procedures used by the Vermont State Colleges ("VSC" or the "Colleges") in accounting for, and reporting, its financial transactions are based on the accrual method of accounting. The significant accounting policies followed by the Colleges are described below.

Basis of Presentation

The accompanying financial statements have been prepared using the economic resources measurement focus and the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America, as prescribed by the Governmental Accounting Standards Board ("GASB").

Revenues are recorded when earned, and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements have been met. The accompanying statements of revenues, expenses and changes in net position demonstrate the degree to which the direct expenses of a given function are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function. Program revenues primarily include charges to students or others who enroll or directly benefit from services that are provided by a particular function. Items not meeting the definition of program revenues are reported as general revenue.

The Colleges have determined that they function as a business-type activity, as defined by GASB. The effect of interfund activity has been eliminated from these financial statements. The basic financial statements and required supplementary information for general-purpose governments consist of management's discussion and analysis, basic financial statements and required supplementary information. The Colleges present the statements of net position, revenues, expenses and changes in net position, and cash flows on a combined College-wide basis.

The Colleges' policy is to define operating activities in the statements of revenues, expenses and changes in net position as those that generally result from exchange transactions such as charges for services provided to students and for the purchase of goods and services. Certain other transactions are reported as non-operating activities. These non-operating activities include the Colleges' operating appropriations from the State, net investment income, gifts, certain grants, and interest expense.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

Net Position
GASB Statement No. 34 requires that resources be classified for accounting purposes into the following four net position categories:

Net investment in capital assets: Capital assets, net of accumulated depreciation and of outstanding principal balances of debt attributable to the acquisition, construction, repair or improvement of those assets.

Restricted - nonexpendable: Net position subject to externally imposed conditions that VSC must maintain in perpetuity.

Restricted - expendable: Net position that is subject to externally imposed conditions that can be fulfilled by the actions of the Colleges or by the passage of time.

Unrestricted: All other categories of net position. Unrestricted net position may be designated by actions of the Colleges' Board of Trustees (the "Board").

In accordance with VSC's policy pertaining to the expenditure of restricted dollars, unrestricted dollars are spent first, followed by restricted dollars, if appropriate.

Cash and Equivalents
The Colleges consider all highly liquid debt instruments purchased with an original maturity date of three months or less to be cash equivalents.

Restricted Cash and Equivalents
The Colleges restricted cash consists of CRF funds that were funded to the Colleges from the State but were not expended as of the years ending June 30, 2021 and 2020. Funds are restricted as they must be used to cover expenses that were incurred due to the COVID-19 pandemic.

Allowance for Doubtful Accounts
Provisions for losses on receivables are determined on the basis of loss experience, known and inherent risks, and current economic conditions.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

Capital Assets
Real estate assets, including improvements, are generally stated at cost. Furnishings and equipment are stated at cost as of date of acquisition or, in the case of gifts, at fair value as of the date of donation. In accordance with the Board's capitalization policy, vehicles, equipment and works of art and historical treasures with a unit cost of at least $5,000 are capitalized. Land, building, leasehold and infrastructure improvements with a unit cost of $50,000 or more are capitalized. Software with a unit cost of $500,000 or more is capitalized. Interest cost on debt related to capital assets is capitalized during the construction period and then depreciated over the life of the project. The Colleges' capital assets, with the exception of land and construction in progress, are depreciated on a straight-line basis over their estimated useful lives, which range from 3 to 50 years. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend asset lives are not capitalized.

Restricted - expendable net position includes certain capital funds appropriated by the State of Vermont to the Vermont Department of Buildings and General Services for the benefit of VSC and unexpended as of fiscal year-end.

Investments
Investments are stated at fair value. Investment securities are exposed to various risks, such as interest rate, market and credit risks. Due to the level of risk associated with certain investment securities, it is possible that changes in the values of the investment securities will occur and that such changes could materially affect the amounts reported in the statements of net position.

Other Significant Accounting Policies
The Colleges' employees are granted vacation and sick leave in varying amounts. In the event of termination, an employee is paid for those accumulated vacation days allowable in accordance with the applicable union contract in force or in the case of non-union personnel, according to the State or Colleges' policy.

Amounts of vested and accumulated vacation leave are reported as accrued compensation and benefits. Amounts are determined based upon the personal service rates in effect as of the balance sheet date. No liability is recorded for non-vesting accumulating rights to receive vacation benefits.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

Refundable Grants
Refundable grants are refundable to the federal government for Federal Perkins and Nursing Student loans.

The Federal Perkins Loan Program Extension Act of 2015 (the "Extension Act"), enacted on December 18, 2015, extended the Perkins Loan Program through September 30, 2017. The Extension Act states that new Perkins Loans cannot be disbursed to students after September 30, 2017. No further extensions were granted for the program as of the date of these financial statements.

Unearned Revenue and Deposits
Deposits and advance payments received for tuition and fees related to certain summer programs and tuition received for the following academic year are reported as unearned revenues.

Student Fees
Student tuition and fees are presented net of scholarships and fellowships applied to students' accounts. Certain other scholarship amounts are paid directly to, or refunded to students, and they are reflected as expenses.

Bond and Note Premiums
Bond and note underwriters' premiums are amortized on the straight-line basis over the life of the respective bond. VSC incurred bond premiums related to the 2013, 2017, and 2020 bonds at the time of the issuance of the bonds. The bond premium for the 2013 bond of $1,898,889 is amortized over 20 years. The bond premium for the 2017 bond of $10,557,129 is amortized over 20.5 years. The bond premium for the 2020 bond of $4,538,755 is amortized over 21.7 years. Cumulative amortization of the bond premium totaled $3,218,862 and $2,385,408 as of June 30, 2021 and 2020, respectively. Cumulative unamortized balances of bond premiums totaled $13,775,911 and $14,609,365 as of June 30, 2021 and 2020, respectively. The bond premiums are included in bonds and notes payable.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

Post-employment Benefits Other Than Pensions ("OPEB")
GASB Statement No. 75, *Accounting and Financial Reporting for Post-employment Benefits Other than Pensions* ("GASB 75"), require governments to account for other post-employment benefits ("OPEB"), primarily healthcare, on an accrual basis rather than on a pay-as-you-go basis. The effect is the total OPEB liability is to be measured as the present value of projected benefit payments to be provided to current active and inactive employees that is attributed to those employees' past periods of service. The Statement requires that the actuarial present value of projected benefit payments be attributed to the periods of employee services using the entry age actuarial cost method with each period's service cost determined as a level percentage of pay.

Income Taxes
The Internal Revenue Service has determined that the Colleges are a wholly owned instrumentality of the State of Vermont, and as such are generally exempt from federal income tax. However, the Colleges are subject to federal income tax on unrelated business income.

Grants
The Colleges receive financial assistance from federal and state agencies in the form of grants and entitlements. Expenditures of funds under these programs require compliance with the grant agreements and are subject to audit by the granting agency.

Use of Estimates in Financial Statement Preparation
The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions about future events. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Management evaluates the estimates and assumptions on an ongoing basis using historical experience and other factors that management believes to be reasonable under the circumstances. Adjustments to estimates and assumptions are made as facts and circumstances require. As future events and their effects cannot be determined with certainty, actual results may differ from the estimates used in preparing the accompanying financial statements. Significant estimates and assumptions are required as part of estimating an allowance for doubtful accounts, depreciation, net position classification, self-funded health insurance accrual, and determining the other post-employment benefits liability.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

Adoption of New Accounting Pronouncements
The Colleges adopted GASB Statement 84 – *Fiduciary Activities* and the certain component unit criteria portion of GASB 97, *Certain Component Unit Criteria, and Accounting and Financial Reporting for Internal Revenue Code Section 457, Deferred Compensation Plans*. The objective of these statements is to establish criteria for identifying and reporting of fiduciary activities. The implementation of these statements did not have a material effect on the financial statements.

New Governmental Accounting Pronouncements
GASB Statement 87 – *Leases* is effective for periods beginning after June 15, 2021. Implementation of this standard will require lessees to recognize on their statement of net position the rights and obligations resulting from leases categorized as operating leases as assets, liabilities, or deferred inflows / outflows of resources. It provides for an election on leases with terms of less than twelve months to be excluded from this Statement.

GASB Statement 89 – *Accounting for Interest Costs Incurred before the End of a Construction Period* is effective for reporting periods beginning after December 15, 2021. The objectives of this Statement are (1) to enhance the relevance and comparability of information about capital assets and the cost of borrowing for a reporting period and (2) to simplify accounting for interest cost incurred before the end of a construction period.

GASB Statement 91 – *Conduit Debt Obligations* is effective for reporting periods beginning after December 15, 2021. The objective of this Statement is to improve the consistency of reporting conduit debt. This Statement requires government entities that issue conduit debt, but are not the obligors, not to recognize the liability unless it is more likely than not that the government issuer will service the debt.

GASB Statement 92 – *Omnibus 2020* is effective for reporting periods beginning after June 15, 2021. The objective of this Statement is to improve comparability in financial reporting for leases, pensions, OPEB, and asset retirement obligations.

GASB Statement 94 – *Public-Private and Public-Private Partnerships and Availability Payment Arrangements* is effective for reporting periods beginning after June 15, 2022. The objective of this Statement is to provide accounting and financial reporting guidance for arrangements in which the governmental entity (the transferor) contracts with an operator to provide public services by conveying control of the right to operate or use a nonfinancial asset.

VERMONT STATE COLLEGES
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Notes to the Financial Statements - Continued

June 30, 2021 and 2020

GASB Statement 96 – *Subscription-Based Information Technology Arrangements (SBITA)* is effective for reporting periods beginning after June 15, 2022. The objective of this Statement is to provide accounting and financial reporting guidance for transactions in which a governmental entity contracts with another party for the right to use their software. A right-of-use asset and a corresponding liability would be recognized for SBITAs.

GASB Statement 97 – *Accounting and Financial Reporting for Internal Revenue Code Section 457, Deferred Compensation Plans* is effective for reporting periods beginning after June 15, 2021. The objective of this Statement is to provide financial reporting consistency in which the potential component unit does not have a governing board and the primary government performs the duties that a governing board would perform. In the absences of a governing board of the potential component unit, the situation should be treated as the same as the primary government appointing a majority of the potential component unit's governing board. Management has not completed its review of the requirements of these standards and its applicability.

Management is in the process of evaluating these pronouncements and has not yet determined their impact on the financial statements.

Reclassifications
Certain amounts on the 2020 financial statements have been reclassified to conform to the 2021 presentation.

Note 2 - **Cash and Equivalents, and Investments**

Cash and Equivalents
Cash and equivalents with maturities of 90 days or less from purchase date are recorded at cost, which approximates market value.

In operating a central treasury and investment pool, individual college cash receipts (except the federal loan funds) are deposited in separate collection deposit accounts in the name of VSC. Disbursements are made from other bank accounts that are funded by transfers from the central treasury.

VERMONT STATE COLLEGES
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Notes to the Financial Statements - Continued

June 30, 2021 and 2020

In accordance with the Uniform Prudent Management of Institutional Funds Act, VSC deems all realized and unrealized gains on permanently restricted investments to be temporarily restricted if the income is restricted by the donor. Absent donor restrictions, the Board of Trustees has adopted a spending policy whereby 5% of the lesser of the current market value of investments or the average portfolio value over the last three years is allowed to be drawn down and allocated to operations.

Cash and equivalents included with non-current assets are restricted primarily for specific programs or to be used to pay for capital construction projects.

At June 30, 2021, the balance of current assets - cash and equivalents and restricted cash and equivalents, consists of approximately $14,300 in petty cash, and the remainder deposited in Federal Deposit Insurance Corporation ("FDIC") insured banking institutions of approximately $80,012,000 per the accounting records of the Colleges, and approximately $81,529,000 per bank records. Of the bank balances, approximately $628,000 was covered by federal depository insurance and approximately $80,901,000 was uninsured and uncollateralized at June 30, 2021.

At June 30, 2021, the balances of non-current assets - cash and equivalents deposited in FDIC insured banking institutions were approximately $937,000 per the accounting records of the Colleges, and approximately $936,000 per bank records. Of the bank balances, approximately $265,000 was covered by federal depository insurance and approximately $671,000 was uninsured and uncollateralized at June 30, 2021.

At June 30, 2020, the balance of current assets - cash and equivalents and restricted cash and equivalents, consists of approximately $15,000 in petty cash, and the remainder deposited in Federal Deposit Insurance Corporation ("FDIC") insured banking institutions of approximately $28,358,000 per the accounting records of the Colleges, and approximately $29,478,000 per bank records. Of the bank balances, approximately $1,191,000 was covered by federal depository insurance and approximately $28,287,000 was uninsured and uncollateralized at June 30, 2020.

At June 30, 2020, the balances of non-current assets - cash and equivalents deposited in FDIC insured banking institutions were approximately $964,000 per the accounting records of the Colleges, and approximately $959,000 per bank records. Of the bank balances, approximately $250,000 was covered by federal depository insurance and approximately $709,000 was uninsured and uncollateralized at June 30, 2020.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

Investments
Investments of the various funds at June 30, 2021 are as follows:

	Fair Value	Cost
U.S. Government bonds	**$ 6,438,074**	**$ 6,078,575**
Corporate bonds	**6,208,330**	**5,890,960**
Common stock and ETF's	**18,645,031**	**11,865,354**
Hedge fund shares	**4,038,558**	**3,906,602**
Mutual funds	**9,998,621**	**8,512,329**
Money market	**9,575,642**	**9,575,642**
Held by bond trustee	**1,068,825**	**1,068,825**
Total Investments	**$ 55,973,081**	**$ 46,898,287**

Investments of the various funds at June 30, 2020 are as follows:

	Fair Value	Cost
U.S. Government bonds	$ 8,760,041	$ 8,277,343
Corporate bonds	8,006,904	7,614,131
Common stock and ETF's	13,072,630	12,538,585
Hedge fund shares	3,379,757	3,601,384
Mutual funds	9,652,272	8,795,025
Money market	5,220,081	5,220,081
Held by bond trustee	1,061,784	1,061,784
Total Investments	$ 49,153,469	$ 47,108,333

Investment maturities include deposits held by the bond trustee, which are invested in various government securities, corporate bonds, commercial grade paper, and money market accounts. The majority of these funds are related to the 2013 bond, and they are held in the bond fund, the reserve fund, and the construction fund. Within the bond fund, there is a principal account, an interest account, and a sinking fund account.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

2021
Investment Maturities (in years)

Investment Type	**Market Value**	**Less than 1**	**1-5**	**6-10**	**More than 10**
Money Market Investments	**$ 9,575,642**	**$ 9,575,642**	**$ -**	**$ -**	**$ -**
Corporate Bonds	**6,208,330**	**1,428,430**	**4,050,902**	**728,998**	**-**
U.S. Govt. Bonds	**6,438,074**	**1,465,385**	**3,771,343**	**1,201,346**	**-**
Total	**$ 22,222,046**	**$ 12,469,457**	**$ 7,822,245**	**$ 1,930,344**	**$ -**
Other Investments					
Common Stock and Mutual Funds	**32,682,210**				
Held by Bond Trustee	**1,068,825**				
Total	**$ 55,973,081**				

2020
Investment Maturities (in years)

Investment Type	Market Value	Less than 1	1-5	6-10	More than 10
Money Market Investments	$ 5,220,081	$ 5,220,081	$ -	$ -	$ -
Corporate Bonds	8,006,904	867,411	4,745,585	2,393,908	-
U.S. Govt. Bonds	8,760,041	2,017,689	5,396,665	1,345,687	-
Total	$ 21,987,026	$ 8,105,181	$ 10,142,250	$ 3,739,595	$ -
Other Investments					
Common Stock and Mutual Funds	26,104,659				
Held by Bond Trustee	1,061,784				
Total	$ 49,153,469				

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Realized gain (loss) is included as a component of investment income. The calculation of realized gains (losses) is independent of the calculation of the net increase (decrease) in the fair value of investments. Realized gains and losses on investments that had been held in more than one fiscal year and sold in the current year may have been recognized as an increase or decrease in the fair value of investments reported in the prior year.

Investment income for the years ended June 30, is as follows:

	2021	2020
Interest and dividend income	**$ 636,663**	$ 1,259,821
Net realized and unrealized gain (loss)	**6,474,107**	242,286
Total investment income	**7,110,770**	1,502,107
Less: management fees	**(195,146)**	(179,362)
Investment income, net	**$ 6,915,624**	$ 1,322,745

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The risk categories for the bond fund holdings held by VSC at June 30, are as follows:

Investment rating*	**2021**	2020
AAA	**$ 6,684,425**	$ 9,013,298
AA+	**77,674**	168,394
AA	**1,431,306**	1,447,534
AA-	**4,133**	8,571
A+	**643,895**	921,686
A	**1,951,764**	2,073,619
A-	**772,682**	1,721,591
BBB+	**847,204**	1,061,009
BBB	**233,321**	153,931
BBB-	**-**	-
BB+	**-**	-
BB	**-**	-
BB-	**-**	-
B+	**-**	-
B	**-**	-
B-	**-**	-
CCC+	**-**	-
Unrated	**9,575,642**	5,417,393
	$ 22,222,046	$ 21,987,026

*These ratings are determined by Standard & Poor's, a division of The McGraw-Hill Companies, Inc. All ratings represent the opinions of the research provider and are disclaimed as not representations or guarantees of performance.

The applicable risk ratings as defined by Standard & Poor's are as follows:

AAA - An obligation rated 'AAA' has an extremely strong capacity to meet its financial commitments. It is the highest rating given to an obligor.

AA - An obligation rated 'AA' differs from the highest rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.

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A - An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.

BBB - An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.

BB - An obligation rated 'BB' is less vulnerable to non-payment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.

B - An obligation rated 'B' is more vulnerable to non-payment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.

CCC - An obligation rated 'CCC' is currently vulnerable to non-payment and is dependent upon favorable business, financial and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.

Plus (+) or minus (-): The ratings from 'AAA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

Fair Value Hierarchy
The fair value hierarchy categorizes inputs to valuation techniques used to measure fair value into three levels. Level 1 inputs are quoted market prices for identical assets or liabilities in active markets that a government can access at the measurement date. Level 2 inputs are inputs, other than quoted prices included within Level 1, that are observable for an asset or liability, directly or indirectly. Level 3 inputs are unobservable inputs. The highest priority is assigned to Level 1 inputs and the lowest to Level 3 inputs. If the fair value is measured using inputs from more than one level of the hierarchy, the measurement is considered to be based on the lowest priority input level that is significant to the entire measurement. Valuation techniques used

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should maximize the use of the observable inputs and minimize the use of unobservable inputs.

The asset's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. The following is a description of the valuation methodologies used for assets at fair value on a recurring basis.

U.S. Government Bonds: Valued at the current available closing price reported or based on values obtained on comparable securities of issuers with similar credit ratings.

Corporate Bonds: Valued at the current available closing price reported or based on values obtained on comparable securities of issuers with similar credit ratings.

Common Stock and Exchange Traded Funds ("ETF"): Value based on quoted prices in active markets of similar instruments.

Hedge Fund Shares: Hedge fund shares held by the Colleges are closed-end hedge funds that are registered with the SEC. The fair values of the investments in this class have been estimated using the net asset value ("NAV") per share of the investments. The hedge fund shares held by the Colleges have redemption periods under 90 days and are considered redeemable in the near term. Hedge funds shares may at times, not be redeemable subject to the business judgement of the hedge funds board of directors.

Mutual funds: Valued at daily closing price as reported by the fund. Mutual funds held by the Colleges are open-end mutual funds that are registered with the SEC. These funds are required to publish their daily net asset value ("NAV") and to transact at that price. The mutual funds held by the Colleges are deemed to be actively traded.

Money market: Value based on quoted prices in active markets of similar instruments.

Held by bond trustee: Valued at the current available closing price reported or based on values obtained on comparable securities of issuers with similar credit ratings.

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The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the Colleges believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The following tables set forth by level, within the fair value hierarchy, the fair value of the Colleges assets measured on a recurring basis:

Assets at Fair Value as of June 30, 2021

	Level 1	**Level 2**	**Level 3**	**Total**
U.S. Government bonds	**$ 6,438,074**	**$ -**	**$ -**	**$ 6,438,074**
Corporate bonds	**-**	**6,208,330**	**-**	**6,208,330**
Common stock and ETF's	**18,645,031**	**-**	**-**	**18,645,031**
Hedge fund shares	**-**	**4,038,558**	**-**	**4,038,558**
Mutual funds	**9,998,621**	**-**	**-**	**9,998,621**
Money market	**9,575,642**	**-**	**-**	**9,575,642**
Held by bond trustee	**1,068,825**	**-**	**-**	**1,068,825**
Total Assets at Fair Value	**$ 45,726,193**	**$ 10,246,888**	**$ -**	**$ 55,973,081**

Assets at Fair Value as of June 30, 2020

	Level 1	Level 2	Level 3	Total
U.S. Government bonds	$ 8,760,041	$ -	$ -	$ 8,760,041
Corporate bonds	-	8,006,904	-	8,006,904
Common stock and ETF's	13,072,630	-	-	13,072,630
Hedge fund shares	-	3,379,757	-	3,379,757
Mutual funds	9,652,272	-	-	9,652,272
Money market	5,220,081	-	-	5,220,081
Held by bond trustee	1,061,784	-	-	1,061,784
Total Assets at Fair Value	$ 37,766,808	$ 11,386,661	$ -	$ 49,153,469

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June 30, 2021 and 2020

Note 3 - **Accounts Receivable, Notes Receivable and Allowance for Bad Debts**

The composition of the Colleges' accounts receivable at June 30, is summarized as follows:

	2021	2020
Student accounts receivable	**$ 12,231,000**	$ 12,762,953
Grants receivable	**6,682,679**	10,107,548
Other receivable	**1,285,705**	1,816,793
Subtotal	**20,199,384**	24,687,294
Allowance for doubtful accounts	**(7,311,690)**	(7,512,563)
Total accounts receivable, net	**$ 12,887,694**	$ 17,174,731

The notes receivable balance in the statements of net position represent the Perkins notes receivable. It is shown net of an allowance for bad debts of approximately $1,205,000 and $1,253,000 at June 30, 2021 and 2020, respectively. This allowance is the aggregate that was reserved for each college based upon historical bad loan reserve requirements, the net decrease in the allowance of $48,000 and net increase of $39,000 in 2021 and 2020, respectively, has been reflected in operating expenses.

Note 4 - **Long-Term Liabilities**

Long-term liabilities consist of the following at June 30,:

	2021				
	Beginning balances	**Additions**	**Reductions**	**Ending balances**	**Current portion**
Long-term liabilities					
Bonds and notes payable	**$ 119,574,365**	**$ -**	**1,613,454**	**$ 117,960,911**	**$ 4,258,454**
Total OPEB obligation	**194,057,554**	**43,946,938**	**-**	**238,004,492**	**-**
Other liabilities	**244,435**	**142,476**	**244,435**	**142,476**	**-**
Refundable grants	**4,751,397**	**-**	**722,044**	**4,029,353**	**-**
Total long-term liabilities	**$ 318,627,751**	**$ 44,089,414**	**$ 2,579,933**	**$ 360,137,232**	**$ 4,258,454**

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	2020									
		Beginning balances		Additions		Reductions		Ending balances		Current portion
Long-term liabilities										
Bonds and notes payable	$	121,086,246	$	28,723,755		30,235,636	$	119,574,365	$	1,613,454
Total OPEB obligation		189,003,550		5,054,004		-		194,057,554		-
Other liabilities		224,866		244,435		224,866		244,435		-
Refundable grants		6,036,744		-		1,285,347		4,751,397		-
Total long-term liabilities	$	316,351,406	$	34,022,194	$	31,745,849	$	318,627,751	$	1,613,454

Bonds and Notes Payable
Outstanding debt as of June 30, is as follows:

	2021	2020
Revenue Bonds, Series 2020A: 3.0% - 5.0% serial bonds aggregating $18,990,000 maturing 2020 through 2037 and a $5,195,000 4.0% term bond due October 2040. Interest on the serial bonds is paid semi-annually on the unpaid balances. Unamortized bond premium of $4,231,897 and $4,451,736 has been added to the liability at June 30, 2021 and 2020, respectively. [1]	**$28,416,897**	$28,636,735
Revenue Bonds, Series 2017: 4.0% - 5.0% serial bonds aggregating $67,660,000 maturing 2021 through 2037 and Interest on serial bonds is paid semi-annually on the unpaid balances. Unamortized bond premium of $8,428,414 and $8,947,085 has been added to the liability at June 30, 2021 and 2020, respectively. [2]	**76,088,414**	76,607,085

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Revenue Bonds, Series 2013:		
4.0% - 5.0% serial bonds aggregating $13,715,000 maturing 2015 through 2032 and 3.125% - 5.0% term bonds aggregating $4,450,000 maturing 2027 through 2030. Interest on serial bonds is paid semi-annually on the unpaid balances. Unamortized bond premium of $1,115,600 and $1,210,545 has been added to the liability at June 30, 2021 and 2020, respectively.	**13,455,600**	14,330,545
	$ 117,960,911	$ 119,574,365

[1] In February 2020, VSC issued Revenue Bonds, Series 2020A, in the principal amount of $18,990,000 in serial bonds and $5,195,000 in term bonds. The 2020A Bonds were issued solely for the purpose of refunding the Series 2010B Bond. The Colleges entered into the bond refunding with the goal to achieve cost savings primarily through the reduction of interest expense. At the time of the issuance, the bond proceeds were put in an irrevocable trust for which the trustee would use the funds to pay off the 2010B Bond at a later date. The refunding decreased the College's total debt service by $5,409,550 and resulted in an economic gain (difference between the present value of the old and new debt service payments) of $5,352,091.

[2] On May 24, 2017, VSC issued the Vermont State Colleges System Bonds 2017 Series A, in the principal amount of $67,660,000. The 2017 Bond was issued for the purpose of (1) refinancing certain indebtedness of VSC; (2) paying the costs of issuance of the 2017 Series A Bond; and (3) paying the breakage fee for the interest rate swap agreements. The Colleges entered into the bond refunding with the goal to achieve cost savings primarily through the reduction of interest expense. The refunding increased the Colleges' total debt service by $15,163,384 and resulted in an economic gain (difference between the present value of the old and new debt service payments) of $1,051,774.

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June 30, 2021 and 2020

Debt Roll-Forward

Long-term debt activity for the years ended June 30, 2021 and 2020 was as follows:

	Balance June 30, 2020	Additions	Repayment	Balance June 30, 2021	Current Portion
Series 2013	$ 13,120,000	$ -	$ (780,000)	$ 12,340,000	$ 810,000
Series 2013 Bond Premium	1,210,545	-	(94,944)	1,115,601	94,944
Series 2013 Bonds	14,330,545	-	(874,944)	13,455,601	904,944
Series 2017	67,660,000	-	-	67,660,000	2,615,000
Series 2017 Bond Premium	8,947,085	-	(518,672)	8,428,413	518,672
Series 2017 Bonds	76,607,085	-	(518,672)	76,088,413	3,133,672
Series 2020	24,185,000	-	-	24,185,000	-
Series 2020 Bond Premium	4,451,735	-	(219,838)	4,231,897	219,839
Series 2020 Bonds	28,636,735	-	(219,838)	28,416,897	219,838
Total Bonds and Notes Payable	$ 119,574,365	$ -	$ (1,613,454)	$ 117,960,911	$ 4,258,454

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June 30, 2021 and 2020

	Balance June 30, 2019	Additions	Repayment	Balance June 30, 2020	Current Portion
Series 2010-B	$ 28,780,000	$ -	$ (28,780,000)	$ -	$ -
Series 2010 Bond Premium	-	-	-	-	-
Series 2010 Bonds	28,780,000	-	(28,780,000)	-	-
Series 2013	13,875,000	-	(755,000)	13,120,000	780,000
Series 2013 Bond Premium	1,305,489	-	(94,944)	1,210,545	94,944
Series 2013 Bonds	15,180,489	-	(849,944)	14,330,545	874,944
Series 2017	67,660,000	-	-	67,660,000	-
Series 2017 Bond Premium	9,465,757	-	(518,672)	8,947,085	518,672
Series 2013 Bonds	77,125,757	-	(518,672)	76,607,085	518,672
Series 2020	-	24,185,000	-	24,185,000	-
Series 2020 Bond Premium	-	4,538,755	(87,020)	4,451,735	219,838
Series 2020 Bonds	-	28,723,755	(87,020)	28,636,735	219,838
Total Bonds and Notes Payable	$ 121,086,246	$ 28,723,755	$ (30,235,636)	$ 119,574,365	$ 1,613,454

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Notes to the Financial Statements - Continued

June 30, 2021 and 2020

Maturities of long-term debt for the next five fiscal years and thereafter are as follows:

Years Ending June 30,	Principal Amount	Interest Amount
2022	$ 3,425,000	$ 4,537,426
2023	3,595,000	5,380,026
2024	3,915,000	5,200,926
2025	5,355,000	5,001,476
2026	5,345,000	4,704,766
2027-2031	30,180,000	16,249,103
2032-2036	33,115,000	6,890,107
2037-2041	19,255,000	1,384,276
	$ 104,185,000	$ 49,348,106

Deferred loss on debt refunding is included in interest expense.

According to the terms of the agreements under which the revenue bonds were sold, the bonds are general obligations of VSC. The 2013 Revenue Bond is also collateralized by deposits held by the trustee in the Bond Fund. VSC is required to make payments to the trustee for deposit into the Bond Fund sufficient to pay the principal and interest fund requirements, when due.

Note 5 - **Deferred Outflows of Resources - Debt Refunding**

During 2017, VSC paid a breakage fee of $10,931,885 to discontinue all of its interest rate swap agreements. The breakage fee is recorded on the statements of net position as a "deferred loss on debt refunding" and is amortized over the life of the old debt it was associated with and is included with interest expense. The amortization of the breakage fee that was included in interest expense was $1,003,346 for the years ended June 30, 2021 and 2020. The unamortized balance of the breakage fee was $6,813,988 and $7,817,334 for years ended June 30, 2021 and 2020.

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During 2020, VSC issued the 2020A Series Bond which was an advanced refunding of the 2010B Bond. As stated in the advanced refunding agreement, the proceeds from the issuance of the 2020A Bond was to be placed in an irrevocable trust and will be used to pay off the 2010B Bond. The difference between the amount in placed in escrow to pay off the 2010B Bond and the net carrying amount of the 2010 Bond was $764,156 and is recognized as a "deferred loss on debt refunding", and is amortized over the life of the old debt it was associated with and is included with interest expense. The amortization of this advanced debt refunding that was included in interest expense was $40,923 and $11,284 for the year ending June 30, 2021 and 2020. The unamortized balance of the advanced debt refunding was $711,859 and $752,872 for years ended June 30, 2021 and 2020.

Note 6 - **Functional Expense Classification**

The following table details VSC’s operating expenses by functional expense classification as of June 30,:

	2021	2020
Instruction	**$ 52,604,295**	$ 53,644,471
Research	**17,395**	17,601
Public Service	**10,145,080**	9,115,632
Academic Support	**20,401,988**	22,024,412
Student Services	**33,286,109**	37,725,010
Institution Support	**42,871,394**	36,537,599
Physical Plant	**8,237,269**	4,713,801
Student Financial Support	**11,080,703**	8,845,326
Depreciation	**9,973,768**	9,999,987
	$ 188,618,001	$ 182,623,839

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Note 7 - **Appropriations**

VSC's operating appropriation from the State of Vermont is made directly to the Colleges and is drawn down on the basis of a monthly allotment. In addition to their operating appropriation, the Colleges received an additional $28,800,000 in bridge funding in fiscal year 2021 to address the structural deficit of the Colleges. Also included in the annual State appropriation for operations is funding for Allied Health of approximately $1,158,000 in fiscal years 2021 and 2020; VMEC of approximately $428,000 in fiscal year 2021 and 2020.

Capital appropriations for VSC made from the State Bond Funds were approximately $2,000,000 and $2,100,000 in fiscal years 2021 and 2020, respectively.

Note 8 - **Retirement Plans**

Eligible faculty and staff participate in a defined contribution retirement plan administered by Teachers Insurance Annuity Association and College Retirement Equities Fund ("TIAA-CREF"). For the years ended June 30, 2021 and 2020, the Colleges' total payroll expense was approximately $73,287,000 and $77,864,000, respectively, of which approximately $50,728,000 and $52,809,000 represented salaries and wages of employees covered under the defined contribution plan, respectively. The Colleges' requirements to contribute to the retirement plan are specified by four collective bargaining agreements and by personnel policies for non-represented employees. Employer contribution rates are established by employee category. There are no required employee contributions to the plan. Depending upon the position category, employees may be eligible for the plan from as early as date of hire to as long as two years from date of hire. All eligible employees are vested from the date of eligibility. During the years ended June 30, 2021 and 2020, contributions made by the Colleges under this plan totaled approximately $4,681,000 and $4,926,000, or approximately 9.23% and 9.33%, of covered salaries, respectively. The defined contribution plan is not a fiduciary activity since the Met does not hold the assets nor has the ability to direct the use, exchange or deployment of the assets.

Additionally, certain employees participate in one of two defined benefit plans (Vermont Employees Retirement System or Vermont State Teachers Retirement System). Employees who were participants in either of these plans prior to their employment by the Colleges are allowed to continue participation. During the years ended June 30, 2021 and 2020, there were no covered salaries for employees participating in the Vermont Employees Retirement System and there were no

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employer contributions. There were no contributions to the Vermont State Teachers Retirement System during 2021 and 2020.

In addition, full-time faculty employees who have worked for the Colleges for 15 years may elect early retirement at age 58 and receive 50% of their annual salary as of their retirement date. In addition, VSC will pay 12% of the retiree's early retirement wages to the individual. This 12% payment represents VSC's contribution, which would have been made to the individual TIAA/CREF pension account. The payments due under this program are funded by VSC, as needed. During the years ended June 30, 2021 and 2020, contributions for these benefits were approximately $780,000 and $826,000, respectively.

The early retirement benefit is no longer being offered to faculty employees hired after February 10, 2005, but those employees who were eligible for early retirement before the benefit was discontinued have the option of electing for early retirement in October of every year. The benefit will be completely phased out when those employees currently eligible for early retirement either elect for early retirement or reach the age of 65.

Note 9 - **Post-Employment Benefits Other Than Pension**

Plan Description: VSC administers a self-insured single-employer defined benefit healthcare plan. The plan provides 100% of the lifetime healthcare payments for eligible employees, spouses or civil union partners. The self-insured plan, administered by CIGNA, covers both active and retired members. Benefit provisions are established through negotiations between VSC and the unions representing VSC employees, and they are reviewed during the bargaining period prior to the termination date of each union contract. The retiree healthcare plan does not issue a publicly available financial report. Employees hired after October 1, 2012 (fulltime faculty after October 1, 2015) are ineligible for retiree medical and dental benefits. The type of employees that were covered by the benefits terms at June 30,:

	2021	2020
Retirees and Beneficiaries	**721**	700
Inactive, Non-retired members	**-**	-
Active plan members	**860**	917
Total plan members	**1,581**	1,617

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Funding Policy: Contribution requirements are also negotiated between VSC and union representatives. VSC contributes 100% of the current-year utilization costs for eligible employees, spouses or civil union partners. For the fiscal years 2021 and 2020, VSC recognized employer contributions of $7,306,213 and $6,986,981, respectively, for both healthcare and early retirement. The plan is financed on a pay-as-you-go basis. In fiscal years 2021 and 2020, there were minimal member contributions to the plan from new retirees hired before July 1, 2000. No assets are accumulated in a trust that meets the criteria in paragraph 4 of Statement 75.

Annual OPEB Cost and Total OPEB Obligation: VSC's OPEB cost (expense) includes most changes in the total OPEB liability. The effects of changes, such as service costs and interest on the total OPEB liability, must be reported in the current reporting period as an OPEB expense. The effects of changes, such as the change in actuarial assumptions and differences between expected and actual experiences, are required to be included in OPEB expense over the current and future periods. Such changes must be amortized in a systematic and rational manner over a closed period equal to the average of the expected remaining service lives of all employees that are provided with benefits through the OPEB plan beginning in the current period.

At June 30, 2021 and 2020, VSC reported a total OPEB liability of $238,004,492 and $194,057,554, respectively. The total OPEB liability as of June 30, 2021, the reporting date, was measured as of June 30, 2020, the measurement date, and the actuarial valuation date of July 1, 2019, which was rolled forward from the prior measurement date of June 30, 2019. The total OPEB liability as of June 30, 2020, the reporting date, was measured as of June 30, 2019, the measurement date, and the total OPEB liability was determined by an actuarial valuation date as of July 1, 2019.

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The following table shows the components of VSC's annual OPEB costs for the year ended June 30, 2021 and 2020, and the changes in VSC's total OPEB obligation to the retiree healthcare plan are as follows:

	2021	2020
Interest on total OPEB obligation	**$ 6,671,317**	$ 7,194,823
Service Cost	**3,672,170**	4,532,612
Amortization of current year for difference between expected and actual experience	**991,437**	991,437
Amortization of current year for changes in plan actuarial assumptions	**5,300,477**	(301,243)
Annual OPEB cost	**16,635,401**	12,417,629
Difference between expected and actual experience to be recognized in future years	**(991,437)**	(727,905)
Difference between changes in plan actuarial assumptions to be recognized in future years	**35,199,955**	(454,099)
Benefit payments	**(6,896,981)**	(6,181,621)
Increase in total OPEB obligation	**43,946,938**	5,054,004
Total OPEB obligation - Beginning of Year	**194,057,554**	189,003,550
Total OPEB obligation - End of Year	**$ 238,004,492**	$ 194,057,554

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June 30, 2021 and 2020

Deferred Outflows of Resources related to OPEB:

VSC reported deferred outflows of resources related to OPEB from the following sources for the year ended June 30,:

Deferred Outflows of Resources	**2021**	2020
Differences between projected and actual experience	**$ 7,408,077**	$ 8,702,485
Changes in plan actual assumptions	**35,292,123**	461,711
Contributions subsequent to the measurement date	**7,306,213**	6,986,981
Total	**$ 50,006,413**	$ 16,151,177

Deferred Inflows of Resources related to OPEB:

VSC reported deferred inflows of resources related to OPEB from the following sources for the year ended June 30,:

Deferred Inflows of Resources	**2021**	2020
Differences between projected and actual experience	**$ 1,820,860**	$ 2,123,831
Changes in plan actual assumptions	**2,055,450**	2,424,993
Total	**$ 3,876,310**	$ 4,548,824

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

VSC's contributions of $7,306,213 and $6,986,981 made during fiscal year ending 2021 and 2020, respectively, subsequent to the measurement date will be recognized as a reduction of the total OPEB liability in the succeeding year. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized as increases (decreases) in pension expense as follows:

Years Ending June 30,	
2022	$ 6,291,914
2023	6,291,914
2024	6,291,914
2025	6,291,914
2026	6,324,073
2027 and after	7,332,161
	$ 38,823,890

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

Actuarial Assumptions: The total OPEB liability was determined using the following actuarial assumptions, applied to all periods included in the measurement, unless otherwise specified:

Measurement date	June 30, 2020	June 30, 2019
Inflation	2.5%	2.5%
Salary increases	3.5% per year	3.5% per year
Discount rate	2.21%	3.50%
Healthcare Cost Trend Rate	4.7%, increasing incrementally to an ultimate rate of 5.2% in 2023, then decreasing incrementally to an ultimate rate of 3.8% in 2050	4.7%, increasing incrementally to an ultimate rate of 5.2% in 2023, then decreasing incrementally to an ultimate rate of 3.8% in 2050

The discount rate was based on the Bond Buyer 20-Bond GO Index.

Future Employment: Age-related turnover rates were developed based on the experience from July 1, 2017 to July 1, 2019. These rates were used as the basis for assigning active members a probability of remaining employed until the assumed retirement age and for developing an expected future working lifetime assumption for purposes of allocating to periods the present value of total benefits to be paid. Employees less than 40 had an annual turnover rate of 8.5%, which was the same rate used in the prior measurement date. Employees less than 65 had an annual turnover rate of 3.5%, which was the same rate used in the prior measurement date.

Mortality: Life expectancies were based on the RP-2006 Table (base rates underlying RP-2014) projected to 2017 and thereafter, with MP-2019 projection scale which is published by the Retirement Plans Experience Committee of the Society of Actuaries. In the prior measurement date, the same rate was used.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

Retirement Rate: Age-related retirement rates tables were developed based on input and analysis of the current retiree population overall and the new retirees over the last five years. The age related tables assumed rates of retirement beginning at age 55.

Marital Status: Marital status of member at the calculation date was assumed to be 70% married based on current retiree population. Spousal participation was assumed to be 90% at the calculation date.

Healthcare Cost Trend Rate: Dental claims are expected to increase at 2.0 per annum. Medical trend rates are based on the Society of Actuaries ("SOA") Long-Run Medical Cost Trend Model.

Sensitivity of the Colleges' proportionate share of the total OPEB liability to changes in the discount rate: The following presents the Colleges' proportionate share of the total OPEB liability, as well as what the Colleges' proportionate share of the total OPEB liability would be if it were calculated using a discount rate that is 1-percentage-point lower or 1-percentage-point higher than the current discount rate:

2021

1.00% Decrease 1.21%	**Current Discount Rate 2.21%**	**1.00% Increase 3.21%**
$ 281,487,793	**$ 238,004,492**	**$ 204,566,933**

2020

1.00% Decrease 2.50%	Current Discount Rate 3.50%	1.00% Increase 4.50%
$ 222,043,023	$ 194,057,554	$ 171,021,205

Sensitivity of the Colleges' proportionate share of the total OPEB liability to changes in the healthcare cost trend rates: The following presents the Colleges' proportionate share of the total OPEB liability, as well as what the Colleges' proportionate share of the total OPEB liability would be if it were calculated using healthcare cost trend rates that are 1-percentage-point lower or 1-percentage-point higher than the current healthcare cost trend rates:

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

2021

1.00% Decrease	**Current Healthcare Cost Trend Rate (A)**	**1.00% Increase**
$ 203,930,702	**$ 238,004,492**	**$ 281,230,049**

2020

1.00% Decrease	Current Healthcare Cost Trend Rate (A)	1.00% Increase
$ 170,034,818	$ 194,057,554	$ 223,911,882

(A) - See page 56 for current healthcare cost trend rate.

Note 10 - **Leases**

The Colleges have various operating leases for classrooms, office space, equipment and motor vehicles. The majority of these leases have terms equal to or less than ten years and in some cases contain escalation and maintenance clauses, as well as renewal options. Total rental expense for all operating leases was approximately $3,515,000 and $3,352,000 in 2021 and 2020, respectively.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

Future minimum rental payments required under operating leases with non-cancelable terms in excess of one year at June 30, 2021 are as follows:

Years Ending June 30,	Real Estate	Vehicles and Equipment	Total
2022	$ 2,342,874	$ 379,107	$ 2,721,981
2023	1,957,502	310,616	2,268,118
2024	1,686,811	86,009	1,772,820
2025	1,189,630	41,618	1,231,248
2026	1,218,779	2,694	1,221,473
2027 and thereafter	2,388,799	-	2,388,799
	$ 10,784,395	$ 820,044	$ 11,604,439

Note 11 - **Capital Assets**

Property and equipment activity for the years ended June 30, 2021 and 2020 is summarized below:

	Balance June 30, 2020	Additions	Transfers	Retirements	Balance June 30, 2021
Land	$ 9,004,664	$ -	$ -	$ (334,316)	$ 8,670,348
Construction-in-process	2,866,436	4,180,658	(2,187,628)	-	4,859,466
Subtotal - Capital assets not depreciated	11,871,100	4,180,658	(2,187,628)	(334,316)	13,529,814
Infrastructure	41,568,376	56,634	771,866	(66,863)	42,330,013
Buildings and improvements	261,963,614	-	1,343,935	(1,976,446)	261,331,103
Leasehold improvements	4,090,271	-	-	-	4,090,271
Equipment	36,932,380	1,170,583	71,827	(131,226)	38,043,564
Subtotal - Capital assets depreciated	344,554,641	1,227,217	2,187,628	(2,174,535)	345,794,951
Less accumulated depreciation	(205,446,665)	(9,973,768)	-	839,339	(214,581,094)
Capital assets, net	$ 150,979,076	$ (4,565,893)	$ -	$ (1,669,512)	$ 144,743,671

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

	Balance June 30, 2019	Additions	Transfers	Retirements	Balance June 30, 2020
Land	$ 9,004,664	$ -	$ -	$ -	$ 9,004,664
Construction-in-process	1,604,504	3,046,796	(1,784,864)	-	2,866,436
Subtotal - Capital assets not depreciated	10,609,168	3,046,796	(1,784,864)	-	11,871,100
Infrastructure	40,998,521	197,553	372,302	-	41,568,376
Buildings and improvements	260,551,052	-	1,412,562	-	261,963,614
Leasehold improvements	4,090,271	-	-	-	4,090,271
Equipment	36,425,264	653,149	-	(146,033)	36,932,380
Subtotal - Capital assets depreciated	342,065,108	850,702	1,784,864	(146,033)	344,554,641
Less accumulated depreciation	(195,569,567)	(9,999,987)	-	122,889	(205,446,665)
Capital assets, net	$ 157,104,709	$ (6,102,489)	$ -	$ (23,144)	$ 150,979,076

Note 12 - **Contingencies and Commitments**

Contingencies

VSC participates in various federally funded programs. These programs are subject to financial and compliance audits and resolution of identified questioned costs. The amount, if any, of expenditures that may be disallowed by the granting agency cannot be determined at this time.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

VSC is also exposed to various risks of loss related to torts; theft of, damage to and destruction of assets; errors and omissions; injuries to employees; and natural disasters. VSC manages these risks through a combination of commercial insurance packages purchased in the name of VSC, and through self-insurance for medical and dental claims. VSC has entered into contracts with a third-party claims administrator, which essentially caps medical claim costs (stop-loss) at an agreed-upon level. Individual stop-loss is $200,000 of paid claims per covered member per year. Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years. Reserves for medical and dental claims are included in accrued liabilities in the amount of approximately $1,879,000 June 30, 2021 and $1,447,000 at June 30, 2020 and are based on historical data. A medical and dental claim roll-forward is presented below:

	2021	2020
Medical and dental claims reserve, beginning of year	**$ 1,447,100**	$ 2,560,000
Incurred claims	**19,682,000**	16,837,100
Payments on claims	**(19,250,000)**	(17,950,000)
Medical and dental claims reserve, end of year	**$ 1,879,100**	$ 1,447,100

VSC self-insures its workers' compensation program and is operated by a third-party claims administrator. Contributions to the plan are based on estimated payroll and rates adjusted by an experience modification factor. VSC has purchased stop-loss insurance, which is effective for individual claims over $200,000 and for aggregate claims in excess of $1,477,000 per year. VSC has obtained a letter of credit in the amount of $600,000 to be used in the event of failure to pay premiums on the stop-loss policy. This is collateralized by a certificate of deposit. A workers' compensation roll-forward is presented below:

	2021	2020
Workers' compensation reserve, beginning of year	**$ 365,000**	$ 297,000
Workers' compensation accrued during the year	**674,000**	842,000
Claims paid/reserved/claims administration	**(637,000)**	(774,000)
Workers' compensation reserve, end of year	**$ 402,000**	$ 365,000

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Financial Statements - Continued

June 30, 2021 and 2020

Commitments
VSC has entered into various construction contracts. The following commitments are ongoing projects at June 30, 2021:

Project	Expended through June 30, 2021	Committed Future Costs	Total Committed Costs of Project
VTC - Advanced Manufacturing Center-	$ 1,208,337	$ 714,320	$ 1,922,657
VTC - Axis Milling Machine	141,670	330,563	472,233
VTC - Lab Equipment	296,874	692,707	989,571
VTC - ProX SLS 6100 Printer	-	385,343	385,343
Total	$ 1,646,881	$ 2,122,933	$ 3,769,804

Employment Contracts
The Colleges have employment contracts with certain officers that expire on various dates through fiscal year 2021. The agreements provide for aggregate annual base salaries of $379,000 in fiscal year 2021, respectively, and may be terminated with cause at any time.

Service Concession Agreements
The Colleges entered into a service concession agreement with Sodexo Operations, LLC (“Sodexo”) to manage and operate its food services for VSC’s students, faculty, staff, employees and guests through June 2022; the agreement was cancelable by either party at any time. Under the agreement, Sodexo made annual contributions to VSC to be used at VSC’s discretion for food service facility enhancements. In March 2020, with the commencement of the pandemic, VSC exercised its right to the catastrophe clause of its existing contract with Sodexo. In August 2020, VSC entered into a new service concession agreement with Sodexo continuing through August 2025. The new agreement will not require annual contributions.

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REQUIRED SUPPLEMENTARY INFORMATION
(Unaudited)

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Schedule of Changes in Total OPEB Liability (Unaudited)

Year ended	June 30, 2021	June 30, 2020	June 30, 2019	June 30, 2018
Measurement date	June 30, 2020	June 30, 2019	June 30, 2018	June 30, 2017
Valuation date	July 1, 2019	July 1, 2019	July 1, 2017	July 1, 2017
Total OPEB liability				
Service Cost	$ 3,672,170	$ 4,532,612	$ 4,515,546	$ 4,359,477
Interest	6,671,317	7,194,823	6,647,387	6,185,678
Changes of benefit terms	-	-	-	-
Differences between expected and actual experience	-	263,532	(1,778,447)	12,241,959
Changes of assumptions or other inputs	40,500,432	(755,342)	(2,480,058)	666,613
Benefit payments	(6,896,981)	(6,181,621)	(6,399,026)	(6,464,225)
Net change in total OPEB liability	43,946,938	5,054,004	505,402	16,989,502
Total OPEB liability - beginning	194,057,554	189,003,550	188,498,148	171,508,646
Total OPEB liability - ending	$ 238,004,492	$ 194,057,554	$ 189,003,550	$ 188,498,148
Covered payroll	50,942,334	49,219,646	50,074,973	51,380,910
Total OPEB liability as a percentage of covered-employee payroll	467.20%	394.27%	377.44%	366.86%

Notes:

The GASB pronouncement requiring the presentation of the information on this schedule became effective for years beginning after June 15, 2017 and is intended to provide data for the most recent ten years.

See accompanying notes to the required supplementary information.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Required Supplementary Information - OPEB (Unaudited)

June 30, 2021 and 2020

Note 1 - **Change in Plan Assumptions**

Measurement date – June 30, 2020

Change in Discount Rate

The discount rate was decreased from 3.50% to 2.21%

Measurement date – June 30, 2019

Change in Discount Rate

The discount rate was decreased from 3.87% to 3.5%

Employee Turnover

Employees less than 40 had an annual turnover rate of 8.5%, an increase from the 7.5% rate used in the prior measurement date. Employees less than 65 had an annual turnover rate of 3.5%, an increase from the 2.5% used in the prior measurement date.

Mortality Rates

Mortality rates used general scale MP-2019 for males and females. In the prior measurement date, general scale MP-2017 was used.

Change in Trend on Future Costs

The healthcare trend rate decreased from 5.4% to 4.7%. The medical trend was developed using the SOA Getzen Model and noted the following economic assumptions that changed from the prior measurement date:

- Rate of Inflation was 2.5% which was decreased from 2.6%
- Rate of Growth in Real Income/GDP per capital was 1.25% which was an increase from 1.15%
- Health share of GDP resistance point was 25% which was an increase from 20%
- Year for limiting cost growth to GDP was 2050. 200 was used in the prior measurement date.

VERMONT STATE COLLEGES
(a Component Unit of the State of Vermont)

Notes to the Required Supplementary Information - OPEB (Unaudited) - Continued

June 30, 2021 and 2020

<u>Measurement date – June 30, 2018</u>

Change in Trend on Future Costs

The healthcare trend rate decreased from 5.5% to 5.4%.

Change in Discount Rate

The discount rate was increased from 3.58% to 3.87%.

<u>Measurement date – June 30, 2017</u>

Change in Discount Rate

The discount rate decreased to 3.58% based upon the change of the discount method to the discount rate of the Bond Buyer 20-Bond GO Index as of the measurement date as required by GASB Statement 74. The June 30, 2016 discount rate was calculated to be 3.75%.

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Board of Trustees of
Vermont State Colleges
Montpelier, Vermont

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Vermont State Colleges (a component unit of the State of Vermont) (the "Colleges"), which comprise the statements of net position as of June 30, 2021 and 2020, the related statements of revenues, expenses and changes in net position, and cash flows for the years then ended, and the related notes to the financial statements, which collectively comprise the Vermont State Colleges' basic financial statements and have issued our report thereon dated DATE.

Internal Control Over Financial Reporting
In planning and performing our audits of the financial statements, we considered the Vermont State Colleges' internal control over financial reporting ("internal control") as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Colleges' internal control. Accordingly, we do not express an opinion on the effectiveness of the Colleges' internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audits we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters
As part of obtaining reasonable assurance about whether the Vermont State Colleges' financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the financial statements. However, providing an opinion on compliance with those provisions was not an objective of our audits and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report
The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Certified Public Accountants
Braintree, Massachusetts

DATE

VERMONT STATE COLLEGES

MANAGEMENT LETTER

JUNE 30, 2021

VERMONT STATE COLLEGES

Management Letter

June 30, 2021

C O N T E N T S

To the Board of Trustees
Vermont State Colleges
Montpelier, Vermont

Management of the Vermont State Colleges is responsible for establishing and maintaining effective internal controls over financial reporting. In planning and performing our audit of the financial statements of Vermont State Colleges (the "Colleges") as of and for the year ended June 30, 2021, in accordance with auditing standards generally accepted in the United States of America, we considered the Colleges' internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Colleges' internal control. Accordingly, we do not express an opinion on the effectiveness of the Colleges' internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the Colleges' financial statements will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses or significant deficiencies, as defined above. However, we noted a certain matter relating to the internal control environment of the Colleges and have included that comment and recommendation within this report.

This communication is intended solely for the information and use of management, the Board of Trustees and others within the Colleges and is not intended to be, and should not be, used by anyone other than these specified parties.

Certified Public Accountants
Braintree, Massachusetts

DATE

STATUS OF PRIOR YEAR COMMENTS

Vermont State Colleges
Page 2

Perkins Loans Adjusting Entries

Prior Year Comment:

During our review of the Perkins loan reconciliations as of June 30, 2020, OCD noted that the VSC Colleges had returned Perkins Loan Program funds to the Federal Government as part of the winding down of the Perkins Loans Program. VSC has this obligation to return the Federal Government Contributions recorded as a refundable grant liability on its statement of net position. However, when payments were made in FY2020, they were improperly expensed instead of being applied against the refundable grant liability. VSC noted that these payments were expensed so that they could be easily tracked and then stated on the annual Fiscal Operations Report and Application to Participate (FISAP). However, applying the payment as an expense and not against the liability does not follow general accepted accounting principles (GAAP). OCD proposed an adjustment of approximately $1.3 million to apply payments to the refundable grant liability and reverse out the payments that were improperly expensed on their books.

Auditors Recommendation:

We recommend that VSC establish procedures to ensure Perkins Loan accounts are properly recorded according to GAAP.

Managements Response:

To prevent this same error from recurring we have clearly documented the correct recording method for the Perkins Loan transactions. This documentation has been filed with our year end close procedures. Additionally, a new System Controller is scheduled to begin work on November 16, 2020 giving the VSC the opportunity to review transaction thresholds and offer a fresh perspective on our general accounting practices. We expect this review will allow for incremental improvement in system-level controls.

Current Year Status:

We evaluated this comment and management response during the audit for the year ending June 30, 2021, and noted no additional issues.

Vermont State Colleges
Page 3

CONCLUSION

We would like to thank all of the management and staff who assisted during the course of our fieldwork. The staff was very helpful and exhibited a genuine effort and pride in their work. If we can be of any assistance in the implementation of any of the above-mentioned recommendations, please do not hesitate to call our office.

VERMONT STATE COLLEGES SYSTEM
BOARD OF TRUSTEES
RESOLUTION 2021-023

Acceptance of the FY2020 Audited Financial Statements

WHEREAS, The Vermont State Colleges has contracted with O'Connor & Drew to perform its FY2021 financial statements audit, and the auditors have delivered the draft financial statements; and

WHEREAS, The Board's Audit Committee has reviewed these materials and recommended that the Board accept them; therefore; and

WHEREAS, Federal guidance regarding the single audit has only recently been received; therefore so be it

RESOLVED, That the Board of Trustees of the Vermont State Colleges hereby accepts the FY2020 Financial Statement Audit Report by O'Connor & Drew; and be it further

RESOLVED, That O'Connor & Drew will complete the Uniform Guidance Single Audit Report and Advisory Comments as soon as practicable; and be it further

RESOLVED, That the completed Uniform Guidance Single Audit Report and Advisory Comments will be presented for review and approval by the Audit Committee of the Board of Trustees of the Vermont State Colleges at its next regularly scheduled meeting following completion of the report by O'Connor & Drew.

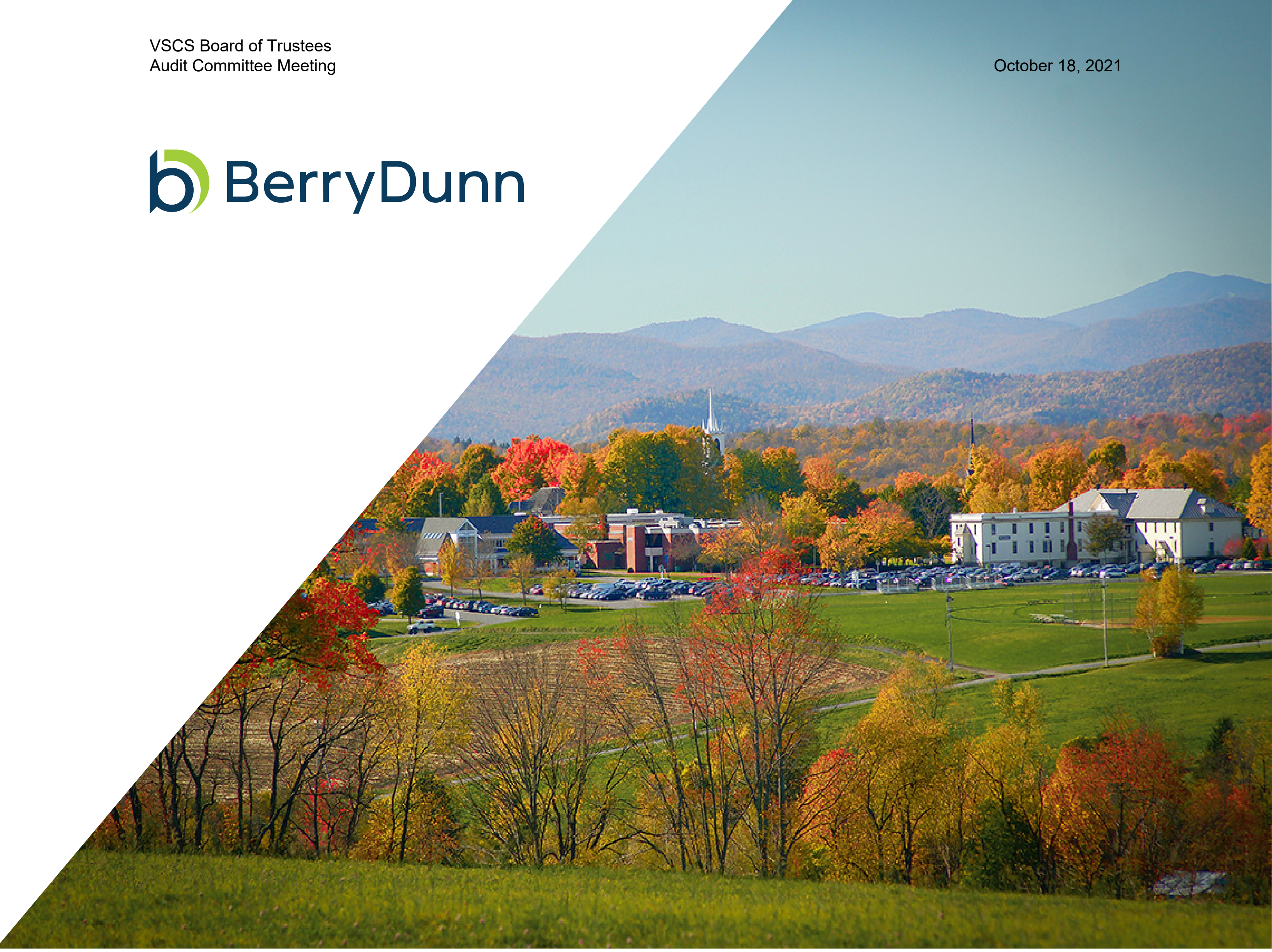
Approved: _________________, 2021

____
Lynn Dickinson, Chair of the Board of Trustees

ITEM 3:

Internal Audit Report

BerryDunn



Vermont State Colleges System

Payroll and Benefits Internal Audit

Version 3

VERMONT
STATE COLLEGES SYSTEM

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Submitted On:

June 17, 2021

berrydunn.com

Table of Contents

BerryDunn

1.0 Executive Summary

As of July 1, 2019, the Vermont State Colleges System (the System) implemented both a new payroll (UKG) and a benefits administration system (Benefits Prime). At this time, the System moved all aspects related to payroll processing, benefits administration, and retiree benefits administration from the institutions to the Office of the Chancellor. As with many projects involving this level of change, there were some initial challenges that the System needed to work through. During fiscal year 2021, the System has worked diligently to address the initial concerns over the payroll system and processes from the institution level as well as continuing to utilize enhanced functionality within the new systems.

In March 2021, BerryDunn was engaged by the System to provide internal audit services of payroll and benefits administration and to prepare documentation of system-wide payroll and benefits processes. Our work included reviewing existing policies, procedures, and individual campus system memos. We also performed formal interviews with key individuals within the Office of the Chancellor and the five institutions. Based on the understanding we obtained through our reviews and inquiries, we designed testing related to newly and terminated employees, employee rates, administration of benefits, reporting, and overall internal controls over the payroll function. This work enabled BerryDunn to identify opportunities for improvement to strength internal controls and improve process efficiency. The details of the specific opportunities for improvement are found in Section 5.0 of this report.

BerryDunn identified the following key themes which summarize the results of our internal audit work:

- **Reviews and Approvals** – Implement documented reviews and approvals over the data entered into the UKG system (payroll system) and time reporting in order to validate that the data entered is accurate and appropriate. This will require adding reporting and view-only capabilities in UKG for specific individuals. This will also require additional training and follow up on supervisors to ensure they are reviewing timesheet timely.
- **Consistency** – The System would benefit from processes, forms and delivery of the forms to be standardized across for all Institutions. This would require the System to determine which method is considered to be the most appropriate and efficient in order to complete the necessary tasks for payroll and benefits administration.

The opportunities for improvement identified in this report should then be evaluated in light of the identified priority level and the System management priorities. The System management has provided responses and corrective action plans for each opportunity for improvement that was identified. A communication plan should be established to track progress on action plans.

BerryDunn would like readers to understand that this report is critical by nature and may not reflect the many strengths of the System's operations that we observed. The System stakeholders displayed a strong desire for continuous improvement for its internal controls and policies to help ensure that all funds entrusted to it are used ethically, prudently, and for their designated purpose. The BerryDunn team would like to acknowledge and thank the leadership, staff and stakeholders at the System for their cooperation and participation in this project.

2.0 Project Overview

During the last two fiscal years, the System went through significant changes with implementing two new systems for payroll processing and benefits administration as well as centralized the payroll and benefits administration functions. The System understands the importance of regularly testing the adequacy of internal controls. BerryDunn was engaged to assist management with this testing as well as to document the procedures and controls surrounding the payroll and benefits process.

2.1 Objectives

The System's overall objectives of an internal audit are to determine whether the Institutions: Managed and used resources in an efficient, effective, and economical manner; administered funds in compliance with applicable laws, regulations, policies, and procedures; and implemented internal controls to prevent or detect material errors or irregularities. In alignment with the System's goals, BerryDunn completed the internal audit to assist with:

- document current processes and data flow
- strengthen internal controls
- reduce liability around the financial processes
- enhance operations
- promote quality and effectiveness of financial processes

2.2 Approach

BerryDunn's project approach included the following phases:

1. Reviewing written policies and procedures regarding payroll and benefits administration.
2. Inquiries of key individuals involved in the administration and processing of payroll and benefits at both the Office of the Chancellor and the individual institutions.
3. Performing walkthroughs and detailed testing for compliance with established policies, procedures, laws, regulations, collective bargaining agreements, and industry best practices. The testing included reviewing new hires, terminations, contract and stipend pay, vacation accruals, and an overarching payroll test of controls.
4. Development of report including areas for improvement to assist management in improving the internal control structure of the payroll and benefits administration in addition to detailed documentation of the procedures and controls of each process.

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3.0 Current Environment

This section identifies the current financial practices, procedures, and systems. The main functions of payroll and benefits administration can be divided into four main functions (1) new hires, (2) terminated employees, (3) payroll processing, and (4) on-going maintenance/routine reporting.

3.1 New Hires

Vacant/Existing Position	The hiring process begins at the individual institution level with the identification of a vacant position. Once a vacancy has been identified, the applicable supervisor can request the job posting to be created. This form is not standardized and is unique to each individual Institution. Completion of these forms involve reviewing and/or creating a job description, determining the applicable salary code, and identifying a hiring committee. The Institution HR creates the job posting in the recruiting software. The job posting is then reviewed through a multi-level review process within the recruiting software. The approval will begin at the Department Level Dean and then be reviewed by the Dean of Administration. Certain positions require an additional level of review by the President, but they do not approve the posting itself. The Office of the Chancellor (the OC) is only involved in a vacant hire if the job description is being significantly changed and/or reclassified. For full-time faculty positions, the hiring process starts with the annual budgeting process. The Executive Leadership team at each institution will meet to review enrollment projections for the upcoming year, annual budgeting, and specific needs of departments.
Newly Created Position	If the position requested is not a vacant or previously approved position, discussions between the supervisor and/or Dean of the specific department and the Dean of Administration would occur. The Dean of Administration would review the requested position and determine the appropriateness of the need and if it is within the Department's budget. Once the approval is granted, the Institution HR is alerted of the position and will start the process with the OC for the position to be classified. The approval process is done electronically within the recruiting software. Currently, the System Director of Human Resources and Benefits Administration (System HR Director) will classify the position utilizing the Palmer System but this may change in the future. This is a method that is performed manually and not a software. Classifications are necessary to determine the step and grade for specific positions based on the scope of work the position entails.
Part-time Faculty & Assignment Contracts	Hiring decisions related to part-time faculty and assignment positions are handled through the Academic Deans office. The pay scales are determined using the union agreements and hiring decisions are based on need and budgeting. The need for these positions is determined during the annual budgeting process and the overall needs for specific courses. The assistant in the Dean's office will set up the employment contract in the Colleague software and assign the employee to the specific course. The contract is then approved by the Department Level Dean and the Dean of

	Administration electronically in Colleague. Colleague is a software utilized for maintaining course, credits, classes, and assignment contracts. Prior to July 1, 2019, the Colleague Software was also utilized for payroll, benefits, and human resource functions prior to the transition to UKG. The employee will also approve and accept their contract in Colleague electronically. Regularly, the System Payroll Manager will review the Colleague System to determine if there are any new assignment contracts that need to be transferred into UKG. If there are new contracts, key information from the contracts including the employee name, amount, and dates of the contract are imported from Colleague into UKG by the System Payroll Manager. As long as the individual is set up as an active employee in UKG, the information will transfer in. If there is a new employee receiving an assignment contract, a ticket will be submitted to the OC with the Personnel Action Form (PAF) applicable new hire information to be set up in the System. This step is done by the Academic Deans office at some institutions and the Institution HR at other institutions. The hiring for these positions follows a different process than traditional hires and there are inconsistencies at the Institutional level as to the involvement of the Institution HR. At certain institutions, the Institution HR creates the PAF and sends the new hire information through the ticketing system, while at other institutions, this step is handled outside of Human Resources.
Student Hires	Student hires are another function that are performed outside of the HR function. For a newly created position, the request will start at the department level in which the formal request is prepared. This request would include the position's supervisor and the need for the position. This position would then be approved by the Dean of Administration and if the position was a Federal Work-Study position, also approved by the Student Financial Aid Director. The hiring for these positions is handled within the respective Student Administrative Services (SAS) and Student Financial Aid (SFA) offices. Available non-Federal Work Study student positions are advertised within the career services department. Federal Work Study (FWS) positions are determined between the financial aid office and the students once they are awarded FWS aid. A student will work with their respective SAS or SFA office to be assigned a work contract. The contract is provided to the student to be completed by the faculty or department that will be supervising the student. There is no hiring committee and traditionally no interview process with these hires. Once the contract is completed and signed, the forms will go back to the SAS or SFA office where the on-boarding will begin. The student will receive assistance in completing their Federal Employment Eligibility Verification Form I-9 (I-9). Once the on-boarding is completed, the packet is provided to the OC through the ticketing system for the student employee to be set up in UKG. The Institution's HR is only involved in notifying the supervisor that the set-up has been complete in UKG and providing the student with their UKG log in. PAF forms are not consistently used for student hires.

Application and Decision-Making Process	Once the position has obtained all of the necessary approval, whether a vacant position, newly created position, or part-time/assignment contract, the position is posted externally. The Institution HR sends a welcome email to all committee members and considerations for selecting a candidate. The hiring committee can review all applications electronically and will make their selections for interviewing candidates. Once the interviews are held, the hiring committee will select their candidate and alert the Institution HR to begin completing background checks, checking references, and drafting the offer/appointment letter. Staff and non-bargaining unit employees pay rates are determined based on qualifications and budgetary review performed at the institution level. Any positions for full-time faculty require a final interview with the President of the institution and their input into the selection. For full-time faculty, the Academic Dean's Office will draft the offer/appointment letter and the salary is based off of respective points system under the Collective Bargaining Agreement (CBA). The points system also factors in the number of historical credits that a faculty member has taught. For part-time faculty, the Institution HR will draft the offer/appointment letter. The salary is based on the pay grade system under the CBA and is determined by the number of historical credits the faculty member has taught. The acceptance of the offer/appointment letter by the employee is also done electronically.
Recruitment Software	The System had historically used the Interview Exchange software for the recruiting process including applicant tracking. Interview Exchange was used to create, post, and recruit for vacant positions. The software did not support electronic approvals for positions, nor did it have the capability to process appointment letters through the approval process. The software also did not interface with UKG. Once a candidate was selected to be hired, all of the on-boarding paperwork was done manually and included in the ticket to the OC for the employee to be added to the UKG System. Starting in the first quarter of 2021, the System is now utilizing the recruiting module of UKG to store the job posting, select and notify a hiring committee, and obtain the necessary approvals for the position prior to posting and for appointment letters. With the transition to the UKG recruiting module, the Institution HR creates the offer letter, gets all necessary approvals and transfers the candidate from the recruiting module to the on-boarding module.. With this recruiting module, the Institutions have also transitioned to the electronic on-boarding process in the UKG software, which includes a self-service portal that the employee completes. This has eliminated the need to scan all of the new hire documentation to the OC through the ticket software as the information is now stored electronically. When a ticket for a new hire is created, the PAF and appointment letter may be provided to the OC.
Ticketing System	The OC utilizes an electronic ticketing system software for Payroll and Benefits Administration in order to process and track activity from the individual Institution level. When an individual is hired, terminated, or modified in another way, a ticket will be generated at the Institution level to be processed at the OC. Once a ticket is received, one of the System Employee Specialists will either assign the ticket to themselves to address

Onboarding of New Hire	or will assign the ticket to either the System Payroll Manager or the System HR Director. The originator of the ticket will receive email notification when a ticket has been assigned to an individual and when the ticket has been closed and completed. The ticketing system maintains an audit log with information related to the originator, assignee, and any activity made on the specific ticket. Once the candidate accepts the offer, the on-boarding can begin. This process begins at the individual Institution level. This process has transferred from a paper-driven system to electronic with the roll out of the on-boarding functionality in UKG. The Institution HR or hiring manager will work with the candidate to complete and verify the I-9 within UKG. Once the I-9 is completed, a PAF is generated by HR which includes the details regarding the name of the employee, position, reason for the form, start and end date, rate of pay, supervisor, general ledger account for the expenses, etc. Institution HR will then generate a ticket through the OC ticketing system and include the completed PAF and the signed appointment letter. This information is then received by one of the two System Employee Specialists within the OC They are responsible for setting up and providing the employee with their System email address and log in information.
Benefits Administration	When the employee is set up in UKG, the employee also is set up in Prime Benefits, the benefits module of UKG. The PAF that is submitted to the OC includes information related to the bargaining unit the employee will be under, which will trigger a specific benefits code in UKG. The benefits the employee is eligible for will auto populate based on the benefits code utilized. System HR Specialists sendnew employees a welcome email with the enrollment information and specific log-in information to the self-service portal. The email will include the necessary information for the new employee but also provides an opportunity for the employee to meet with the HR Specialists on any questions they may have. The process to add a new employee to specific benefit was automated in when UKG went live for specific vendors. When a new employee is set up, a file feeds from Payroll to the benefits vendor. The vendor will reach out to the employee to set-up their account. Key controls identified: - Access within UKG to add, remove, or update an employee is limited to the two System Employee Specialists and a part-time employee within the OC. There is no access granted to individuals at the Institution level. The System Payroll Manager does not have access to recruitment, onboarding, etc. - The System DFO runs a "Pre-Audit Report" payroll report from UKG and shares it with the OC Payroll and HR teams after payroll has been entered, but prior to the release. The report is compared to the

Key Controls	prior payroll register for reasonableness. The System DFO will work with the System Payroll Manager to modify any issues that are identified from the review prior to payroll being released.

3.2 Terminated Employees

Non-Assignment Contract Employees	The process to terminate a non-assignment contract employee begins at the individual Institution level. In instances in which the termination is voluntary, the employee will notify their supervisor or Institution HR via email of their termination and last day of employment. The Institution HR will initiate a resignation acknowledgement that is approved by the institution's president. A PAF is completed by the Institution HR which indicates whether the termination was voluntary, involuntary, or due to retirement. The PAF will document the last day of work as well as whether the employee would be eligible for re-hire. The Institution HR submits a ticket through the OC ticketing system which will include the PAF and resignation letter as backup. The ticket is assigned to the System Payroll Manager who then downloads and saves the information into an electronic folder for the upcoming payroll. The System Payroll Manager calculates the final pay, including any vacation or sick payouts, and manually adds the amount to the paycheck. This calculation is not reviewed by a second person. The System Payroll Manager will assign the ticket back to the System Human Resources to terminate the employee in UKG and handles benefits. The UKG software does not have the ability to perform pro-rata calculations. UKG does not allow an employee to be marked as terminated until their last payroll has been processed. Once the final pay has been processed, the System Payroll Manager assigned a ticket back to HR for the employees to be terminated in the UKG. Either the System HR Director or one of the System Employee Specialists will mark the employee as terminated.
Assignment and Temporary Work Contract Employees (Instructors, Faculty, and Temp employees)	For assignment contract and temporary work contract employees, a PAF is used to communicate termination at the end of the semester. While the assignment end date is entered into UKG, the system doesn't automatically terminate the employee on their end date. This introduces the potential for untimely terminations and poses a risk of employees being paid past their contract end date. Assignment employees do not utilize a timesheet so the risk is minimal as any payment would need to go through the contract process. Assignment contract and temporary work contract employees are maintained as active in the UKG system until the timeline of three-five consecutive semesters has passed (varies between institutions), per union requirements.

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	The Institution then notifies the OC of the termination either with a batch listing of all faculty to be terminated through email or they will submit a ticket with the individual terminated employee's information through the ticketing system. Either the System HR Director or one of the System Employee Specialists will be assigned to the ticket and will then mark the employee as terminated in UKG. Any terminations communicated via email will be sent to either the System HR Director, System Payroll Manager, or System Employee Specialists who will then create a ticket to assign one of the other employees, System HR Director, or one of the System Employee Specialists, to mark the termination in the system.
Benefits Administration	The enrollment and billings for health, dental, and vision are done through e-mail, while TIAA and long-term disability (LTD) is a manual enrollment process. The process to remove an employee from specific benefits was automated when UKG went live for specific vendors. The electronic submission for health, dental, and vision is done by the System HR Director. The System HR Director also handles the manual termination of an employee within the in LTD benefits. Terminated employees are ignored in the TIAA file fed from Payroll and don't require manual termination.
Access Removal	There is no formal or centralized process to ensure that an employee's access rights are properly removed upon termination, System equipment and badges/keys are returned.
Key Controls	Key Controls identified: – Access within UKG to add, remove, or update an employee is limited to the two System Employee Specialists and a part-time employee within the OC. There is no access granted to individuals at the Institution level. The System Payroll Manager does not have access to recruitment, onboarding, etc. – The System DFO runs a "Pre-Audit Report" payroll report from UKG and shares it with the OC Payroll and HR teams after payroll has been entered, but prior to the release. The report is compared to the prior payroll register for reasonableness. The System DFO will work with the System Payroll Manager to modify any issues that are identified from the review prior to payroll being released. The System DFO reviews an employee deductions report which would flag any employees with deductions for benefits, but had zero pay. This review would identify employees that may have been terminated and were not properly removed from benefits.

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3.3 Payroll Processing

Time Reporting	The UKG software has an electronic time reporting module, UKG Time management module (UTM). All hourly employees are required to manually enter their time in UTM. Time entry is due every other Friday by midnight. Supervisors have until noon on the following Monday to log into UTM and review their employee's time entry. Exempt employees are not required to record their time daily in the time reporting module, however, they are required to record any time-off that is being utilized. After noon on the Monday, the time reporting system is locked. Prior to the time reporting lock date, supervisors have the ability to add or update time of their employees in the system. Any changes that are needed after that point have to be done through the OC ticketing system. The UKG system does not provide a report that identifies any time that was posted or adjusted by someone other than the employee. At the individual employee level in UKG, the System HR Director, System Payroll Manager and System Employee Specialists are able to see an audit trail of when the time was entered and by whom. If an employee did not submit their time by the due date, they will be paid in the next pay period via an adjustment. Special pays for missed time can be performed if there are extenuating circumstances in which the System HR Director would be involved. The hours from the time reporting module are imported to the payroll module for payroll processing. Currently there is no review done by the System Payroll Manager to verify that all time has been properly approved at the supervisor level or that the hours recorded as reasonable. Unapproved hours are included in the import to the payroll module. There is also no review of control totals once the hours have been imported into payroll to verify that all of the hours were included in the import. There is an ongoing initiative with the OC Payroll and HR teams to address this. The import to the payroll module will flag errors and generate an exception report. These errors have to clear before payroll can be processed. Errors will generate if there are hours associated with an inactive employee, if the employee selected the wrong position when recording their hours, if an employee has recorded a holiday or vacation time and their position does not include that earn type, or if time has been recorded on a closed contract period. Management identified a challenge with the time reporting process as it relates to employees or student employees that hold multiple positions. When submitting their time, these employees are required to code their time to specific position/general ledger accounts for which the hours were related to. The UKG system does not allow an individualized list of general ledger accounts to be used, but rather is a drop down of all available general ledger accounts. This leads to issues with where the time is recorded in the general ledger when the journal entry is posted. Since the preliminary walk throughs and test work, UKG has released a patch that the OC Payroll and HR teams are working to install and implement.Once time reporting has been imported

Standard Payroll Processing	from the UTM system and all exceptions have been cleared, payroll is ready to be processed. During the two week period, any tickets that were received through the System Payroll and HR, are saved by the System Payroll Manager to her payroll folder on the computer as they were received. She then enters any new information into the payroll system whether it be new contracts, stipends, or final pay information related to terminations. Once this information has been entered, the System Payroll Manager runs the payroll calculation and sends a copy of the report to the System HR Director, System DFO, and the two System Employee Specialists. The System DFO performs a reasonableness review of the report looking for employees with overtime or unusually high hours. The DFO also reviews for any payroll amounts that are over the amounts that the highest paid employees receive. The System Employee Specialists will follow up with individual Institutions on any questions or issues that are identified through this review. The System DFO also reviews an employee deductions report which would flag any employees with deductions for benefits, but had zero pay. This review would identify employees that may have been terminated and were not properly removed from benefits. Once any issues identified through the initial review of payroll have been addressed, the System Payroll Manager will send an email to the group listed above to verify there are no additional concerns and that payroll has been finished and is ready to be submitted. The System Payroll Manager runs a final payroll calculation report that she spot checks for reasonableness before processing payroll. This step to process payroll can take up to 45 minutes and during this time payroll is unable to be accessed or modified. This step is typically done on Tuesday morning. Payroll is transmitted through UKG every other Tuesday by the System Payroll Manager. Once UKG completes the payroll, the reports are available electronically for review. Each Institution's HR has the ability to see paystubs for all employees with their Institution subsequent to payroll being processed. The reports are saved to a shared payroll drive by the System Payroll Manager. Starting in the 4th quarter of 2020, the System DFO began providing an Informer 5 report to the shared payroll drive. The report includes the cumulative pay of each employee and the GL account the employee's pay was posted to. Prime Benefits/UKG is set up to process certain insurance payments such as health, dental, and vision. All of these are finalized through the normal payables process.. The AFLAC insurance is paid through Payables with employee withholdings and is performed by the System Payroll Manager. This is a manual process rather than electronic. TIAA are paid electronically on a biweekly basis. Long-Term Disability (LTD) payments is not electronic and is performed manually. The System DFO coordinates the monthly TIAA payments. The System HR Director runs a report from UKG to prepare a check request for the LTD coverage which is submitted through the standard accounts payable disbursement process.

	After payroll is processed, the System Payroll Manager emails the System DFO that the processing is complete and ready for posting to the general ledger. The System DFO generates a detailed GL report and compares a final UKG payroll report to review for reasonableness that the correct general ledger account numbers were used. Once complete, the System DFO will post the detail report from UKG in the form of a journal entry to the general ledger. Tax liability and payment entries as well as benefit entries are also posted each pay period by the System DFO. The System Controller will perform a secondary review after the payroll journals have been posted. Their approval is documented electronically in the document management system.
Student Payroll Processing	Due to taxing regulations regarding when a student is subject to FICA, the System Payroll Manager has to perform manual reviews to verify the taxes withheld for students. The System Payroll Manager runs a Bursar report regarding student employees who are enrolled in less than 6 credits. She then manually reviews a report from UKG to verify that student employees are properly accounted for in regards to FICA withholdings for those under 6 credits and no FICA withheld for those over 6 credits.
Key Controls	Key Controls identified: – Access within UKG to add, remove, or update an employee is limited to the two System Employee Specialists and a part-time employee within the OC. There is no access granted to individuals at the Institution level. The System Payroll Manager does not have access to recruitment, onboarding, etc. – The System DFO runs a "Pre-Audit Report" payroll report from UKG and shares it with the OC Payroll and HR teams after payroll has been entered, but prior to the release. The report is compared to the prior payroll register for reasonableness. The System DFO will work with the System Payroll Manager to modify any issues that are identified from the review prior to payroll being released. The System DFO reviews an employee deductions report which would flag any employees with deductions for benefits, but had zero pay. This review would identify employees that may have been terminated and were not properly removed from benefits.

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3.4 On-going Maintenance and Reporting

Changes to Personnel Records	Any changes to benefits or rates are done at the OC by either the System Employee Specialists or the System Payroll Manager (Note: the System Payroll Manager does not handle benefit changes). Changes are originated through the ticketing system by either the employee, the supervisor, or the Institution HR. The ticketing system is also available to employees for questions they may have with the self-portal access. Annual raises are done in bulk through an import that is performed by the System HR Director. This process was started in July 2020 and has been utilized a few times since then. Prior to July 2020, raises were inputted individually by the System HR Director.
Key Controls	Key controls identified: – Access within UKG to add, remove, or update an employee is limited to the two System Employee Specialists and a part-time employee within the OC. There is no access granted to individuals at the institution level nor the System Payroll Manager. – Ticketing system with audit trail for changes
Quarterly Reporting	Each quarter, UKG processes the System's Federal Employee's Quarterly Federal Tax form 941 (form 941) and unemployment filings. The System DFO performs a quarterly reconciliation between the form 941 and the general ledger. The System HR Director currently prepares the quarterly "Vermont Healthcare Declaration" which is required by the State for those employees that do not have insurance and they are required to pay a set amount per full-time equivalent. In addition, a Department of Labor New Hire Report is also prepared.
Annual Reporting	On an annual basis, the System Payroll Manager prepares the annual Federal Form W2s and W3. The Federal Forms 1099R and 1096 are processed internally by the System Payroll Manager with reports from UKG. The System Employee Specialists prepare Federal Form 1095S.

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4.0 Testing Performed

In additions to the work sessions performed with the OC and the individual Institutions, BerryDunn also sampled payroll and benefit transactions for compliance with the System's policies and procedures, laws and regulations, collective bargaining agreements, and industry best practices.

4.1 New Hire Testing

Testing performed:

- We were provided a listing of all new hires that included faculty, staff, student employees, and contract pay at all Institutions and the System office from the period of July 1, 2020 through the end of April 2021. We selected three faculty/staff to test within each individual Institution and the OC, three students at each Institution, and three contract pays at each Institution.
- Our testing included reviewing the audit trail of documentation submitted from the Institution through the OC's ticketing system software, validating the existence of the employee through the review of the I-9, reviewing for appropriateness of the date of hire, verifying appropriate and approved rate of pay, and correct information was set up in the UKG system.

Results of testing:

- See Opportunity noted at 5.1 below – no formal process to review new hires added to UKG for accuracy and completeness.
    - We noted through our testing that there was one student selected for testing in which the rate the student was paid per hour did not agree to the PAF or the approved contract. The employee was paid an additional $0.09 per hour for the semester.
    - There was one full-time salaried employee where their scheduled hours in UKG were modified, which as a result changed their bi-weekly pay amount. This amounted to the employee being paid $96.00 less than they should have for one pay period. Management identified the error in the pay period immediately following, corrected the employee rate information in UKG, and provided a pro-rated pay for the subsequent payroll to make up the difference. As of the current date the employee's scheduled hours and bi-weekly pay amount have been updated properly in UKG and the employee has been paid the full amount earned and owed.
- See Opportunity noted at 5.5 below – inconsistency with documentation submitted to the OC for processing

4.2 Terminated Employee Testing

<u>Testing performed:</u>

- We were provided a listing of employees that were terminated in UKG that included faculty, staff, student employees, and contract pay at all Institutions and the System office from the period of July 1, 2020 through the end of April 2021. We selected three terminated employees to test from each Institution and the OC.
- Our testing included reviewing the audit trail of documentation submitted from the Institution through the OC's ticketing system software, reviewing the consistency and appropriateness between the termination date on the PAF and the date of terminated in UKG and Prime Benefits, inclusion of proper documentation of the termination notification and acknowledgement, reviewing and recalculating the final payment, and verifying that the employee was not paid beyond their termination date.

<u>Results of testing:</u>

- See Opportunity noted at 5.1 below – No formal process to review terminated employees removed from UKG for accuracy and completeness.
- See Opportunity noted at 5.2 below – No formalized process to communicating the termination of an employee and no formal process to remove an employee from UKG, other access and collect hardware.
- See Opportunity noted at 5.2 below – No formal process to ensure that employees are terminated timely in UKG. 7 out of the 15 employees tested were maintained in UKG after their last day of employment. Timeframes ranged from 1 month – 4 years. Due to the functionality in UKG and the integration with the System's networks and access as a whole, these employees ultimately had computing access until they were formally terminated in UKG. We did note that while the employees were still active in UKG beyond their termination, they were not paid beyond their termination date. The 7 employees included three non-union staff, two student employees, and two instructors/faculty.

4.3 User Access Rights

<u>Testing performed:</u>

- Provided a listing of all employees and their specific access to UKG.
- Our testing included reviewing a sample of employees access Institutions of similar positions to verify that their access was consistent. Also reviewed the access to verify that the access granted was appropriate given their position and responsibilities.

<u>Results of testing:</u>

- See Opportunity noted at 5.4 below – The System DFO has the ability to process payroll and ability to add and terminate employees within UKG with the current user access rights granted. Given the System DFO's review over payroll is considered a key control, there is a lack of independence in her review.

- See Opportunity noted at 5.4 below – The System HR Director has the ability to add and terminate employees, as well as input manual pay into the payroll process in UKG with the current user access rights granted. There should be a segregation of duties between HR and Payroll responsibilities.

4.4 Overall Payroll Test of Controls

Testing Performed:

- Provided payroll registers throughout FY21 and selected six pay periods for testing. Selected five employees for testing at each Institution and the OC for a total of 25 selections.
- Our testing included verifying the employee was paid according to their approved offer letter/appointment letter/assignment contract, paid in accordance with the timesheet and that the timesheet was properly approved, expense was posted to the proper general ledger account, and that the overall payroll journal entry was properly approved.
- Our testing also included verifying that the benefits an employee was enrolled in were consistent with the employee authorizations and the respective CBA offerings for the position, level, and start date.

Results of testing:

- See Opportunity noted at 5.3 below – no formal review required over time reporting. 3 out of 15 student's timesheets tested had no supervisor approval. 2 out of 25 hourly staff's timesheets tested had no supervisor approval.
- Untimely review of payroll journal entries posted to the general ledger by the secondary reviewer. Timeframe of review ranged from 2 weeks - 2 months of 6 pay dates we tested.

4.5 Accrued Vacation Testing

Testing Performed:

- Using the same sample for the payroll test of controls, received information related to the date of hire for each employee and the various accrued vacation policies under the CBAs.
- Reviewed each employee selected for testing to determine if their accrued vacation amount was calculating at the correct amount per pay period based on the respective CBA and the employee's date of hire.

Results of testing:

- No exceptions noted in our testing.

5.0 Opportunities for Improvement

The opportunities for improvement are the result of inquires with key individuals, documentation review, and transactional testing in conjunction with BerryDunn's experience with internal audits, internal control reviews, internal control assessments, and best practices in higher education.

The opportunities for improvement are classified by high, moderate, or low rankings to assist the System's management with prioritizing remediation efforts. See Table 01 below for the classification description. BerryDunn's classifications are provided to assist management in understanding the internal audit results and for discussion purposes. It is management's responsibility to consider the System's operations, assess operations and risks, and implement or modify appropriate controls to address these recommendations.

Table 01: Opportunities for Improvement Classification Table

Classification	Description
iii	**High** – Represents an increased control risk and warrants management attention.
ii	**Moderate** – Represents a control improvement and should be addressed as part of the System's operational plans.
!	**Low** – Represents a process or best-practice improvement and addressed at management's discretion.

5.1 Review and validation of changes made to payroll and benefits

Classification: High

Opportunity Identified:

Through our inquiries and testing, it was determined that the System does not have a process in place to review changes made to payroll and benefit information as it relates to newly hired employees, terminated employees, or on-going changes or maintenance, for accuracy or reasonableness.

Recommendation:

BerryDunn recommends that a review be implemented to validate the data entered in the UKG System is accurate and appropriate. This review should occur at both the Office of the Chancellor and the individual Institutions. An individual that is outside of the payroll and the data entry process should review all changes recorded in the System to validate that they are accurately entered and appropriate. We also recommend that a secondary review be performed at the individual institution level to verify that all information has been properly accounted for. In most instances, changes that are entered into the UKG System originated at the institutional level and are submitted to the OC through the ticketing system. The individuals at the institution level would have the knowledge to review the changes made to determine that all the necessary changes were included and they were approved and appropriate. The System should consider utilizing technology whether through the ticketing system or the UKG System to automatic the process and create an audit trail. If the System is unable to utilize technology for performing these reviews, they should consider utilizing a payroll change report that is customized for each individual institution to review their specific data. The report review at the OC level should include all activity for the entire System.

Management Response:

We agree with the recommendation. We will explore the use of automated workflows within UKG such as wage changes, reclassifications, and terminations that will enable us to utilize pre-built and well-controlled processes to electronically compare the requests to what has been entered into the system.

Automated workflows will streamline the process as data entry will originate from the campuses (supervisors and hiring managers) and then be approved by the appropriate resources from the institution such as the president or designee and/or human resources professionals.

With each payroll, Chancellor's Office Human Resources staff will review a random sample of all changes made through the workflow process to ensure consistency with VSCS policies and procedures, bargaining unit agreements, and documented practices.

Additionally, the VSCS will explore the use of UKG audit reports by institution for an additional post-payroll review.

5.2 Formalize the employee termination process

Classification: High

Opportunity Identified:

Through our review of documentation and inquiries with individuals at each Institution and the OC, there are inconsistencies and a decentralized process as it relates to the termination of an employee. We specifically noted through our testing that there are inconsistencies with the timeliness of terminating employees in UKG, the process for communicating terminations, and de-activation of access rights and returning equipment. From discussions with individuals at the Institutions and the OC, there is not a universal understanding of the process from start to finish. The use of a PAF to start the termination process with UKG depends on the type of position the employee holds (faculty, staff, assignment contract, and student) and who is responsible to communicate the termination to the OC. We noted for assignment contract employees, the employees remain active in the system past their contract end date until they have not taught any credits for three consecutive semesters. This could provide the opportunity for manual pay to be processed during their time of inactivity.

Through our terminated employee testing, we also noted a number of the employees selected for testing were terminated untimely from their last pay date. These employees were identified by either the Institution HR or System HR during 2020 and 2021 through running reports on a monthly and/or quarterly basis of employees to determine employees who had not received pay for an extended amount of time. This was used as a determining factor if they should be terminated in the system. While no employees were identified in our testing as being paid subsequent to the termination, there is a risk of employees receiving additional pay or employer benefits paid if terminations were not processed timely. It was also noted through our discussions that due to the functionality in UKG and the integration with the System's networks and access as a whole, employees continue to have computing access until they were formally terminated in UKG. There are many departments and individuals that play a role in this process; however, there is no centralized notification used or tracking of the steps taken.

Recommendation:

We recommend that the System create a formal terminated employee checklist that is maintained and monitored by the Institution HR. This form should include termination of the employee from UKG, benefits, access rights, returning System-owned property, returning PCard, etc. This checklist should be integrated with the inventory tracking feature of UKG. We also recommend reviewing the capabilities in UKG to determine a report that can run each pay period with employees' contract end dates to verify no employees were missed from being terminated timely. In addition, we recommend determining the capabilities to mark assignment contract employees as inactive for the periods of time they are not contracted to work as opposed to waiting for three consecutive terms to pass. While developing the formal process and additional reviews, the System should evaluate the functionalities in UKG and other software packages to explore automating processes and procedures to better leverage available technology.

Management Response:

We agree with the recommendation. As with the response for 5.1, we will explore the use of an automated workflow within UKG for termination processing to streamline the process. In leveraging the workflow process, we will explore the use of automated notification to interested parties regarding property and equipment to ensure the return of assets owned by the VSCS.

As with 5.1 data entry is expected to originate at the campus with action originated by the supervisor and approved by president or designee and institutional human resources. These action will be separate and apart from review and approval before final processing by Chancellor's Office Human Resources and Payroll staff.

Additionally, the Chancellor's HR office will review a random sample of all changes made through the workflow process.

We will explore the possibility of UKG audit reports by institution for an additional post-payroll review.

Finally, we are exploring options within UKG to inactivate employees who do not have an active contract.

5.3 Review of time reporting

Classification: High

Opportunity Identified:

As a result of our inquiries and testing, it was noted that employees record their time electronically in the time reporting module of UKG on a bi-weekly basis and time entry is due every other Friday. Supervisors are required to approve their employee's time no later than noon on the following Monday. After noon on that Monday, the time reporting module is locked and the hours are then imported into the UKG payroll processing module to be processed. All of the hours are imported into UKG regardless of if the time was approved by a supervisor. There is no formal follow up review performed to verify if time had been approved.

It was also noted that supervisors have the ability to add time for an employee or modify time previously entered by an employee. There is currently no formal review performed for the time that is manually modified or entered on behalf of an employee. The UKG System does maintain an audit trail of the individual who entered the time or made the change, however, there is no system generated report to review this time.

Through our inquiries it was also noted that the vacation time that is entered into the time reporting module is not deducted from their overall accrual balance until the timesheet is approved. In instances where a timesheet is not approved, the employee's accrued balance may not accurately reflect their available vacation time.

Recommendation:

We recommend that the System implement a formal review process for time reporting including approval and adjustments. We understand that there is a very tight turnaround that does not allow significant room for follow up if time entry is not reviewed and the need to pay employees for time worked by law. We recommend that the System consider the overall due date structure for when time is due, approvals are due, and payroll is started to see if there are any modifications that can be made to the timeline in order to allow for the time necessary to follow up on unapproved time.

The System should also identify who would be responsible for the follow up with specific supervisors on any unapproved time for a pay period. We have seen with other College Systems that this level of review and follow up occurs at the individual Institution level.

If the System is unable to determine a process that ensures that a level of review has occurred prior to payroll being processed, we recommend that time entry be reviewed by a specific date subsequent to when payroll is processed. While payroll will already be processed, a level of review of time reporting is an essential internal control for overall fiscal and asset management.

Management Response:

We agree with the recommendation. A report has been developed to identify supervisors who are not approving time by the due date for payroll processing. Outreach and education has and will continue to occur to increase compliance. So far, there has been a marked improvement to time approval.

A process is being developed to require supervisor approval post-payroll, when necessary. Additionally, further reporting to senior management where continued noncompliance has taken place will be developed.

5.4 Roles and responsibilities of Payroll and Human Resources

Classification: High

Opportunity Identified:

We noted through our discussions and testing that the access within UKG to perform specific functions is restricted to a limited number of authorized individuals. This access includes adding, terminating, and updating employees and is restricted to the System Employee Specialists, System HR Director, and System DFO. We do understand that all of the individuals also have the ability to input manual pay and modify the payroll processing module of payroll. We also noted that System HR Director and the System DFO have full administrator access within UKG which enables them to change an individual user's access rights and abilities within UKG. The System DFO serves as the payroll backup and has the ability to finalize and upload payroll. This access hinders the ability to clearly define and separate the human resource function as separate and distinct from payroll processing function and implement clear responsibilities and reviews.

Through our review of access rights, we also noted that all of the Institution HR Directors have the same view-only access in UKG with the exception of the CCV HR Director. The CCV HR Director has report access which is unique to this one individual.

Recommendation:

We recommend that the System evaluate the tasks performed by the System HR Director, the Employee Specialists, and the System Payroll Manager to ensure that they are consistent with strong segregation of duties. We also recommend that the System review the access rights to the various modules in UKG to further separate and define the roles and responsibilities. This would also include evaluating the individuals who have administrator access to the System and limiting those to individuals outside of the Human Resource and Payroll functions. Tasks related to employee set up, demographics, and benefits administration should be limited to the Human Resource professionals. Tasks related to processing payroll and inputting manual or retro-pays, should be performed by the System Payroll Manager. The System HR Director should have a supervisory role in the process that includes reviewing data entered or modified as it relates to employees as well as a review of the manual or retro-pays. The System HR Director access should also be modified to a read-only function in order to be able to provide an effective review over the data. The System should also consider the appropriate individual to serve as a backup for the System Payroll Manager.

We also recommend that the System re-evaluate the access rights granted to the Institution HR Director to verify that they have ability to review key reports that are noted in other recommendations above.

We do understand that the System has limited personnel at both the Office of the Chancellor and the individual institutions in which compensating controls may need to be put into place to mitigate risks presented with the current roles and responsibilities.

Management Response:

We agree with the recommendation. A read-only role has been created and assigned to institutional HR directors to allow them to run reports and access information as they need it.

We will explore creating a role specific to the System DFO to ensure they have the access they need for their primary and back-up responsibilities while limiting their other edit access.

Where segregation of duties is not possible, an audit report will be developed to identify those situations where the System HR director has to make changes to entered data. It will be reviewed by another person as a compensating control.

5.5 Consistency of documentation submitted to the Office of the Chancellor

Classification: Moderate

Opportunity Identified:

Through our inquiries, we noted there are inconsistencies among Institutions in the information uploaded to the OC, including who is submitting the information and what is being submitted.

- The OC utilizes a ticketing system to transfer information for processing in relation to payroll and benefits. Individuals are aware that information can be directly transferred to the System PR Manager's drop box thus bypassing the ticketing system.
- There is no standard with regard to which individuals at an Institution level should submit payroll and benefit information to the OC for processing which could lead to duplicate requests and payments.
- Within the various Institutions and employment types, there are inconsistencies in regards to when a PAF is used and provided to the OC for processing.

Recommendation:

BerryDunn recommends that the OC consider determining and communicating the manner in which information is provided to the OC for processing that includes the individual responsible for submitting the information and what documentation is specifically required. The OC should develop a standard checklist for new hires by type (faculty, staff, assignment contract, and student) that outlines the best practices and requirements for documentation submissions to the OC for processing that would be implemented across all Institutions. The checklist should include all aspects of the hiring process that would also include the Information Technology Department for any equipment that employee will be provided, Campus Security for the activation of badges and keys to buildings, and Finance if the employee will have a PCard. We understand that the UKG system allows a tracking system for equipment, access, PCards, etc. that an employee may be granted. We recommend that the System utilize this feature in order to centrally track and maintain a listing of System-owned items and access an employee may have. The System should also review the capabilities of UKG to determine if there are features in the software that would allow a new hire checklist to be automated and tracked within the software.

With the implementation of the Recruiting module of UKG, the System should also review the PAF process as a whole to determine if the entire form is necessary to be submitted to the OC. Many of the items from the PAF are now entered into the Recruiting module with the job posting or by the employee themselves through the application process. This data is then transferred into the UKG system, which has eliminated much of the data entry done by the System Employee Specialists. In order to create efficiencies, the PAF should be reviewed to determine if there is redundant information being included and what should be required moving forward.

As a best practice, BerryDunn further recommends that the ticketing system be the means in which information is submitted to the OC for processing as this provides a clear audit trail and acknowledgement when a task has been assigned and completed. The Institution HR should be the individual to submit information to the OC as it relates to new hires, terminations, and modification to a role or rate. We understand that there are several tickets that would continue be submitted at the individual employee level.

Management Response:

We agree with the recommendation. As with the response for 5.1, we will explore the use of an automated workflow within UKG that will limit the use of manual processing and create consistency. As the automated workflows are implemented it is expected that tickets requiring manual processing will be dramatically reduced. This conversion will ultimately increase the efficiency of the human resources and payroll processes and reduce the number of steps necessary to process at transaction at both the institutions and the Chancellor's Office.

5.6 Review process over manual pay

Classification: Moderate

Opportunity Identified:

There are several times during the year that an employee may receive a pay that is not routine and is manually calculated. These payrolls would include any retro-pay associated with pay rate increases, final paychecks, and vacation time pay out. Based on inquires and testing, we noted that manual pays are calculated by the System Payroll Manager and processed for payment. There is no formal review over these calculations by an individual other than the preparer.

Recommendation:

BerryDunn recommends that the System consider creating a formal review be performed over the manual payroll calculations to verify the accuracy of the calculation. This review should be performed by an individual outside of the payroll processing function. While developing these additional reviews, the System should consider evaluating the functionalities in UKG and other software packages to explore automated processes and procedures to better leverage available technology.

Management Response:

We agree with the recommendation. The VSCS has implemented a secondary review of all manual pay calculations. Calculations made by OC Payroll are now review by OC Human Resources and all OC Human Resources calculations are new reviewed by OC Payroll.

5.7 Vendor Due Diligence Policy

Classification: Moderate

Opportunity Identified:

During our testing and inquiries, we noted that the System does not have process to obtain the System of Organization Controls (SOC) Reports for the applicable third-party service organizations. We also noted that there is no formal process to evaluate these reports on an on-going basis or to review vendor contracts to verify compliance with the terms.

Recommendation:

BerryDunn recommends that the System consider creating a formal Vendor Due Diligence policy that includes the on-going monitoring and evaluation of outside vendors. This policy should include:

- Reviewing each User Agreement for key terms and deliverables under the agreement in order to track compliance with each User Agreement.
- Determining if the service organization can provide a SOC 1 Type 2 report. This would also include identifying if there are any subservice organization identified in the reports that have been carved out from the primary service organization. If the subservice organization has been carved out, determine if the subservice organization can provide a SOC 1 Type 2 report.
- Reviewing and evaluating the SOC 1 Type 2 reports for the service and subservice organization to determine if there are any findings that could have a potential impact on the System's internal controls.
- Reviewing and evaluating the complementary user controls identified in the reports to determine if these are incorporated into the System's existing internal controls.

Management Response:

We agree with the recommendation. New contracts for software acquisition will be reviewed under the new *Hardware and Software Acquisition and Review Policy* which requires OC IT and Security to review and sign off on purchases that contain protected information, financial data, etc. As a part of this review, SOC reports will be collected.

5.8 Enhanced Functionality in UKG

Classification: Low

Opportunity Identified:

Through our discussions with the Institutions and the OC, it was noted that there are several functions related to employee data management, payroll processing, and benefits administration that are currently being performed in a manual function that could be automated through UKG. We understand that the System has contracted with UKG to perform an additional optimization review of the functionality of the Systems in order to provide additional enhanced.

We noted through the discussions the following:

- Pro-Rate Pay and Final Payout Calculations are performed manually as there is no functionality in UKG to perform these calculations. With these calculations being calculated manually, there is risk due to human error that the calculated are being performed incorrectly resulting in incorrect final pay amounts to employees.
- UKG does not have the ability to administrator employees holding multiple positions. When an employee holds more than one position, only one supervisor can be set up as an approver for time entry. Also when the employee has to enter their time, they have to know the general ledger accounts in which their time should be coded to for the different positions. When the employee selects the general ledger code, UKG does not have the option to include a listing of those general ledger codes relevant to the particular employee, but rather they have the entire list of potential general ledger codes to choose from.
- Due to IRS regulations, student employees are exempt from FICA withholdings. The process to set these employees as exempt is a manual process performed by the System Payroll Manager and requires reviewing records from other Systems.

Recommendation:

BerryDunn recommends that the System consider working with UKG to determine if there are additional enhancements that could be provided in order to automate or streamline the functions discussed above. We also recommend that the System consider working with UKG to modify the employee set up process to better account for and manage employees with more than one position.

The System should also consider forming a committee that includes representative for each Institution or solicit feedback from the Institution in order to determine any additional enhancements that are needed and to agree to the prioritizing of the enhancements.

Management Response:

We agree with the recommendation. The VSCS Human Resources Council is comprised of the lead human resources professional at each institution. This group meets at least monthly and typically weekly to discuss issues of common concern and system improvements will be a key portion of future agendas.

Additionally, we have engaged with UKG for optimization services and will look to implement system improvements regularly.

5.9 Employee Assistance

Classification: Low

Opportunity Identified:

Through our inquiries at the Institution level it was noted that there is concern and confusion over the resources available to employees for questions on payroll and benefit related topics and the key individual to address specific questions. We understand with the transition to centralize payroll and benefits administration, the individual Institutions do not have a specific payroll or benefits representative on their campus and these functions are maintained within the OC.

Recommendation:

BerryDunn recommends the System consider developing a best practice as to the individuals and/or departments that should be responsible for or considered the point of reference for questions or concerns from the employees. This should be included in the on-boarding documentation as well as published on an employee portal for ease of use and understanding by the employees. The System should establish a method to regularly communicate this information to the employees through emails and training.

Management Response:

The HR Council will develop best practices for new and existing employees to ensure they have a consistent point of reference for questions or concerns.

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6.0 Appendices

6.1 Appendix A: VSCS Participant List

Table 01: Kick-off Meeting Participants

Name	Role
Sharron Scott	System Chief Financial Officer
Renee Hunt	System Controller

Table 02: Work session with the Office of the Chancellor

Name	Role
Katrina Meigs	System Director of Human Resources and Benefits Administration
Jocelyn Haley	System Director of Financial Operations
Tracy Sweet	System Payroll Manager
Marissa Greene	System Employee Specialist
Laura Macierira	System Employee Specialist

Table 03: Work session with Northern Vermont University

Name	Role
Toby Stewert	Dean of Administration
Danielle Spring	Chief Budget & Finance Officer
Kathy Armstrong	Director of Human Resources
Dottie Dearborn	Financial Aid Officer
Tracy Sherbrook	Assist to the Provost
Susan Nichols	Assist to the Provost

Table 04: Work session with Castleton University

Name	Role
Laura Jakubowski	Chief Budget & Finance Officer
Janet Hazelton	Director of Human Resources

Table 05: Work session with Community College of Vermont

Name	Role
Bo Finnegan	Director of Human Resources
Brenda Flint	Controller, CCV, and VTC
Gisele Hodgdon	Director of Business Operations
Kasey Warner	Business Manager

Table 06: Work session with Vermont Technical College

Name	Role
Lit Tyler	Dean of Administration
Kelly-Rue Riso	Director of Human Resources
Brenda Flint	Controller, CCV, and VTC
Jessica Huynh	Human Resource Specialist

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VERMONT STATE COLLEGES SYSTEM

6.2 Appendix B: VSCS Flow Charts

The table below should be used in conjunction with the flow charts as a legend for colors and shapes utilized.

Table 01: Flow Charts Legend

	Process Start
	Process Step
	Decision Point
	Off-Page Connector
	On-Page Connector
	Opportunity for Improvement – See Details in Section 5.0
	Document Input/output
	Existing Key Control
	Inconsistences Notes Among the Institutions; Model Process Included in the Flow Charts
	Process End

ITEM 4:

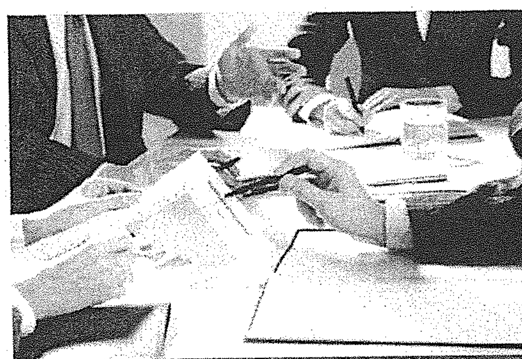
Supplemental Materials

Audit Committees: The Roles and Responsibilities

While audit committees are not required for all organizations, those who use one – or plan to form one – should pay close attention to how audit committees operate.

What is an audit committee?

The primary purpose of an audit committee is to provide oversight of the financial reporting process, the audit process, the system of internal controls and compliance with laws and regulations.



The audit committee can expect to review significant accounting and reporting issues and recent professional and regulatory pronouncements to understand the potential impact on financial statements. An understanding of how management develops internal interim financial information is necessary to assess whether reports are complete and accurate.

The committee reviews the results of the audit with management and external auditors, including matters required to be communicated to the committee under generally accepted auditing standards.

Audit committees will consider internal controls and review their effectiveness. Reports on, and management responses to, observations and significant findings should be obtained and reviewed by the committee. Controls over financial reporting, information technology security and operational matters fall under the purview of the committee.

Audit Committees: The Roles and Responsibilities

How does an audit committee work?

The committee establishes procedures for accepting confidential, anonymous concerns relative to financial reporting and internal control matters. Often referred to as a "whistle-blower policy," the procedures allow individuals to bring questions and issues to light without fear of retribution.

The audit committee is responsible for the appointment, compensation and oversight of the work of the auditor. As such, CPAs report directly to the audit committee, not management.

"Audit committees should re-examine focus, monitor effectiveness and set the course for future activities."

Audit committees should meet separately with external auditors to discuss matters that the committee or auditors believe should be discussed privately. The committee will also review the proposed audit approach and handle coordination of the audit effort with internal audit staff, if applicable.

When an internal audit function exists, the committee will review and approve the audit plan, review staffing and organization of the function and meet with internal auditors and management on a periodic basis to discuss matters of concern that may arise.

What do audit committee members do?

Committee members can expect to participate in an executive session at each meeting. These sessions can be used to meet with auditors, key members of management or financial reporting staff and provide the opportunity to glean candid information on potentially sensitive topics.

A recent survey of audit committee members reveals that a key focus has become enterprise risk management (ERM). Those surveyed ranked the level of challenge related to enterprise risk management significantly above governance, risk management, financial reporting and internal audit.

Audit Committees: The Roles and Responsibilities

The reason is simple. ERM embraces every risk perspective of an organization. While the entire board is responsible for enterprise risk management, the ownership may rest with the audit committee. Audit committees should re-examine focus, monitor effectiveness and set the course for future activities. Newly formed committees can benefit from the wealth of experience offered by those who have spent time in the trenches.

Effective internal control emanates from the top and permeates throughout an organization. Senior management must set the tone for internal control and the audit committee can be an important piece in the internal control puzzle.

All too frequently in the past, audit committees were stacked with cronies of the chairman and president. They tended to be rubber stamps of the chief executives that met the letter, but certainly not the spirit, of the rules. In such an environment, they tended to disguise control rather than contribute to it.

However, an audit committee established with the proper attitude and responsibility will accomplish exactly that. If you're a skeptic, you naturally may wonder how more bureaucracy can contribute to profits.

What is an audit committee charter?

An audit committee charter sets forth the general purpose, authority, composition and responsibilities of the committee. The charter should be tailored to the organization.

On an annual basis, the committee should determine that all responsibilities outlined in the charter have been carried out. In addition, the charter should be reviewed and proposed updates presented to the board for approval.

While the charter must remain effective, so must committee members. Best practices include an annual evaluation of members' performance.

Audit Committees: The Roles and Responsibilities

Although audit committees may be reluctant to focus on self-measurement for fear of disclosing weaknesses, evaluation of committee activities is a key tool in achieving and maintaining a high degree of effectiveness.

What are the benefits of an audit committee?

Good management involves matching key tasks with the appropriate people to achieve better results. Your company can derive the most benefit from an audit committee by following these five steps:

1. Leverage your time. Financial reporting is becoming more important and complicated every year. An audit committee should be led by a designated "financial expert" and staffed with a select group of people knowledgeable about financial matters.

2. Improve your internal control. Internal control may not be at the top of your list of important objectives but it should be. Internal control is more than dual signatures on checks and segregation of duties. Properly designed, it will support every aspect of your company.

Proper internal controls will lead to higher efficiencies in all processes, less waste of resources, more objective evaluation methods and more timely and accurate management measurements. Think how valuable such improvements would be for your organization and how much you would be willing to pay a consultant to guide you in the right direction. This is another role an effective audit committee can fill.

Audit Committees: The Roles and Responsibilities

3. Improve your financial management. The audit committee focuses on the financial management and reporting of the company. This group provides a high level of specific expertise in this critical area of your company.

Financial management and reporting determine your credit-worthiness to outsiders and growth targets and successes to insiders. They are the key determinants in establishing the market value of your company – the ultimate scoreboard for management's results.

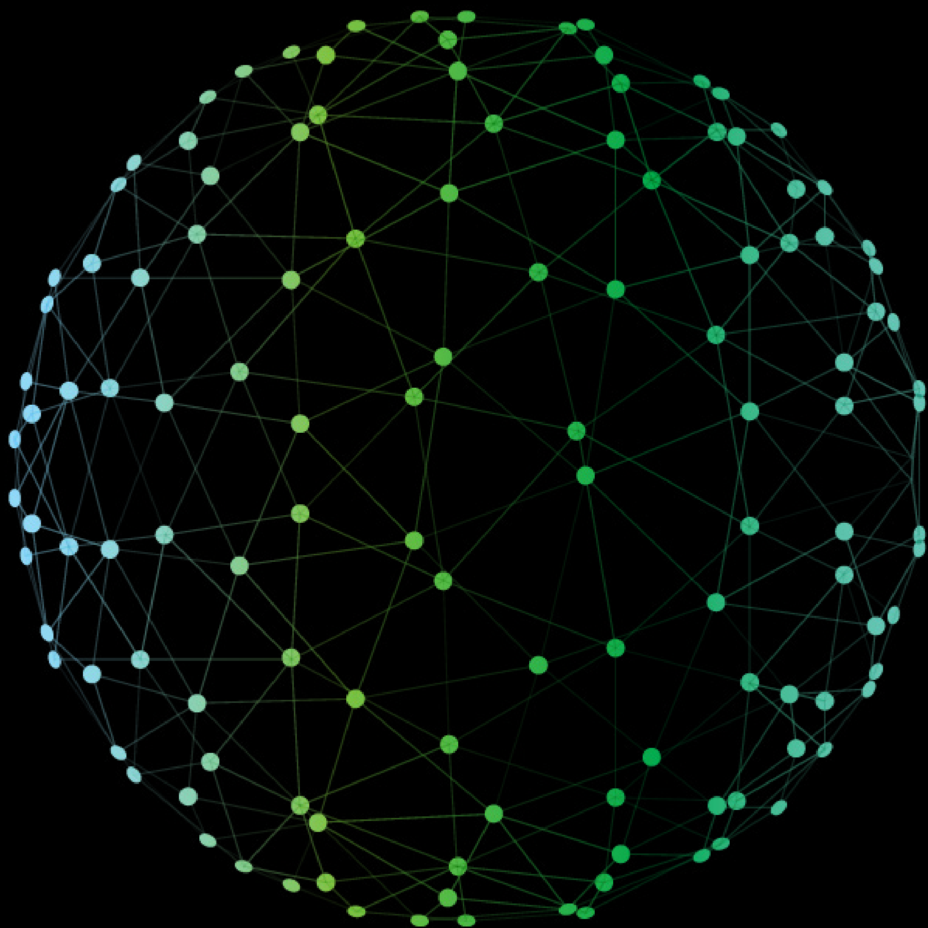
Does your board actively manage your company's financial and reporting functions – or delegate them to the outside auditor? You and your board have the responsibility and are held accountable for these functions.

4. Clarify the roles and responsibilities of your board of directors. A common myth is that a company can get by without an audit committee. The board of directors may be responsible for doing the work of an audit committee.

But without clear responsibilities assigned, there is the risk that the task may be inefficiently or ineffectively executed or perhaps not executed at all. Having a separate audit committee clarifies key responsibilities for your board.

5. Bring value to your audit dollar. An audit is an expensive endeavor that all too many view as a "necessary evil" or another cost of borrowing. An active audit committee stays involved with the auditors throughout the year. The audit committee's relationship with the auditor is similar to a willing and engaged patient who makes the physician better and more effective. Hidden problems can be discovered early and dealt with before they grow into something dangerous.

Deloitte.



The role of the audit committee

April 2018

Center *for*
Board Effectiveness

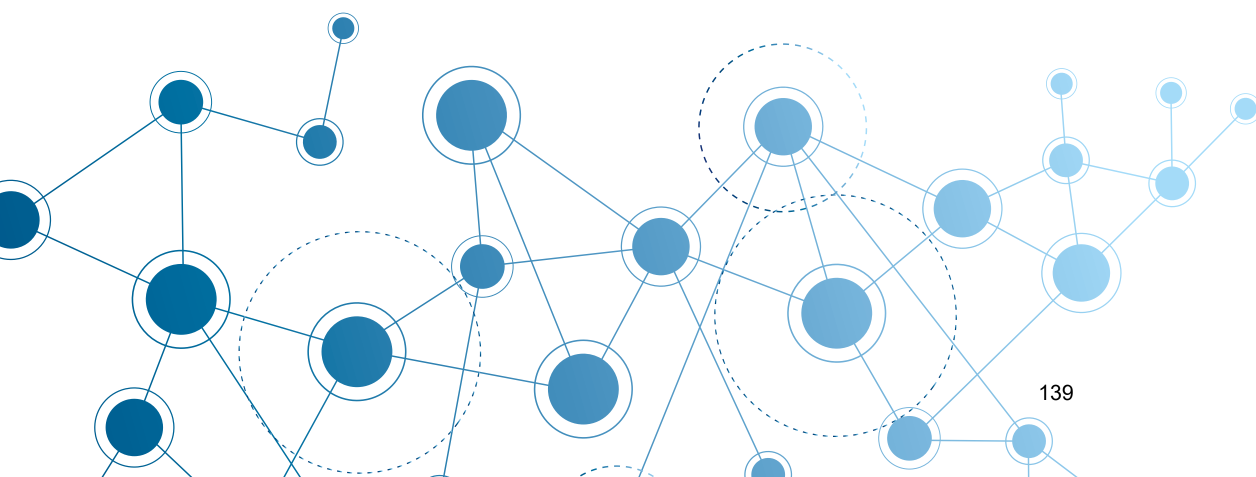
The role of the audit committee

Oversight of financial reporting and related internal controls
Review of filings and earnings releases
Risk oversight
Oversight of the independent auditor
Ethics and compliance
Oversight of internal audit
Other interactions with management and the board
Audit committee external communications

The role of the audit committee

As an audit committee member, it is important to understand the rules relevant to your role. This section provides an overview of an audit committee's responsibilities in overseeing financial reporting and related internal controls, risk, and ethics and compliance. It also discusses the committee's role in overseeing the internal and independent auditors, as well as how the committee may interact with other members of management and external stakeholders. Finally, it highlights the committee's responsibilities with respect to disclosures in the proxy statement.

SEC, PCAOB, NYSE, and NASDAQ rules are highlighted where relevant, and we have noted leading practices, tools, and resources to help audit committee members execute their responsibilities.



Oversight of financial reporting and related internal controls

The audit committee, management, and the independent auditor all have distinct roles in financial reporting. Management is responsible for preparing the financial statements, establishing and maintaining adequate internal control over financial reporting (ICFR), and evaluating the effectiveness of ICFR. The independent auditor is responsible for expressing an opinion on the fairness with which the financial statements present, in all material respects, the financial position, the results of operations, and cash flows in conformity with GAAP, and, when applicable, evaluating the effectiveness of ICFR.

To oversee ICFR successfully, the audit committee should be familiar with the processes and controls management has put in place and understand whether those processes and controls are designed and operating effectively. The audit committee should work with management, the internal auditors, and the independent auditor to gain the knowledge needed to provide appropriate oversight of this area.

Likewise, the audit committee is responsible for overseeing the entire financial reporting process. To do so effectively, it should be familiar with the processes and controls that management has established and determine whether they were designed effectively.

The audit committee's role is one of oversight and monitoring, and in carrying out this responsibility, the committee may rely on management, the independent auditor, and any advisers the committee might engage, provided its reliance is reasonable.

The audit committee should consider having management identify and discuss any significant accounting policies, estimates, and judgments made. A quarterly analysis of these areas may be useful to prepare for these discussions, and management should tailor the analysis to highlight changes and include new or unusual items. Because Regulation S-X, Rule 2-07 requires the independent auditor to discuss the effects of alternative GAAP methods on the financial statements, the information presented by management should be corroborated by the independent auditor.

NYSE requirements. NYSE listing standards require the audit committee to review major issues regarding accounting principles and the presentation of the financial statements. These include significant changes in the company's selection or application of accounting principles, the adequacy of internal controls, and any special audit steps adopted in response to what the NYSE terms "material control deficiencies." These discussions can be held, generally with management, during the review of the quarterly financial statements to be filed with the SEC.

The audit committee is also required to review management's analyses of significant issues in financial reporting and judgments made in preparing the financial statements, including the effects of alternative GAAP methods. This discussion may also be held during the review of the quarterly financial statements. The audit committee also should review the effects of regulatory and accounting initiatives, as well as off-balance-sheet transactions, on the financial statements. For example:

- Management and the audit committee should discuss pending technical and regulatory matters that could affect the financial statements, and the audit committee should be updated on management's plans to implement new technical or regulatory guidelines.
- The review of off-balance-sheet structures should also be a recurring agenda item, and may be conducted as part of the committee's review of management's discussion and analysis in the annual and quarterly reports. The exact frequency of these discussions will depend on the company's operations and preferences. Finally, the audit committee should consider reviewing off-balance-sheet transactions, or at least material ones, before they are executed.

NASDAQ requirements. NASDAQ requires disclosure of the audit committee's purpose, as set out in its charter, of overseeing accounting and financial reporting processes of the company and audits of the financial statements. See the **audit committee charter** section of this guide for details.

Fraud risk

In conjunction with risk oversight, the audit committee should be satisfied that the company has programs and policies in place to prevent and identify fraud. It should work with management to oversee the establishment of appropriate antifraud controls and programs and to take the necessary steps when fraud is detected. The audit committee should also be satisfied that the organization has implemented an appropriate ethics and compliance program and established a reporting hotline. See the **ethics and code of conduct** and **reporting hotline procedures** sections later in this guide for more information.

Audit committee members should be aware of three main areas of fraud risk:

- Financial statement fraud, which includes intentional misstatements in or omissions from financial statements
- Asset misappropriation, which may include check forgery, theft of money, inventory theft, payroll fraud, or theft of services
- Corruption, which may include schemes such as kickbacks, shell companies, bribes to influence decision makers, or manipulation of contracts.

One way the audit committee can help oversee the prevention and detection of financial statement fraud is by monitoring management's assessment of ICFR.

The audit committee should also have an awareness of the US Foreign Corrupt Practices Act (FCPA) and other non-US anticorruption laws that may be applicable (e.g., the UK Bribery Act). As the SEC and Department of Justice note in the Resource Guide to the FCPA, anticorruption compliance "begins with the board of directors and senior executives setting the proper tone for the rest of the company." To that end, the audit committee should:

- Understand the company's obligations and responsibilities regarding anticorruption laws to which it is subject
- Determine whether the company has dedicated appropriate oversight, autonomy, and resources to its anticorruption compliance program; depending on the company's size, this could involve assigning an individual who is specifically charged with anticorruption compliance and has a direct reporting line to the committee

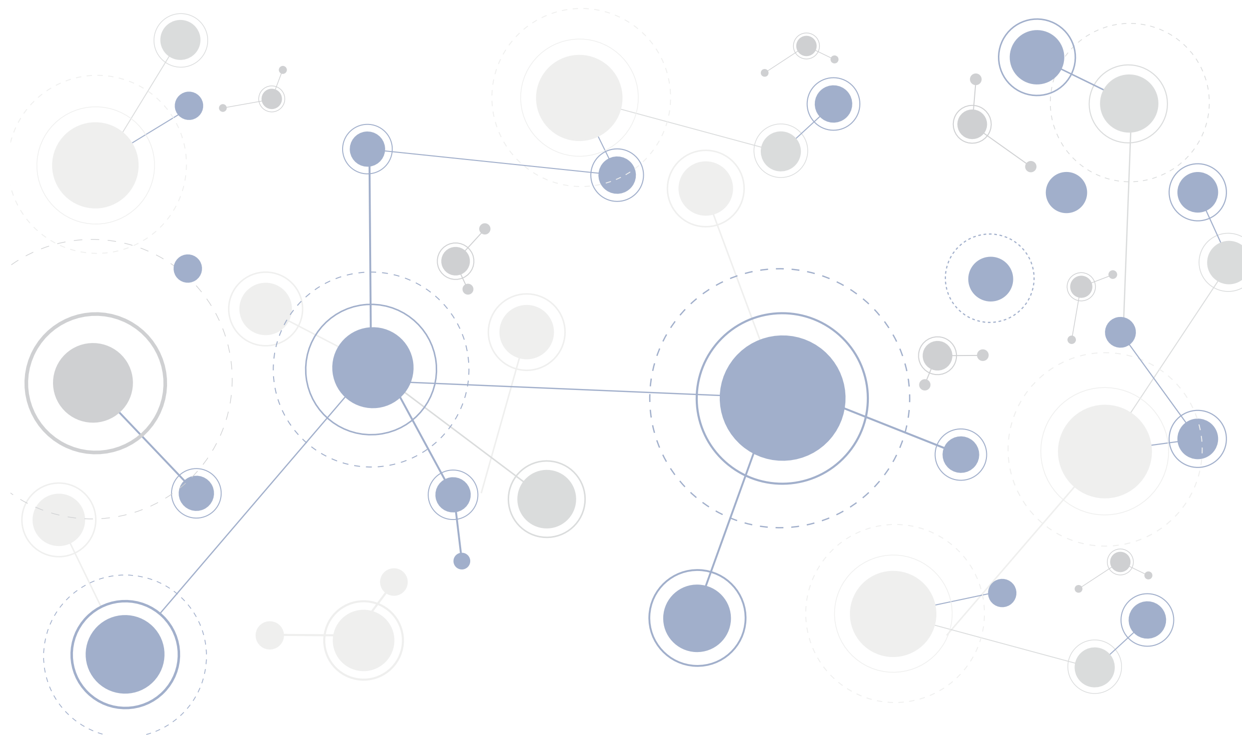
- Understand specific policies and procedures in place to identify and mitigate corruption-related risks
- Discuss with management specific corruption-related risks that have been identified, including allegations of corruption that may have been received through the company's monitoring and reporting mechanisms, as well as management's plans for responding to such risks
- Monitor any actual violations, including management's response.

2013 COSO framework. The 2013 Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) provides a formal structure for designing and evaluating the effectiveness of internal control. It emphasizes the role of the board—and, by delegation or regulation, the role of the audit committee—in overseeing internal control, which remains an essential aspect of effective governance. In particular, the framework highlights:

- The board's role in the control environment, including clarification of expectations for integrity and ethics, conflicts of interest, adherence to codes of conduct, and other matters
- The board's assessment of the risk that management could override internal controls and careful consideration of the possibility that management may override such controls
- The establishment and maintenance of open lines of communication between management and the board and the provision of separate lines of communication, such as whistleblower hotlines.

Tools and resources

The Anti-Fraud Collaboration released a report titled *The Fraud-Resistant Organization* that identifies three central themes critical to fraud deterrence and detection.



Review of filings and earnings releases

The audit committee generally reviews earnings releases, SEC filings containing financial information, and other financial information and earnings guidance provided to analysts, ratings agencies, and others. The committee should consider how it will execute these responsibilities to satisfy itself that all information is presented fairly and in a transparent manner. This should include a focus on consistency of information, tone, and messaging across all financial communications.

The audit committee should confirm that an appropriate legal review has been completed to verify the completeness of disclosures, including any obligation to report on trends. This legal review should also consider compliance with the company's policies on forward-looking statements and the completeness of any related disclaimers.

NYSE requirements. NYSE listing standards require that the audit committee meet to discuss the company's annual audited financial statements and quarterly financial statements with management and the independent auditor. They also require the audit committee charter to address the committee's responsibility to discuss earnings press releases and the financial information and guidance provided to analysts and ratings agencies.

The commentary to the listing standards indicates that this discussion may be in general terms, and the audit committee may discuss the type of information disclosed and the type of presentation made. The commentary also indicates that the discussion should pay particular attention to any pro forma or adjusted non-GAAP financial information.

Note that SEC rules require the audit committee to recommend to the board that the audited financial statements be included in the company's annual report on Form 10-K.

Two-thirds of audit committees meet via conference call to discuss earnings releases, while **22%** review earnings releases at in-person meetings

Source: *Deloitte 2016 Board Practices Report*

Questions for audit committees to consider

Earnings guidance

The audit committee should discuss earnings guidance with management. Questions to consider include:

- When did management last evaluate its approach to providing earnings guidance? Is a change in approach warranted as a result of the current economic environment and other circumstances facing the company?
- How can pressures to meet expectations in the short term influence the quality of the company's reported financial results and management behavior?
- What practices do the company's competitors follow with respect to earnings guidance and other forward-looking information?
- What are management's reasons for providing or not providing earnings-per-share targets and other types of forward-looking information?
- How confident is management in its ability to forecast earnings accurately? Is the disclosure of a range of earnings estimates preferable to a specific target? Should the time frame for which estimates are provided be modified or are more frequent updates necessary?
- What are the company's long-term value drivers? What is the specific quantitative and qualitative information—be it financial or nonfinancial in nature—that best reflects these drivers? Is this information provided to investors and analysts on a forward-looking basis?
- Has management considered seeking input directly from shareholders regarding the types of forward-looking information they would find meaningful?
- Do current circumstances warrant enhanced audit committee review of earnings estimates and other forward-looking information before it is made public?
- If the company changes its approach to the provision of earnings guidance and forward-looking information, should the audit committee modify its practices for reviewing that information?

Questions for audit committees to consider

Non-GAAP measures

The SEC rules regarding the use of non-GAAP financial measures require, among other things, that disclosure of any material information containing non-GAAP financial measures must include the most directly comparable GAAP financial measures, that the GAAP measures must be disclosed with equal or greater prominence, and that the GAAP and non-GAAP measures must be reconciled. The SEC has recently taken a hard look at non-GAAP measures in response to concerns about their increased use and prominence. As a result, companies and audit committees should consider re-examining their use of non-GAAP measures and related controls and the disclosure of those measures. The audit committee should consider asking the following questions:

- Is the measure misleading or prohibited?
- Is the measure presented with the most directly comparable GAAP measure and with no greater prominence than the GAAP measure?
- Is the measure defined and described appropriately and clearly labeled as non-GAAP?
- Does the reconciliation between the GAAP and non-GAAP measure clearly label and describe the nature of each adjustment, and is each adjustment appropriate?
- Is there transparent and company-specific disclosure of the substantive reasons why management believes that the measure is useful for investors and the purpose for which management uses the measure?
- Is the measure prepared consistently from period to period in accordance with a defined policy, and is it comparable to that of the company's peers?
- Is the measure balanced (e.g., does it adjust not only for nonrecurring expenses but also for nonrecurring gains)?
- Does the measure appropriately focus on material adjustments and not include immaterial adjustments that would not seem to be a focus of management?
- Do the disclosure controls and procedures address non-GAAP measures?
- Does the audit committee oversee the preparation and use of non-GAAP measures?
- Does the audit committee have a clear understanding how non-GAAP measures impact compensation? Are the audit and compensation committees aligned on this?

Tools and resources

Deloitte's publications *A Chance to Self-Correct: SEC Urges Companies to Take a Fresh Look at Their Non-GAAP Measures* and *A Roadmap to Non-GAAP Financial Measures* provide additional information, including ways for a company to assess the appropriateness of its non-GAAP measures and control considerations.

Additionally, in March 2018, the Center for Audit Quality issued *Non-GAAP Measures: A Roadmap for Audit Committees*, a guide intended to help audit committees enhance their oversight of these measures used by company management. The roadmap provides key considerations for audit committees, including leading practices to assess whether a company's non-GAAP metrics present a balanced representation of the company's performance.

Questions for audit committees to consider

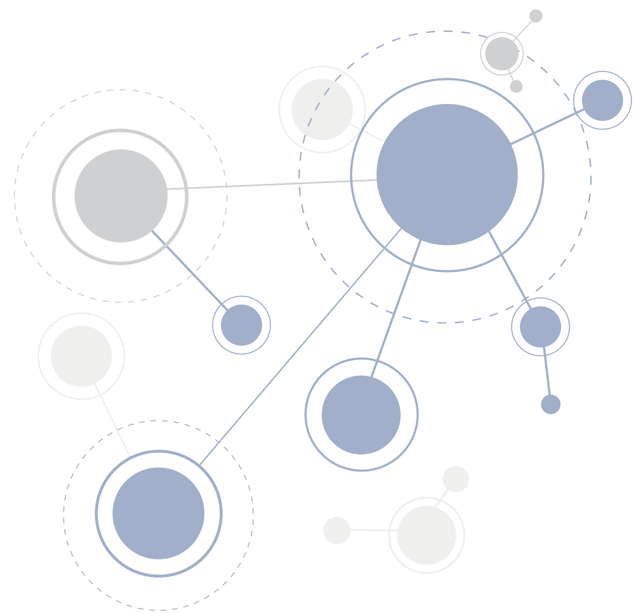
Related-party transactions

NASDAQ and NYSE listing standards each contemplate that the audit committee of a listed company, or another independent body of the board, will review all related-party transactions. In some instances, this responsibility is assigned to the audit committee. The following questions may help the audit committee assess its process for approving related-party transactions:

- What process will the committee follow in reviewing and approving related-party transactions? Is this process documented?
- Will special meetings be called as potential transactions arise, or is there a process to review transactions between scheduled meetings?
- What information does the committee need to make an informed judgment about the appropriateness of a transaction?
- Who will be responsible for presenting this information?

For each transaction brought for approval, the committee may consider asking:

- What are the business reasons for the transaction? Are these reasons in line with the company's overall strategy and objectives?
- When and how will the transaction have to be disclosed? How will investors view the transaction when it is disclosed?
- Which insiders could benefit from the transaction and in what way?
- What impact will the transaction have on the financial statements?
- Are any outside advisers needed to help understand the implications of the transaction?



Risk oversight

Given the dynamic business environment, which creates an ever-changing risk landscape, boards should make sure the risk oversight function is well defined and effective. The board plays a critical role in understanding and influencing management's processes for identifying, assessing, and continually monitoring risks. The board should clearly define which risks the full board should discuss regularly versus the risks that can appropriately be delegated primarily to a board committee. While many boards have a defined risk governance structure in place, it is important to continually assess the structure as companies face new risks.

A leading practice is for management to maintain a list of all enterprise-wide risks, which are then mapped to specific board committees with the expertise to oversee them. For example, human resource and compensation risks may be delegated to the compensation committee for oversight, and the audit committee should have a key role in overseeing financial risks. In many instances, the full board takes direct responsibility for and regularly discusses the company's most strategic risks, which include risks that could disrupt and materially impact the company's business strategy. Committee charters should be updated to align with the defined risk governance structure.

For companies outside the financial services industry, where many companies have separate board risk committees, any risks not assigned to a specific committee during this process are often delegated to the audit committee. While it may be appropriate for the audit committee to take responsibility for reviewing the guidelines, processes, and policies management has in place to identify, assess, and manage risk, boards should take care not to overburden the audit committee

Questions for audit committees to consider

Risk oversight

When the board or audit committee is considering the effectiveness of the company's enterprise risk management—the process of planning, organizing, leading, and controlling activities to minimize the effect of downside risk on the organization—it may consider the following questions:

- Which board committees are responsible for various aspects of risk governance? Has the risk governance structure been defined?
- How do the various board committees oversee risk? Is there appropriate coordination and communication between all relevant stakeholders?
- Does the board consider the relationship between strategy and risk? What are the potential internal and external risks to the success of the strategy?
- Does management provide the board with the information needed to oversee the risk management process effectively?
- What are the company's policies and processes for identifying, assessing, and continually monitoring the major financial risk exposures on an integrated, enterprise-wide basis?
- Has management assigned owners for each risk that has been identified?
- How might the company's compensation programs encourage inappropriate focus on short-term financial performance? Are the audit committee and compensation committee aligned on such risks?
- What mechanisms does management use to monitor emerging financial risks? What are the early warning mechanisms, and how effective are they? How, and how often, are they calibrated?
- Which framework has management selected for the financial risk management program? What criteria were used to select it?
- What is the role of technology in the risk management program? How was it chosen, and when was it last evaluated?
- Is cyber risk receiving adequate time and focus on the audit committee agenda?

with risk oversight responsibilities. The NYSE listing standards further define the audit committee's role in discussing policies with respect to risk assessment and risk management:

> While it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.[1]

The SEC considers risk oversight a primary responsibility of the board and requires disclosure of its role in this area. Disclosures include whether the entire board is involved in risk oversight; whether certain aspects are executed by individual board committees; and whether the employees responsible for risk management report directly to the board. Such disclosures informs shareholders' understanding of the board's process for overseeing risk.

[1] NYSE listing standards, 303A.07 *Audit Committee Additional Requirements*.

Tools and resources

Deloitte's publications, *Risk Committee Resource Guide for Boards*; *Risk Intelligent Governance: Lessons from State of the Art Board Practices*; and *Bank Board Risk Governance: Driving Performance through Enhanced Risk Oversight*, provide additional information for boards and audit committee members on risk oversight.

The audit committee's potential role in overseeing cyber risk

It is often challenging for even the most tech-savvy business leaders to keep up with the scope and pace of developments related to big data, social media, cloud computing, IT implementations, cyber risk, and other technology matters. These developments carry a complex set of risks, the most serious of which can compromise sensitive information and significantly disrupt business processes. Cyber risk is often at the top of the agenda for management and boards at companies of all sizes and industries. The pervasiveness of cyber risk significantly increases concerns about financial information; internal controls; and a wide variety of risks, including the reputational risks that can result from a cyber incident. Oversight of a successful cyber risk management program requires proactive engagement and is most frequently the responsibility of the full board. In some organizations, a level of oversight may be delegated to a risk committee or the audit committee.

In companies where the audit committee holds some responsibility for cyber risk management, the committee should first obtain a clear understanding of the specific areas it is expected to oversee. In those organizations, the audit committee, in its capacity of overseeing financial risks and monitoring management's policies and procedures, may have expertise and be asked to play a significant strategic role in monitoring management's preparation for and response to cyber threats, coordinating cyber risk management initiatives and policies, and confirming their efficacy. Those audit committees may take the lead in monitoring cyber threat trends, regulatory developments, and major threats to the company. Other responsibilities may include setting expectations and accountability for management, as well as assessing the adequacy of resources, funding, and focus on cyber risk management activities.

For those audit committees charged with this oversight, engaging in regular dialogue with the chief information officer, chief information security officer, and other technology-focused leaders can help the committee determine where attention should be focused. Although cyber risk is frequently on the full board's agenda, audit committees are increasingly receiving regular updates from relevant technology leaders, with some technology risk-related topic on almost every meeting agenda. The audit committee chairman can be a particularly effective liaison with other groups in enforcing and communicating expectations regarding cyber and financial risk mitigation.

We need to arm corporate boards with a mechanism to thoughtfully assess management's assertions about the design and effectiveness of their organizations' cyber defenses.

Sarah Bloom Raskin, Former Deputy Secretary of the US Department of Treasury, at the PCAOB's 10th annual International Institute on Audit Regulation event in Washington, DC

To which groups has the board allocated the majority of tasks connected to the following areas of risk oversight? (Respondents could select multiple groups for each risk.)

	The "big" picture	Reputational risks	Financial stability risk	Cyber risks	Compliance risks	Talent risks	Incentive risks
The full board	96%	86%	47%	41%	22%	46%	21%
Audit committee	5%	9%	51%	51%	69%	2%	5%

Source: *2016–2017 NACD Public Company Governance Survey*, National Association of Corporate Directors

Cybersecurity risk management

In April 2017, the AICPA released its cybersecurity risk management attestation reporting framework, which is intended to expand cyber risk reporting to address the marketplace need for greater stakeholder transparency. This reporting framework establishes a standardized reporting mechanism to provide a broad range of users with useful information about an entity's cybersecurity risk management program to support informed and strategic decision making. It consists of the following components:

- Management's description of the entity's cybersecurity risk management program
- Management's assertion on the presentation of the description and the operating effectiveness of the controls to achieve the cybersecurity objectives
- Practitioner's report on the presentation of the description and the operating effectiveness of the controls to achieve the cybersecurity objectives.

Leveraging a unified approach for performing and reporting on an entity's cyber risk management program and related controls could help boards and audit committees effectively execute their oversight responsibilities with respect to cyber risk.

See Deloitte's Cybersecurity risk management assessment page.

Enhanced cybersecurity disclosure guidance

The SEC issued interpretive guidance on February 21, 2018, that largely refreshes the SEC's 2011 staff guidance related to cybersecurity disclosure obligations. The latest guidance does not establish any new disclosure obligations but rather presents the SEC's views on how its existing rules should be interpreted in connection with cybersecurity threats and incidents. It also expands on the initial concepts discussed, concentrating more heavily on cybersecurity policies and controls, most notably those related to cybersecurity escalation procedures and the application of insider trading prohibitions. The guidance also addresses the importance of avoiding selective disclosure, as well as considering the role of the board of directors in risk oversight. The release applies to public operating companies, including foreign private issuers, but does not address the specific implications of cybersecurity for other regulated entities under the federal securities laws, such as registered investment companies, investment advisers, brokers, dealers, exchanges, and self-regulatory organizations.

The new guidance clarifies the SEC's view on the role of the board of directors in overseeing cybersecurity risk. If the risk is material to a company's business, the discussion of the board of directors' role in the risk oversight function should include the nature of its responsibilities for overseeing the management of this risk. The SEC believes that "disclosures regarding a company's cybersecurity risk management program and how the board of directors engages with management on cybersecurity issues allow investors to assess how a board of directors is discharging its risk oversight responsibility in this increasingly important area."

For more information about the latest guidance, refer to Deloitte's *Heads Up: In the Spirit of Full Cybersecurity Disclosure.*

The audit committee's role in M&A

The audit committee has an important role in M&A, both before and after a transaction.

Before the deal is done: Due diligence
Although due diligence is largely management's responsibility, the audit committee can provide critical oversight in areas such as risk analysis, internal controls, and even the basic financial information on which the terms are based. Weakness in a target's internal control systems can create unpleasant surprises that, in the absence of due diligence, may not be discovered until it is too late. This could be a critical factor when management is required to evaluate the post-integration controls in accordance with the Sarbanes-Oxley Act. While target financial information may be prepared with the best of intentions, and may even be audited, audit committee oversight can provide greater comfort that the financial information is accurate and complete. Other areas of due diligence oversight include tax, insurance, and Foreign Corrupt Practices Act compliance.

Audit committees can and should satisfy themselves that the due diligence process is thorough and that the board is fully informed of related risks before the transaction is approved. They can do this in much the same way they address day-to-day matters: ask questions, identify areas of risk to consider, and provide guidance on how to solve problems.

Post-merger integration oversight
While post-merger integration is sometimes overlooked in the excitement of closing a deal, it can be critical to the success or failure of the transaction. The audit committee has a vital role to play here, too.

One area of audit committee focus is the melding of internal control systems and processes so they are stable on Day 1 or as soon as possible thereafter. SEC rules adopted under the Sarbanes-Oxley Act require public companies to integrate disclosure controls as well as controls over financial reporting. Failure to do so can have significant consequences. Even when both parties have high-quality systems, processes that do not work well together may create control problems, leading to reportable deficiencies or even material weaknesses.

Other areas of audit committee responsibility include oversight of talent integration in the financial and accounting areas and monitoring that computer systems and technology platforms can communicate with each other from the outset.

For additional information, read Deloitte's *On the Board's Agenda: Post-Merger Integration*.

Special requirements for financial institutions

Following the enactment of the Dodd-Frank Act in July 2010, the Federal Reserve Board issued a new regulation setting forth enhanced prudential standards for large banking organizations, including risk committee requirements. Specifically, all bank holding companies (BHCs) with total consolidated assets of $10 billion or more are required to maintain a risk committee that approves and periodically reviews the risk management policies of the BHC's global operations and oversees the operation of the BHC's global risk management framework. More stringent requirements apply to BHCs with total consolidated assets of $50 billion or more. The corporate governance requirements state that the risk committee must:

- Have a formal, written charter that is approved by the BHC's board of directors
- Meet at least quarterly, or more frequently if needed, and fully document and maintain records of its proceedings, including risk management decisions.

Moreover, the risk committee at each BHC with total consolidated assets of $50 billion or more is required to:

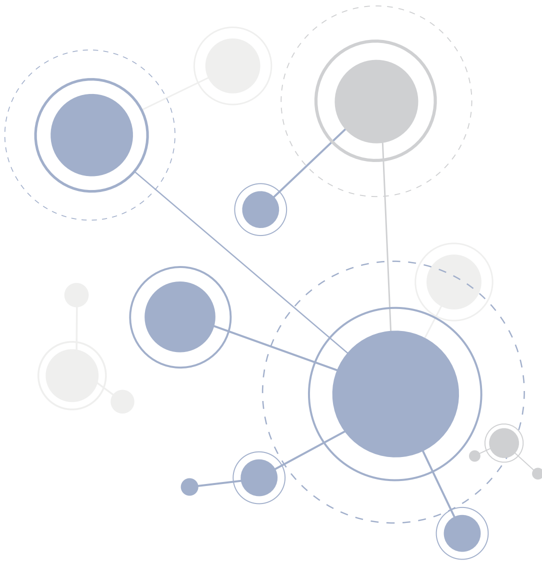
- Be an independent committee of the board of directors that has, as its sole and exclusive function, responsibility for the risk management policies of the BHC's global operations and oversight of the operation of the BHC's global risk management framework
- Report directly to the BHC's board of directors
- Receive and review regular reports not less than quarterly from the BHC's chief risk officer.

See the Federal Reserve's final rule and Deloitte's practical guide to the rule for additional requirements and guidance.

Soon after the Federal Reserve Board finalized its EPS framework, the Office of the Comptroller of the Currency (OCC) issued heightened standards applicable to national banks, insured federal savings associations, insured federal branches of foreign banks with total consolidated assets of $50 billion or more, and OCC-regulated institutions with total consolidated assets of less than $50 billion if that institution's parent company controls at least one other covered institution.

Among other things, each covered institution is required to establish and adhere to a formal, written risk governance framework that is designed by independent risk management and approved by the board of directors or the board's risk committee.

See the OCC's heightened standards for additional requirements and guidance.



Oversight of the independent auditor

Audit committees of listed companies are directly responsible for the appointment, compensation, and oversight of the independent auditor, including the resolution of any disagreements with management. It is optimal for the audit committee, management, the internal auditors, and the independent auditor to work together in a spirit of mutual respect and cooperation.

The audit committee and the independent auditor typically meet at least quarterly to thoroughly discuss a wide variety of matters, including the company's financial reporting, internal controls, and the audit, from planning to conclusion of the audit. These discussions should also include educational and evaluative topics. Executive sessions with the independent auditor are a way to maintain open communication and identify concerns, and they are required for NYSE-listed companies.

Auditor communications

The NYSE, NASDAQ, and PCAOB outline communications that are required between the audit committee and the independent auditor. Many of these communications are focused on the responsibility of the audit committee to oversee the independent auditor.

NYSE requirements. NYSE listing standards require the audit committee to communicate with the independent auditor in the following ways:

- Meet with the independent auditor to review and discuss the company's annual audited financial statements and quarterly financial statements, including disclosures in management's discussion and analysis
- Periodically, meet separately with the independent auditor, management, and the internal auditors
- Obtain a formal written communication from the independent auditor regarding independence and other matters annually
- Review with the independent auditor any audit problems or difficulties and management's response
- Set clear hiring policies for employees or former employees of the company's independent auditor.

NASDAQ requirements. NASDAQ listing standards require the audit committees of listed companies to obtain a formal written statement from the independent auditor consistent with PCAOB Ethics and Independence Rule 3526, *Communication with Audit Committees Concerning Independence*.

PCAOB requirements.[1] Some communications between the auditor and the audit committee are driven by standards the auditor must follow in conducting the audit. There are a number of PCAOB standards that require communications with the audit committee. The primary one is Auditing Standard No. 1301 (AS 1301), *Communications with Audit Committees*, The communications under this standard can be oral or written, but must be made in a timely manner and prior to issuance of the auditor's report. The standard addresses communications relevant to different phases of the audit, from the auditor's engagement through the issuance of the auditor's report. It also requires communications relevant to various aspects of the company's accounting and reporting, as well any disagreements between the auditor and management.

[1] The PCAOB requirements encompass the items the independent auditor is required to communicate to the audit committee by SEC's Regulation S-X, Rule 2-07, *Communication with Audit Committees*. The SEC stated in its release adopting this rule that it expects these discussions to occur prior to filing Form 10-Q or Form 10-K.

Summary of PCAOB required communications

Communications required by AS 1301

- Significant issues discussed with management before the auditor's appointment or retention
- An understanding of the terms of the audit
- Information relevant to the audit
- Overview of the audit strategy, timing of the audit, and significant risks
- Results of the audit, including:
  - Significant accounting policies and practices
  - Critical accounting policies and practices
  - Critical accounting estimates
  - Significant unusual transactions
- Auditor's evaluation of the quality of the company's financial reporting
- Other information in documents containing audited financial statements
- Difficult or contentious matters about which the auditor consulted
- Management consultations with other accountants
- Going-concern matters
- Uncorrected and corrected misstatements
- Material written communications
- Departure from the auditor's standard report
- Disagreements with management
- Difficulties encountered in performing the audit
- Other matters

Communications required by other PCAOB standards or rules

- Material weaknesses and significant deficiencies in internal control (AS 2201)
- Representations of management (AS 2201)
- Fraud and illegal acts (AS 2401 and 2405)
- Communications in connection with interim reviews (AS 4105)
- Preapproval of services (Rules 3524 and 3525)
- Independence matters (Rule 3526)
- Related parties (AS 2410)
- Auditing fair-value measurements and disclosures (AS 2502)

PCAOB adopts changes to the auditor's report

The SEC approved the standard requiring changes to the auditor's report on October 23, 2017. In a statement announcing its approval of this standard that significantly modifies the auditor's reporting model, Chairman Jay Clayton stated his strong support for the objective of the rule, namely for the auditors to provide investors with meaningful insights into the audit. Chairman Clayton highlighted the important role of the audit committee and noted that the SEC and PCAOB will monitor the results of the new standard's implementation, including consideration of any unintended consequences.

The new auditor reporting standard will significantly modify the auditor's reporting model while retaining the current "pass/fail" opinion of the existing auditor's report. The primary changes include:

- Standardized ordering and inclusion of section headers, with the opinion section appearing first
- Enhanced descriptions of the auditor's role and responsibilities, including a statement regarding independence requirements
- Communication of critical audit matters (CAMs)
- Disclosure of auditor tenure—the year in which the auditor began serving consecutively as the company's auditor.

A CAM is defined as a matter communicated, or required to be communicated, to the audit committee that:

- Relates to accounts or disclosures that are material to the financial statements
- Involves especially challenging, subjective, or complex auditor judgment.

The new requirements will be phased in, with CAM disclosure effective for large accelerated filers for audits of fiscal years ending on or after June 30, 2019, and for all other audits to which the requirement applies for fiscal years ending on or after December 15, 2020. The remaining changes apply to auditor reports issued for fiscal years ending on or after December 15, 2017.

Although the standard will be implemented in accordance with phased-in effective dates, management and audit committees will most likely want to start to consider the implications of the new requirements and discuss them with their auditors. Potential questions regarding CAMs may include:

- What matters could be CAMs?
- How will management and the audit committee engage with the auditor as CAMs are identified and the auditor's descriptions of the CAMs are developed and finalized?
- How will the timing of auditor communications with management and the audit committee accommodate the discussion of CAMs?
- How do the auditor's statements regarding CAMs compare to management's disclosures regarding the same matters?

Deloitte's *Heads Up* provides additional information on the new rule.

I strongly support the objective of the rule to provide investors with meaningful insights into the audit from the auditor. CAMs are designed to provide investors and other financial statement users with the auditor's perspective on matters discussed with the audit committee that relate to material accounts or disclosures and involve especially challenging, subjective, or complex auditor judgment. Investors will benefit from understanding more about how auditors view these matters.

Jay Clayton, SEC Chairman

Auditor independence

The SEC and PCAOB rules govern the independence of accountants who audit or review financial statements and prepare attestation reports filed with the SEC. The rules recognize the critical role of audit committees in financial reporting, their unique position in monitoring auditor independence, and their direct responsibility for the oversight of the independent auditor. Although most audit firms are rigorous in monitoring and enforcing these independence requirements, it is important that audit committee members be aware of them as well.

The SEC independence rules address the following issues related to registrants.

Financial interests. The rule states that independence is impaired if the audit firm or certain of its people have a direct or material indirect financial interest in an audit client. Examples of prohibited financial interests include an investment in the audit client's debt or equity securities, certain loans, deposits not fully insured by the Federal Deposit Insurance Corporation, broker-dealer account balances not fully insured by the Securities Investor Protection Corporation, and certain individual insurance products.

Employment relationships. The rule states that independence is impaired if a current partner, principal, shareholder, or professional employee of the independent auditor has an employment relationship with, or serves as a member of the board or similar management or governing body of, the audit client. Former partners, principals, shareholders, or professional employees of the independent auditor cannot be employed in an accounting role or financial reporting oversight role—one who exercises more than minimal influence over the contents of accounting records or prepares them—at an audit client unless they are fully separated from the independent auditor, financially and otherwise. Even if this separation is achieved, former members of the audit engagement team for an issuer cannot take a financial reporting oversight role for the issuer before completion of one annual audit subsequent to the engagement period when the individual was a part of the engagement team. Employment restrictions also apply to certain close family members of the independent auditor's personnel.

Business relationships. The rule prohibits an independent auditor from having a direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders. This prohibition does not preclude the independent auditor from providing permissible services to the audit client or purchasing goods or services from the audit client as a consumer in the ordinary course of business, commonly known as a vendor business relationship.

Nonaudit services provided by auditors. The rule sets forth 10 categories of services that impair the auditor's independence if provided to an audit client. The rule permits an auditor to provide other nonaudit services to an issuer if the services are preapproved by the audit committee. Permissible nonaudit services include due diligence for mergers and acquisitions, internal control reviews, and tax services that are not prohibited by the PCAOB.

In certain limited circumstances, the independent auditor may provide bookkeeping, design, and implementation of financial information systems; appraisal or valuation services; actuarial services; and internal audit outsourcing to a nonclient affiliate of an audit client if "it is reasonable to conclude that the results of these services will not be subject to auditing procedures during an audit of the audit client's financial statements." This is referred to as the "not-subject-to-audit" exception.

The following nonaudit services are prohibited to the independent auditor:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client
- Design and implementation of financial information systems
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing
- Management functions
- Human resources
- Broker-dealer, investment advisory, or investment banking services
- Legal services
- Expert services.

The audit committee's administration of the audit engagement (preapproval). The audit committee must preapprove permissible audit and nonaudit services to be provided to the issuer and its subsidiaries. Preapproval can be obtained directly or based on policies and procedures established by the audit committee that are detailed as to the type of service. These policies and procedures do not circumvent the need to inform the audit committee of the service, and the committee cannot delegate its preapproval responsibilities to management. It can, however, delegate preapprovals to one or more members of the committee if the preapprovals are reported at the next scheduled meeting of the full committee.

Further, the PCAOB rules provide that an audit firm seeking preapproval of tax services or nonaudit services related to internal control over financial reporting must:

- Describe, in writing, the scope of the service. For tax services, the audit firm must describe, in writing, (i) the fee structure for the engagement, any side letter or other amendment to the engagement letter, or any other agreement between the firm and the audit client relating to the service; and (ii) any compensation arrangement or other agreement between the registered public accounting firm or an affiliate and any person other than the audit client with respect to promoting, marketing, or recommending a transaction covered by the service.
- Discuss with the audit committee of the issuer the potential effects of the services on the independence of the firm.

Contingent fees and commissions. The rule states that independence is impaired if the independent auditor provides any service or product to an audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client. The PCAOB also has discretion to prohibit any other service that it determines, by regulation, to be impermissible. In addition to prohibiting the independent auditor from providing a service or product to an audit client for a contingent fee or commission, the PCAOB has issued rules prohibiting the independent auditor from:

- Marketing, planning, or opining in favor of the tax treatment of a confidential or aggressive tax transaction
- Providing tax services to persons in a financial reporting oversight role for an audit client.

Partner rotation. The rule requires the lead audit and engagement quality review partners to rotate after five years, at which time they are subject to a five-year "time-out" period. Audit partners who are significantly involved with senior management or the audit committee or who are responsible for decisions on accounting matters that affect the financial statements must rotate after seven years and are subject to a two-year time-out period. This includes audit partners who serve as the lead partner for significant subsidiaries. Significant subsidiaries are defined as those accounting for greater than 20 percent of an issuer's revenues or assets. Other specialty partners, such as tax partners, are not required to rotate.

Compensation of audit partners. Under the SEC's rule, an auditor is not independent if, at any point during the audit and professional engagement period, any audit partner receives compensation from selling engagements to provide the audit client with any services other than audit, review, or attest services.

For the purpose of this restriction, the SEC defines the term "audit partner" as the lead and concurring partners and other partners on the engagement team who have responsibility for making decisions on significant auditing, accounting, and reporting matters that affect the financial statements or who maintain regular contact with management or the audit committee. This includes all audit partners serving the client at the issuer or parent, with the exception of specialty partners, as well as the lead partner at subsidiaries whose assets or revenues constitute at least 20 percent of the consolidated assets or revenues.

Evaluation of the independent auditor

Inherent in the audit committee's duty to appoint, compensate, and oversee the independent auditor is the idea that the audit committee will do some form of evaluation of the auditor.

The NYSE listing standards require the audit committee to review a report by the independent auditor describing its quality controls, results of investigations, and independence. The commentary accompanying this listing standard states that after reviewing the report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance, and independence. The commentary to this standard specifies that the "evaluation should include the review and evaluation of the lead partner of the independent auditor," and "should take into account the opinions of management and the company's internal auditors (or other personnel responsible for the internal audit function)."

Practices for evaluating the independent auditor range from highly formalized processes with extensive documentation to more informal assessments. Factors the audit committee may consider in developing an evaluation process include:

- **Frequency and timing of the evaluation.** Many audit committees perform the evaluation annually, immediately following the issuance of the Form 10-K and in conjunction with their decision to reappoint the independent auditor.
- **Parties involved in the assessment.** Although the SEC does not explicitly require the audit committee to formally evaluate the independent auditor, many committees conduct some form of evaluation to make decisions on the auditor's initial appointment or annual reappointment. While the audit committee is responsible for the appointment, compensation, and oversight of the independent auditor, it may not be practical for the audit committee to oversee and coordinate the entire evaluation. In many instances, the audit committee delegates the coordination responsibility to internal

audit, the legal department, or another group in the company. The party responsible for coordinating the evaluation should obtain information not only from the audit committee, but also from senior financial management and the internal auditors. Depending on the size and structure of the company, it may be appropriate to obtain input from the management of significant operating locations or business units.

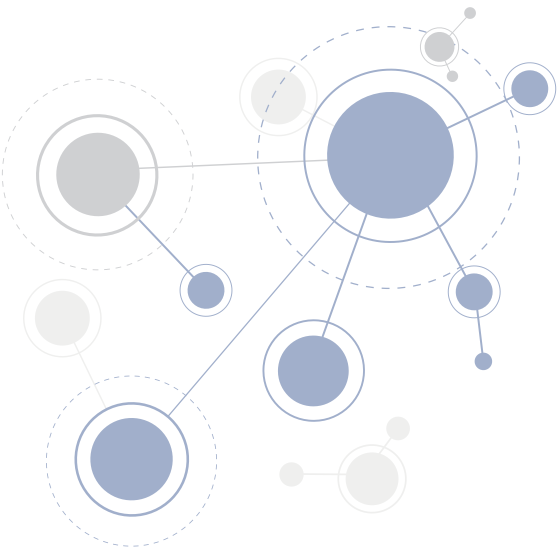
- **Form and nature of the assessment.** Some independent auditors have assessment questionnaires for evaluating client service. Audit committees can use these questionnaires, tailor them to fit their needs, or create their own. The assessment can be done by having the relevant parties complete the questionnaire in writing or by holding interviews. They may also have a discussion about the experience the audit committee and others at the company have had in working with the independent auditor.
- **Assessment criteria.** The criteria for evaluating the independent auditor vary. Common criteria specific to the engagement team include technical competence; industry knowledge; frequency and quality of communication; cohesiveness as a team; demonstrated independence, objectivity, and professional skepticism; and the level of support provided to the audit committee in fulfilling its responsibilities. Audit committees may consider information about the characteristics of the audit firm itself, such as size, financial strength and stability, presence in key markets, approach to professional development, technological capabilities, nature of the audit approach, quality of thought leadership, and eminence in the marketplace. The results of the PCAOB inspection process and peer reviews may also be considered in the evaluation.

Tools and resources

For additional information, read Deloitte's *Appointing, Assessing, and Compensating the Independent Auditor: The Role of the Audit Committee*.

The Audit Committee Collaboration, a partnership of the Center for Audit Quality and US corporate governance and policy organizations, has issued an *External Auditor Assessment Tool* for audit committees. The tool assists audit committees in carrying out their responsibility of appointing, overseeing, and determining compensation for the independent auditor.

The PCAOB issued *Information for Audit Committees about the PCAOB Inspection Process* to help audit committees better understand the PCOAB's inspection process and how to gather information from their audit firms about inspections.



Questions for audit committees to consider

Audit innovation

With advances in technology, auditors are turning to innovation to enhance quality and drive value into the audit. In understanding how the independent auditor is using innovation, the audit committee may consider the following questions:

- How is the independent auditor leveraging innovation to enhance audit execution?
- What investments is the independent auditor making in audit innovation, and how do those investments translate to enhanced audit quality and value for the company?
- What insights is the independent auditor able to provide about the company and its financial and internal controls processes through the audit and with the use of new technologies, including audit analytics?
- What are some of the emerging technologies that the independent auditor is exploring for use in the audit? How may the company benefit from the independent auditor's use of these emerging technologies?
- With respect to innovation, how is the independent auditor differentiating itself from competitors to add value to the audit?

Ethics and compliance

As highlighted by several court rulings and the US Federal Sentencing Guidelines for organizations, executives and boards of directors have special responsibilities for the oversight and management of ethics and compliance programs, an important component of which is a robust code of ethics or conduct.

The board should consider the audit committee's role in overseeing the company's ethics and compliance programs, noting that NYSE-listed companies are required to have the audit committee oversee legal and regulatory compliance.

Ethics and code of conduct

A culture that embraces the importance of ethics and compliance can be established only if employees, officers, and directors understand the requirements of the code of ethics.

The SEC, the NYSE, and NASDAQ all require a code of ethics or a code of conduct. There are similarities among the requirements, but there are also differences.

SEC requirements. The SEC requires registrants to disclose whether they have written codes of ethics that apply to their principal executive officers, principal financial officers, principal accounting officers or controllers, or individuals performing similar functions. If they do not, they must explain why not. A company registered in the United States must disclose any changes to, or waivers from, the code of ethics that apply to the CEO or senior financial officers, generally within four business days after it amends its code of ethics or grants a waiver. The NYSE and NASDAQ listing standards have the same four-day rule.

The SEC rule defines a code of ethics as a written standard that is reasonably designed to deter wrongdoing and to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest in personal and professional relationships
- Full, fair, accurate, timely, and understandable disclosure in the company's SEC filings and other public communications
- Compliance with applicable laws, rules, and regulations
- The prompt internal reporting of violations to parties identified in the code
- Accountability for adherence to the code.

Companies must include these disclosures in their annual reports and must make the code of ethics available to the public through one of the methods listed in Item 406 of Regulation S-K.

NYSE requirements. NYSE listing standards require a code of conduct that covers not only senior financial officers, but all employees. Specifically, the websites of NYSE-listed companies must disclose the code of conduct applicable to employees, directors, and officers. Companies can determine their own policies, but the code must contain the items listed in NYSE 303A.10, only some of which are required by the SEC.

NASDAQ requirements. NASDAQ listing standards require public disclosure of a code of conduct applicable to all employees, officers, and directors. NASDAQ's criteria for the code of conduct are consistent with the SEC's requirements.

86%
of audit committees receive a report on internal tips from a hotline or other reporting mechanism at least once a year

26%
of audit committees receive these reports at every committee meeting

Source: *Deloitte 2016 Board Practices Report*

In addition, each code of conduct must provide for prompt and consistent enforcement, protection for individuals who report questionable behavior, clear and objective standards for compliance, and a fair process for addressing violations.

Both the NYSE and NASDAQ listing standards permit companies to have more than one code of conduct as long as all directors, officers, and employees are covered by a code. For example, some companies have developed a separate code for directors, whose roles and responsibilities differ from those of officers and other employees.

Common practices and considerations. Those responsible for overseeing ethics and compliance should work with management to determine that the company's code of ethics or conduct complies with the applicable requirements. Companies may update the code in response to new issues or situations. Legal counsel should be consulted on modifications to the code.

Communication and training are critical to fostering an ethical culture. The code should be available to everyone in the organization, perhaps through inclusion on the company's intranet site and in the employee orientation program and manual. Some companies require individuals, including directors, to sign an annual certification noting that they have read, understood, and complied with the code. If an employee refuses to sign the certification, committees should encourage companies to take prompt and appropriate disciplinary action, up to and including termination. Communication of disciplinary actions taken in response to code violations is a common way of communicating to employees that violations are taken seriously.

Questions for audit committees to consider

Ethics and compliance

To the extent the audit committee is charged with the responsibility to oversee ethics and compliance:

- Does the committee hear directly from the person who has day-to-day responsibility for ethics and compliance matters? Does this person have the ability to hold these discussions in an executive session?
- Do the ethics and compliance governance framework, organizational structure, and reporting lines provide sufficient independence for the audit committee to execute its responsibilities (e.g., does the chief ethics and compliance officer report directly or indirectly to the audit committee)?
- Does the ethics and compliance officer have adequate staff, technology, and other resources to do an effective job?
- Does the company regularly and systematically scrutinize the sources of ethics and compliance failures and react appropriately?
- How does management take action on reports? Is there evidence of employees being disciplined promptly, appropriately, and consistently?
- Does the reporting process keep the audit committee informed of ethics and compliance issues, as well as the actions taken to address them? Is ethics and compliance a regular item on the committee's agenda?
- What type of ongoing monitoring and auditing processes are in place to assess the effectiveness of the ethics and compliance program?
- Is the company's risk culture encouraging the right type of behaviors?

Tools and resources

Deloitte's ethics and compliance resources offer additional information on establishing codes of ethics and robust ethics and compliance programs, including *Building World-Class Ethics and Compliance Programs: Making a Good Program Great*, and *In Focus: Compliance Trends Survey*, a collaboration between Deloitte and *Compliance Week*.

Reporting hotline procedures

Companies often use hotlines as a mechanism to report a range of ethics and compliance issues, including potential violations of the code of ethics. A thorough, independent, and objective process should be established by management and the audit committee for investigating complaints. Companies use various procedures, but the most common method of receiving tips from inside and outside the organization is through a telephone and Web-based hotline administered by an internal department or a third party.

SEC regulations and the NYSE and NASDAQ listing standards require the audit committees of listed companies to establish procedures for:

- Receiving, retaining, and addressing complaints regarding accounting, internal controls, or auditing matters, whether from internal or external sources who wish to remain anonymous, as well as reporting a range of compliance matters, including violations of the code of conduct and allegations of fraud or corruption
- The confidential, anonymous submission of employee concerns regarding questionable accounting or auditing matters.

The audit committee should work with management to confirm that the appropriate members of management are aware of questions or complaints received from internal sources and third parties, including vendors, through the various reporting methods available. Responsibility for investigating questions or concerns and reporting back to the audit committee often falls on individuals in the ethics and compliance, internal audit, legal, or risk management departments.

The audit committee should also establish expectations with respect to the type of complaints that will be reported to them and how they will be communicated. Some complaints may warrant immediate communication, such as those involving senior management and significant dollar amounts. In addition to these immediate reporting situations, the audit committee should receive a regular analysis of the complaints received, including a root-cause analysis; their resolution; and the steps taken to avoid similar violations in the future. The audit committee should also determine which complaints warrant a discussion with the board.

A telephone and Web-based hotline monitored by an independent third party is common. If the hotline is administered internally, operators should have specific training on where to direct questions or complaints, including those related to human resources, as well as the ability to provide coverage 24 hours a day, 365 days a year and include an anonymous reporting option. Employees can be informed of reporting channels in the code of ethics, the employee handbook, human resources orientation, ethics training, and periodic communications. Instructions for submitting questions or complaints can be posted in company facilities and on intranet sites.

The company's public website is a natural vehicle for communicating the procedures to individuals outside the organization. As discussed in the code of ethics section, NYSE listing standards require companies to adopt codes of ethics and disclose them on their websites. NASDAQ-listed companies also must adopt and disclose codes of ethics, and many have chosen to post their codes on their websites. Telephone operators working in customer service and investor relations should be prepared to answer questions on how to submit concerns and complaints regarding financial reporting.

Under the SEC's whistleblower programs, employees with knowledge of potential securities fraud who report original information to the government or a self-regulatory organization can receive a minimum of 10 percent and as much as 30 percent of monetary sanctions if the enforcement action results in fines of at least $1 million.

Whistleblowers are not required to report issues first through internal company channels; however, those who do so are still eligible for the reward if the company reports the problem to the government or if the whistleblower does so within 120 days of notifying the company.

It is important for the audit committee to work with management and internal audit to understand:

- How hotlines are evaluated, tested, and audited to ensure calls are received, recorded, and managed in a consistent, confidential, accurate, and timely manner
- Opportunities to enhance internal whistleblowing systems and promote reporting mechanisms to all personnel
- The potential value of transaction monitoring tools to help promptly identify potential securities fraud issues such as bribery or financial statement fraud.

Companies with operations in different countries should be careful to comply with those countries' laws, as they may impose requirements, restrictions, and prohibitions different from those applicable in the United States.

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It can help an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control, and governance processes.

Institute of Internal Auditors

Oversight of internal audit

An effective relationship between the audit committee and the internal auditors is fundamental to the success of the internal audit function. It is important for audit committees to assess whether internal audit's priorities, such as monitoring critical controls and developing an audit plan focused on risks identified in the enterprise risk management program, are aligned with those of the audit committee. At some companies, internal audit evaluates and considers suggestions to improve operations and processes.

When the internal audit function reports to the audit committee directly, it allows the internal auditors to remain structurally separate from management and enhances objectivity. This also encourages the free flow of communication on issues and promotes direct feedback from the audit committee on the performance of the chief audit executive.

NYSE requirements. The NYSE listing standards require companies to have an internal audit function. Audit committees are required to oversee the internal audit function and to note this responsibility in their charters. Specific requirements include:

- The audit committee charter must include oversight of the internal audit function as one of its purposes.
- The audit committee's regular report to the board should include issues involving the performance of the internal audit function.
- The audit committee must meet separately with the internal auditors.

NASDAQ requirements. The audit committee oversees the accounting and financial reporting processes of the company. Although NASDAQ companies are not required to have an internal audit function, for those that do, oversight of internal audit is often one component of overseeing accounting and financial reporting.

Common practices and considerations. The specific expectations for internal audit functions vary by organization, but may include:

- Objectively monitor and report on the health of financial, operational, and compliance controls
- Provide insight into the effectiveness of risk management
- Offer guidance regarding internal/compliance controls
- Act as a catalyst for positive change in processes and controls
- Deliver value to the audit committee, other directors, and management in the areas of controls and risk management to assist in the audit committee's assessment of the efficacy of programs and procedures
- Coordinate activities and share perspectives with the independent auditor.

In support of these expectations, the audit committee and the chief audit executive (CAE) should have a strong relationship characterized by open communication. The audit committee should challenge the CAE and the internal audit department by setting high expectations, communicating those expectations clearly, and holding the department accountable for meeting them. The CAE should be candid in raising concerns with the audit committee when they arise.

It is important for the audit committee to see that the internal auditors have appropriate independence and stature and are visibly supported by senior management throughout the organization. They should support the CAE, providing guidance and assistance when he or she reports potential management lapses.

In addition to making themselves available when contacted by the CAE, members of the audit committee should engage with the CAE regularly to maintain a reporting relationship that is both substantive and communicative. Holding regular executive sessions with the CAE is common and is required for NYSE-listed companies. The audit committee should actively participate in discussing goals and evaluating the performance of the CAE; these responsibilities should not be delegated solely to the CFO or CEO.

The audit committee should understand and approve the annual internal audit plan and determine if the CAE has a sufficient budget and related resources to execute against it. In determining that resources are adequate, audit committees often consider whether the CAE and his or her staff are adequately compensated. As part of this review, they should review and evaluate the status of the enterprise-wide risk management program and the alignment of risks to the internal audit plan. The audit committee should also evaluate the progress and results of the internal audit plan against the original plans and any significant changes made subsequently.

The International Standards for Professional Practice of Internal Auditing established by the Institute of Internal Auditors (IIA) require internal auditors to maintain a certain level of independence from the work they audit. This means that an internal auditor should have no personal or professional involvement with the area being audited and should maintain an impartial perspective on all engagements. Internal auditors should have access to records and personnel when necessary, and they should be allowed to employ appropriate investigative techniques without impediment.

Internal audit departments should also employ quality processes with a focus on continuous improvement. These processes should be periodically reviewed through self-assessment and/or external reviews. The IIA's standards require external assessments to be conducted by a qualified, independent party at least once every five years. The CAE should discuss the form and frequency of the external assessment, as well as the qualifications and independence of the external assessor, with the audit committee.

Oversight of internal audit

There are several ways the audit committee can oversee the internal audit function. The IIA provides the following checklist of considerations for audit committees in overseeing the internal auditors:

- The audit committee engages in an open, transparent relationship with the CAE.
- The audit committee reviews and approves the internal audit charter and internal audit plan annually.
- As a result of discussions with the CAE, the audit committee has a clear understanding of the strengths and weaknesses of the organization's internal control and risk management systems.
- Internal audit is sufficiently resourced with competent, objective professionals to carry out the internal audit plan, which has been reviewed and approved by the audit committee.
- Internal audit is empowered to be independent by its appropriate reporting relationships to executive management and the audit committee.
- The audit committee addresses with the CAE all issues related to internal audit independence, objectivity, and resources.
- Internal audit is quality-oriented and has a quality assurance and improvement program in place.
- The audit committee regularly communicates with the CAE about the performance and improvement of the CAE and internal audit.
- Internal audit reports are actionable, and audit recommendations and other improvements are implemented by management satisfactorily.
- The audit committee meets periodically with the CAE without the presence of management.

Questions for audit committees to consider

Interactions with internal audit

- Does internal audit have a clearly articulated strategy that is reviewed and approved by the audit committee periodically?
- Does internal audit have a clear set of performance expectations that are aligned with the success measures of the audit committee and measured and reported to the audit committee?
- Does internal audit have a charter that is reviewed and approved by the audit committee periodically? Does internal audit operate in accordance with its charter?
- Is the internal audit plan aligned to the primary risks of the organization and other assurance activities? Is internal audit's risk assessment process linked to the company's enterprise risk management activities appropriately?
- Is internal audit flexible and dynamic in addressing new risks promptly and meeting the needs of the audit committee?
- Is internal audit effective in using advanced technologies, such as data analytics, to improve audit quality?
- Does internal audit organize or perform peer reviews or self-assessments of its performance and report the results to the audit committee?
- Does the CAE have the right mix of experience and capabilities, including industry knowledge and business acumen, to understand the company's risks?
- Does the CAE have a professional certification, such as certified internal auditor, and participate in relevant continuing education programs?
- Is internal audit funded and adequately and staffed with the appropriate mix of professionals needed to achieve its objectives?
- Does internal audit's reporting structure within the organization ensure sufficient independence and respect from management and other employees?
- Is the level of assurance provided by internal audit and its interaction with other assurance sources clear and appropriate for the audit committee?
- Does the internal audit function have and demonstrate the level of independence needed to execute its responsibilities properly?
- Does internal audit meet with the independent auditor regularly to discuss risk assessments, the scope of procedures, or opportunities to achieve greater efficiencies and effectiveness in the company's audit services?
- Does internal audit report issues in a timely manner and address them with management?
- Are issues identified and reported by internal audit highlighted to the audit committee appropriately, and is the progress of remediation tracked and reported?
- Are reports and other communications from internal audit to the audit committee of an appropriate standard and do they provide value?

Other interactions with management and the board

In executing their governance responsibilities, audit committees frequently interact with other stakeholders, in addition to the internal and independent auditors.

Interactions with the finance organization

The finance function's leaders and professionals can have a direct impact on a company's risk profile, value creation, and return on investment for investors and other stakeholders. The audit committee relies significantly on the finance function and needs to maintain an open and effective relationship with them. Their oversight can contribute to the finance organization's interest in having the right resources available to support the quality and reliability of financial accounting, reporting, and related controls. Audit committees may also provide input on the assessment and compensation of finance professionals who they interact with regularly.

The audit committee can help monitor and strengthen finance talent initiatives, in particular the succession plans for leaders and finance professionals in roles of critical importance, through regular discussions with the CEO, CFO, and other finance executives, as well as regular oversight of issues related to finance talent.

Common practices and considerations. Interactions with the finance organization vary, but may include the following practices:

- To foster open communication, meet periodically with management, the director of the internal audit function, and the independent auditor in separate executive sessions (NYSE Corporate Governance Rule 303A.07(b)(iii)(E)).
- Provide input on the performance of key finance executives, including the CFO and CAO.
- Provide input into management's goal-setting process.
- Hold annual discussions of succession planning for the finance organization with the CEO and CFO and regular discussions of the finance organization's bench strength.
- Invite succession candidates to present during audit committee meetings to develop a firsthand view of their potential.
- Understand management's process for early identification and resolution of accounting and other issues.
- Understand plans to address new accounting and reporting requirements and related risks.
- Visit company locations and meet with members of management periodically.

Questions for audit committees to consider

Finance organization talent

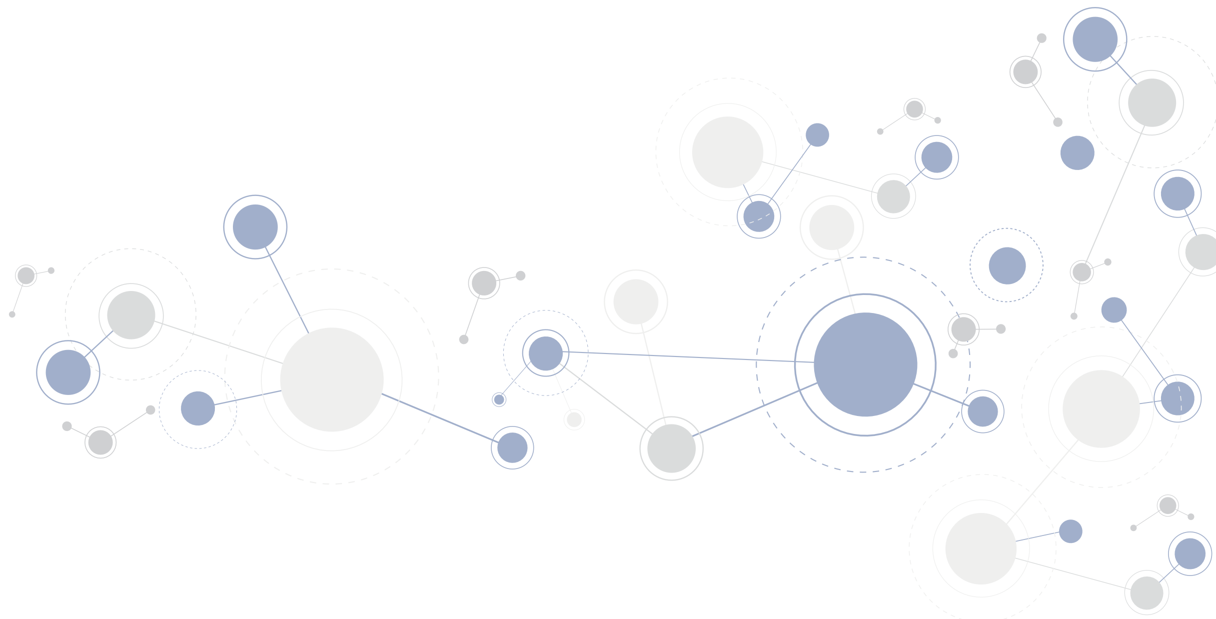
- Do you have adequate personnel, both in numbers and quality, to fulfill your responsibilities with respect to the financial statements and internal control over financial reporting?
- What is the succession plan for key finance positions?
- Are there finance professionals in the pipeline of potential leaders that the audit committee should meet? Are succession candidates given an opportunity to meet with the audit committee?
- What plans are in place to respond to unexpected turnover in finance roles? Is someone ready to begin immediately, and if not, what are the backup plans to hire temporary resources?
- What formal training and development programs are in place to keep finance professionals up to date with the latest developments and requirements? Do professionals receive training on advanced technologies that could enhance the effectiveness of the finance organization?
- How does the audit committee participate in the evaluation of the CFO? What kind of evaluation criteria are important to the audit committee?

Interactions with the board and other committees

As the audit committee seeks to align its structure with the company's strategic priorities, it should consider the coordination required among other board committees and the full board to facilitate the optimal allocation and coverage of topics that affect more than one group and to reduce the likelihood of something falling through the cracks. The audit committee should understand the roles and responsibilities of other board committees and consider whether they could benefit from periodic joint meetings to discuss areas of common interest and significant matters.

It is particularly important for the audit committee to coordinate with the compensation committee as it considers the risk that compensation policies have on the financial statements and internal controls. The audit committee should understand management and general employee compensation plans and how related metrics may affect fraud risks. Additionally, as companies increasingly use non-GAAP metrics to determine compensation, the audit committee should understand how those metrics may impact risk and may need to be addressed in the reconciliation between non-GAAP and GAAP information.

The audit committee chairman should also coordinate with the nominating and governance committee as it considers board candidates. The chairman should communicate the skills and experiences needed from members to effectively carry out the audit committee's responsibilities.



Audit committee external communications

Investors, policymakers, and regulators are continuing to show interest in more detailed disclosure about audit committees, their activities, and their oversight of the relationship with independent auditors. As these external parties request additional clarification about the roles and responsibilities, audit committees should consider whether they should enhance disclosures in the proxy statement.

Various SEC rules and exchange listing requirements address audit- and audit committee-related information that must be disclosed in the proxy statement, including the audit committee report, and on company websites.

SEC rules require companies to disclose the name of each audit committee member and include an audit committee report in their proxy statements. In the report, the audit committee must state whether it has:

- Reviewed and discussed the audited financial statements with management
- Discussed with the independent auditor all matters required under applicable auditing standards
- Received required independence disclosures from the independent auditor.

Based on this review and discussion, the report must also include a statement of whether the audit committee recommended to the board that the audited financial statements be included in the annual report to be filed with the SEC.

Proxy statements must disclose whether the board has adopted a written charter for the audit committee, and if so, include a copy of the charter as an appendix to the proxy statements at least once every three years.

Audit committee reporting

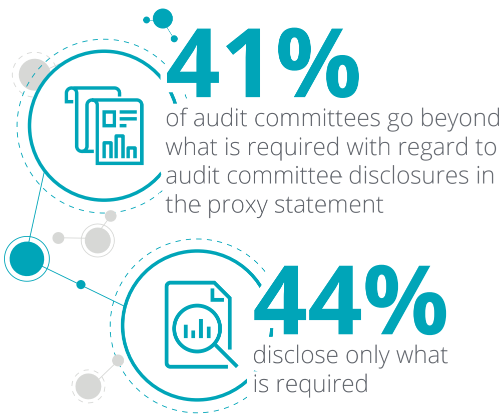
Over the past several years, investors and other governance groups and investors have sought expanded disclosures on how audit committees execute their duties. As recently as November 2016, the United Brotherhood of Carpenters' Pension Fund announced that it would send letters to 75 companies encouraging their audit committees to enhance auditor independence disclosures in 2017 proxy statements—a request they have been making since 2013. The SEC weighed in on the discussion when it issued a request for public comment in a July 2015 concept release titled *Possible Revisions to Audit Committee Disclosures*.

Deloitte's latest proxy statement analysis, *Audit Committee Disclosure in Proxy Statements – 2017 Trends*, indicates that companies have generally increased voluntary disclosures about the role and activities of audit committees over the past several years. While it is not necessary, or possible, to disclose everything an audit committee does each year in fulfilling its duties, additional insight into the structure and activities of the audit committee can help increase investor confidence in both the committee and the company as a whole.

The Center for Audit Quality (CAQ) and Audit Analytics published the *Audit Committee Transparency Barometer* in November 2016, which presents findings from an analysis of audit committee disclosures in proxy statements and measures the robustness of these disclosures among S&P Composite 1500 companies. The report measures the content of proxy statement disclosures in areas that include auditor oversight and scope of duties. The CAQ joined with several governance organizations in 2013 to form the Audit Committee Collaboration,[1] which released a report titled Enhancing the Audit Committee Report: A Call to Action in November 2013 to encourage enhanced audit committee disclosures.

The calls for increased transparency into audit committee duties, including the oversight of the independent auditor, are expected to continue to grow. Audit committees can respond by providing more meaningful disclosures that increase awareness of their responsibilities and how individual committees carry them out. For more information, read the *July 2015 Audit Committee Brief: SEC Issues Concept Release Concerning Audit Committee Reporting Requirements*.

[1] The following groups are members of the Audit Committee Collaboration: Association of Audit Committee Members, Inc.; Center for Audit Quality; Corporate Board Member/NYSE Euronext; The Directors' Council; Independent Directors Council; Mutual Fund Directors Forum; National Association of Corporate Directors; and Tapestry Networks.



Source: *Deloitte 2016 Board Practices Report*

Companies whose securities are quoted on NASDAQ or listed on the NYSE must disclose whether the audit committee members are independent as defined in the applicable listing standards, as well as certain information regarding any director on the audit committee who is not independent.

Regulators continue to solicit views of audit committees with respect to industry- and company-specific knowledge and experience. Taking the time to engage in formal or informal communication with regulators, industry groups, or the independent auditor on these topics can have a substantive impact on the development of standards and rules.

Fee disclosure

The SEC rule requires disclosure of fees paid to the independent auditor for the current and prior years, as well as a description of the services included in all categories, other than for audit fees, for both years. The audit committee's preapproval policies and procedures must be disclosed in a detailed description or by including the policy itself, along with disclosure of any services that were initially missed and later approved under a de minimis exception in the SEC's rule. Disclosures are required in the issuer's annual report as well as the proxy statement, but companies are allowed to incorporate the information into their Form 10-K from their proxy statement.

The SEC's rule that implemented the Sarbanes-Oxley Act expanded the requirements to disclose fees paid to the auditor, and many companies have opted to provide even more information. For instance, many companies subtotal the audit and audit-related fees so shareholders can easily quantify the portion of services that are audit and audit-related in nature.

Because certain institutional investors and proxy advisers, such as Institutional Shareholder Services, have guidelines for proxy-vote recommendations related to audit fees, many companies disclose not only the nature of services in the fee categories but also the amounts associated with specific services. Issuers should consult with legal counsel to determine the content of the fee disclosure. The SEC's four fee categories are:

- **Audit fees** are fees for services that normally would be provided in connection with statutory and regulatory filings or engagements, including the audit of internal control over financial reporting. This category also may include services that only the independent auditor reasonably can provide, such as comfort letters, statutory audits, attest services, consents, and assistance with documents filed with the SEC. Audit fees may include certain services provided by specialists who assist in the audit, such as tax specialists needed to audit the tax provision or valuation specialists needed to audit a fair-value assertion; certain accounting consultations in connection with the audit; and similar items that are not billed as audit services and that only the independent auditor reasonably can provide.
- **Audit-related fees** are for assurance and related services that are performed by the independent auditor, such as audits of employee benefit plans; due diligence related to mergers and acquisitions; accounting consultations and audits in connection with acquisitions; internal control reviews, although not the audit of internal control over financial reporting, which is part of audit fees; attest services that are not required by statute or regulation; and consultation concerning financial accounting and reporting standards to the extent that such consultation is not necessary to complete the GAAS audit.
- **Tax fees** include all tax services except those related to the audit, such as review of the tax provision, which would be included in audit fees. Typically, tax fees cover tax compliance, planning, and advice. Tax compliance generally involves preparation of original and amended tax returns, refund claims, and planning services related to tax payments. Tax planning and tax advice encompass a diverse range of services, including assistance with tax audits and appeals, tax advice related to mergers and acquisitions, employee benefit plans, and requests for rulings or technical advice from tax authorities. The provision of tax services is subject to certain restrictions, among which are that company personnel must make all management decisions and perform all management functions, and that services cannot be provided for an employee with a financial oversight role.
- **All other fees** include all fees paid to the independent auditor for services other than audit, audit-related, or tax services.

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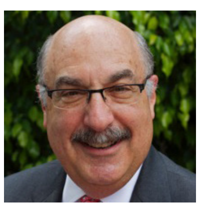

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About this publication

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About the Center for Board Effectiveness

The Center for Board Effectiveness helps directors deliver value to the organizations they serve through a portfolio of high quality, innovative experiences throughout their tenure as board members. Whether an individual is aspiring to board participation or a veteran of many board experiences, the Center's programs enable them to contribute effectively and provide focus in the areas of governance and audit, strategy, risk, innovation, compensation and succession.

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Grant Thornton

Higher Education Audit Committee Guidebook

Contents

The higher education audit committee's guide to protecting your institution's reputation

Your institution'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 of trustees maintain the institution's overall integrity, financial credibility and long-term viability. A sharpened focus on accountability, transparency and ERM has brought the role of the audit committee into the public eye. Ensuring that the institution prepares accurate financial statements, exercises responsible financial management, maintains compliance with laws and regulations, and manages operating risks effectively are critical tasks for every audit committee member.

Understanding that your role as an audit committee member is both rewarding and challenging, Grant Thornton LLP has created this guidebook to provide an overview of the composition, functions and duties of an audit committee.

We are committed to providing outstanding service to meet the audit, tax and advisory needs of our 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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Accountability and independence: Guiding principles of the audit committee

The current environment

Colleges and universities are under scrutiny as never before. From the paying parent to the White House, the expectations of educational institutions to perform their mission wisely and cost-effectively has never been greater. Audit committees are charged with the critical role of assessing their institution's capability to discharge its fiduciary duties effectively, accurately and with integrity.

At the federal level, the IRS has demonstrated a strong interest in institutions' good governance practices and their compliance with tax laws and regulations. The U.S. Government Accountability Office has issued several reports concerning the financial practices of not-for-profit organizations, including higher education, and the Senate Finance Committee has addressed governance practices for many years — often focused specifically on colleges and universities. As a recipient of federal financial support, your granting agencies are also subject to an increased level of accountability to Congress. There is special sensitivity to a college or university's proper use of federal grants and contracts, as well as financial aid dollars.

At the state level, attorneys general, through their responsibility to oversee charitable organizations, are concentrating their energy on enforcing compliance with regulations.

At both the federal and state levels, the tax-exempt status of your institution is seen as a significant form of government subsidy, carrying with it the responsibility for ethical behavior.

As for third parties, news organizations will report any real or perceived transgression by an institution and its trustees or staff. Banks, bond insurers, state debt intermediaries and ratings agencies have all raised their standards of transparency and financial health.

Boards do not want any distraction from the achievement of their institution's mission; therefore, they, too, are setting higher standards for governance and financial practices.

The responsibility for ensuring that college or university administration meets the heightened expectations of today's increasingly stringent climate falls directly on the audit committee.

Guiding principles

The guiding principles of the audit committee can be summed up in two words: accountability and independence.

Accountability

A not-for-profit institution is accountable to stakeholders such as donors, grantors, organizations that provide financing, regulators and people who use the resources of the institution. Those stakeholders rely on the institution to protect its reputation and properly and prudently use the monies it receives — whether fees, donations, grants or exchange contracts. In addition to being accountable to its stakeholders, the institution has a much broader responsibility to society at large because of its tax-exempt status. Tax exemption is a way to recognize the societal value of the services the institution delivers. It is also a method by which all taxpayers underwrite those services. In effect, every taxpayer is a stakeholder in your institution.

In order to govern effectively, the board must verify that management has adopted financial practices that are compliant with regulations and consistent with best practices, and adhere to high ethical standards. The audit committee's primary role is to instill confidence in stakeholders that the institution's financial and tax status, internal controls, risk management, and compliance procedures allow it to fulfill its mission and achieve long-term viability.

Independence

The audit committee is charged with ensuring that management is conducting business at arm's-length basis with all parties, and avoiding conflicts of interest and inside dealings. To carry out this charge effectively, the audit committee itself must be independent of both management and the external auditors. The audit committee concerns itself with three facets of independence:

- The external auditor's opinion on the financial statements must be based only on its independent professional judgment, without improper influence from management.
- The institution's internal auditors must be independent from management and able to report problems and findings openly to the audit committee.
- The institution's board members and management must be independent from vendors. If overlapping financial interests or personal relationships exist, they must be fully disclosed, and the appropriate personnel must recuse themselves from discussions and voting on related matters. The board needs to approve a plan to monitor the conflicted relationships so that they do not create bias in academic or business decision-making.

Basic roles and responsibilities

The audit committee's roles in the institution's governance

Three main roles

First, the audit committee represents the board in overseeing all material aspects of the institution's financial reporting, accounting policies and internal controls that promote good financial stewardship.
To ascertain whether the institution is exercising proper stewardship over its assets, the audit committee must understand the institution's financial management practices, as well as monitor management's corrective actions with respect to the findings of the internal and external auditors' testing and review of the college or university's internal controls and regulatory compliance procedures. These activities are meant to safeguard the institution's assets, promote the reliability and accuracy of its financial reporting, and mitigate the risk of fraud.

Second, the audit committee is often the board committee primarily responsible for inquiring into how the business risks of the institution are being planned for and managed.
Other board committees — such as investment, academic affairs, HR or personnel, facilities, student affairs and development — will have a role in overseeing specific areas of risk. However, it is usually the audit committee that asks the overarching questions that help determine if the planning for and internal controls governing those risks are adequate.

To do this, the audit committee should understand the college or university's enterprise risk profile in terms of governance, personnel, financial, process and operational, academic, regulatory compliance, technology, economic, legislative, competitive and fraud risk. Specific areas to address include:

- Investment practices
- Significant tax risks and tax positions on particular transactions
- Relationships with affiliated organizations
- Disaster recovery plans
- Adherence to donor and grantor requirements (especially unusual or problematic gifts)
- Inquiries from state charities' registration bureaus
- Insurance/litigation claims and adequacy of coverage
- Prevalence of high-profile research projects
- Applicability of clinical trials review protocols in nonmedical school departments
- Vulnerability to technology breaches from outside the college or university
- Faculty and administrators' adherence to conflict-of-interest policies
- Risks associated with various financing agreements and structures
- Overall college or university profile compared with industry standards

The business risk tasks most commonly assigned to an audit committee include business risk assessment and mitigation:

- Understanding the comprehensive assessment of the business and reputational risks faced by the college or university, along with assessing management's plan to manage those risks
- Holding management — including the president — responsible for the effective design and implementation of an internal control structure over financial reporting, nonfinancial reporting, asset stewardship, compliance with laws and regulations, protecting personal employee identification and student information, and private and confidential employee data
- Providing to the internal and external auditor open access to the audit committee for discussion of issues, concerns and scope of work
- Approving the annual internal audit plan and reviewing the reports prepared by internal auditors
- Overseeing the whistleblower policy and process, and confirming that employees have a confidential way to report concerns regarding fraud, financial impropriety and misuse of funds
- Creating an appropriate tone from the top

Third, the audit committee plays a pivotal role in overseeing the institution's audit (internal and external) and compliance functions.
Every college and university must comply with applicable tax, legal, ethical and regulatory requirements. In higher education, regulatory standards dictate financial, billing, safety, employment, grants and contracts, financial aid, spending and investing practices. In addition, most colleges and universities must adhere to regulations specifying how they carry out their programs and what types of matters must be reported to regulators.

An effective audit committee must have a basic understanding of the compliance standards that affect the institution and how the institution adheres to those standards. The audit committee also needs to know which regulatory matters are assessed by the internal and external auditors, and which regulatory matters fall outside the scope of financial management and are instead managed by faculty or administrative staff. In most instances, it is the audit committee that inquires into the role of the institution's compliance officer and ascertains that key committees and the board are kept informed of pertinent issues.

The audit committee is also responsible for overseeing the external and internal audit functions. Audit committee members should meet with the institution's external auditors at least twice a year — once to discuss the audit workplan and once to review the audit findings before they are presented to the board. It is best practice to have internal audit attend all audit committee meetings.

The oversight tasks most commonly assigned to an audit committee in this area include:

Internal and external audit

- Recommending and appointing an independent audit firm
- Discussing the propriety of financial statement presentation and the adequacy of footnote disclosures
- Reviewing disclosures in financial statements to confirm clear and appropriate communication of financial information
- Reviewing and approving the scope of the workplan for the internal and external audits
- Reviewing findings of internal audits and associated control issues
- Receiving and acting upon the results of the internal and external audits
- Requiring follow-up and corrective action plans to be presented by management
- Monitoring implementation of management letter and internal audit recommendations
- Reporting to the board the results of the internal and external audits
- Evaluating the performance of the internal and external auditors
- Resolving disagreements between the external auditors and management
- Reviewing and approving the contract for any nonaudit services provided by the external auditors (optionally, for fees exceeding a certain threshold) if so required based on policy or audit committee charter

Compliance

- Reviewing internally and externally produced reports on the college or university's compliance with laws and regulations that have a direct and indirect effect on financial reporting, and on compliance with the college or university's internal policies and procedures that are designed to ensure compliance
- Reviewing the Forms 990 and 990-T that are filed with the IRS
- Making certain that conflict-of-interest and code-of-ethics policies are implemented and applicable to employees and the board
- Reviewing significant conflicts of interest and related-party transactions
- Ensuring the existence of whistleblower procedures through which stakeholders, including employees, can raise concerns without fear of retaliation
- Ascertaining that a record-retention policy is in place and being followed

Distinction between audit and finance

Some smaller colleges have joint audit and finance committees even though the trend has long been toward the establishment of a separate standing audit committee.

Some states require not-for-profit organizations to have a separate audit committee since the role of an audit committee is quite different from that of a finance committee. A finance committee's principal task is the approval and monitoring of the budget and financial results; performing this function requires individuals who understand the institution's programmatic structure and mission. An audit committee, however, views the institution's financial reporting, disclosure, compliance, internal control and risk processes from a critical perspective to understand and assess institutional weaknesses.

A board-approved charter should spell out the audit committee's exact authority and responsibilities. (For an example of an audit committee charter, see Appendix II.)

Given the audit committee's charge to oversee compliance, financial reporting, fiscal stewardship and business risks — essentially acting as the conscience of the institution — many institutions' charters include the authority to conduct special investigations and engage experts when circumstances require.

Composition

The audit committee is generally composed of three to five members — the majority of whom should be board members. (Some states now require that all audit committee members be trustees.) Regulations permitting, audit committee members who are not on the board can serve effectively and in many instances can serve as accounting or financial statement experts if no board members have that expertise. All audit committee members should be independent of the institution's management — that is, they must not accept, directly or indirectly, any salary or compensatory fees from the institution.

As a general rule, the board treasurer should not serve on the audit committee. The audit committee monitors the institution's financial results, thus creating a conflict with the role of the treasurer. Sometimes there is an overlap between members serving on the audit, finance and investment committees. If such an overlap occurs, it is important that it be kept to a minimum and that there is no overlap for the majority of audit committee members.

Furthermore, in order for the audit committee to act as the conscience of the institution, it is important that it be independent of relationships that could compromise this integrity. Therefore, it is best that no officers of the board serve on the audit committee, and there should be limited participation of other committee members.

Attributes

- Knowledge of the primary activities and operations of the institution
- A solid grounding in business and finance
- A good understanding of internal control concepts
- Financial literacy (i.e., an understanding of basic financial terminology and the ability to read and interpret financial statements)
- Knowledge of business risk and ability to link key operational and financial risks to related controls and control processes
- An understanding of compliance issues unique to the institution

One or more members should be a financial expert, possessing professional knowledge of financial reporting (including GAAP) and internal controls over financial reporting. Ideally, the financial expert should have specific knowledge of financial reporting practices used by colleges and universities.

Of course, the supply of individuals with such backgrounds will vary considerably from one institution to the next. If your college or university does not have board members with a financial background, you should actively recruit bankers, accountants and other financial professionals to fill this need.

Characteristics required

It is very important for audit committee members to possess the skills to listen and actively question what they are told. The audit committee members must be able to maintain a healthy skepticism and should ask management pointed questions about practices, policies and needed improvements. They should pursue these issues until satisfied with the answers received. Individuals who are uncomfortable asking challenging questions or coming to critical conclusions can't serve effectively on an audit committee. The role of the audit committee is not to challenge management for the sake of being challenging, but rather to ensure that needed improvements to controls, risk management and financial practices are diligently put in place.

The final characteristic an audit committee member must possess is a willingness to commit the time and effort necessary to do the job. Depending on your college or university's size and structure, this time commitment could be substantial.

Member liability

Board members of colleges and universities face potential personal legal liabilities. The question of whether serving on an audit committee entails any further legal risk is a legitimate one. Since many of the events that could result in liability for the board stem from failures in internal controls, the audit committee is partly responsible for protecting itself — and the board — from such liability.

Before accepting any board position, investigate whether the institution carries adequate directors' and officers' (D&O) insurance coverage, which protects boards against allegations of wrongdoing. When reviewing the D&O policy, be sure it covers legal costs, which will be incurred regardless of the outcome of a lawsuit. You may wish to consult with legal counsel regarding the relevant laws in your state. You may also want to ask your insurance agent about individual policies that might cover such exposure.

Users of the financial statements

Colleges and universities are unique in the breadth and diversity of the constituencies that have a strong interest in their financial health. All of those constituencies are potential users of the institution's financial statements.

Internal users

The board uses the financial statements to understand the institution's revenues and expenditures, along with the scope and limitations of its financial assets. For the board, the financial statements are among many tools used to evaluate the institution's risk profile. Further, the board uses the external auditor's management letter to assess the effectiveness of the institution's internal controls over financial reporting.

Management uses the financial statements for the same purposes that the board does. In addition, it uses the management letter as a roadmap for improving the institution's internal controls over financial reporting.

Both the board and management should use the financial statements to benchmark similar colleges, universities or other not-for-profit entities. Since GAAP creates consistency across organizations, these internal users can compare assets, revenue sources and expenditure patterns to information contained in the financial statements of peer or aspirant organizations.

Other users of the financial statements can include faculty, students, staff and volunteers.

External users

Donors and granting agencies use the financial statements to assess an institution's financial position and performance. A clean opinion is seen as validating the financial condition of the institution. Banks and ratings agencies use the financial statements to evaluate the financial strength and viability of the institution, which becomes important when it applies for a loan. Accrediting and licensing agencies use the financial statements to determine the soundness of an institution as a service provider. News institutions use the financial statements — along with the Forms 990 and 990-T, and other filings — to seek background information on the institution, usually when following up on an embarrassing disclosure.

Given the wide range of potential users — and uses — of an institution's financial statements, it is essential that audit committee members evaluate them carefully and critically.

The insider's perspective: Working within a college or university

An effective audit committee must work with a variety of groups within an institution — the board, the management team and the internal audit department. It is essential that prospective audit committee members understand their role in each of these relationships.

The audit committee and the board

The audit committee represents the board in fulfilling some of its responsibilities for risk management and financial oversight of the institution.

The audit committee should report at each board meeting (or at a minimum, twice per year). Topics to be addressed include:

- The plans for and results of internal and external audits, and any audit-related issues that merit the board's attention
- Issues of business risk and financial accountability
- Internal control or procedural issues
- New systems and controls evaluated and put in place
- Regulatory issues, including Title IV and Title IX mandatory reporting matters
- Pension audits
- Forms 990 and 990-T review
- Athletics audits

The audit committee and management

Management is responsible for creating and maintaining internal controls, and the audit committee is responsible for understanding if those controls are designed and implemented adequately (supported by findings and recommendations from the internal and external auditors).

While the audit committee works collaboratively with external and internal auditors, and management, the audit committee is independent of each of these groups and must come to its own conclusions.

The audit committee should discuss internal control issues with management and review management's plans for correcting them. In some cases, management may recommend against implementing an auditor's suggestions on a cost-benefit basis — or even recommend an alternative solution. The audit committee should consider these suggestions, discuss them with the auditors if necessary, and bring any unresolved matters to the board's attention.

The emergence of ERM as an integral part of institutional risk-related activities creates a new role for the audit committee in understanding and assessing internal processes and management-led risk committee initiatives for identifying, managing and mitigating risk.

The audit committee can provide management with valuable, objective experience and expertise not available in-house and can serve as a sounding board for any issues related to reputation, strategic risk, operations, finance, internal controls and the public trust. By giving management an opportunity to discuss sensitive matters up front, the audit committee can help fend off potential problems before they arise.

The audit committee and internal audit department

Today, audit committees expect more from their internal audit functions than they did in the past. If your college or university has an internal audit function, the audit committee should work with it in much the same way that it works with the external auditors. To be effective and independent, the internal audit department should be directly accountable to the audit committee. The head of internal audit should have confidential access to the audit committee chair. Additionally, the audit committee should evaluate the performance of the internal audit leader.

The audit committee should review and approve the internal audit workplan. This workplan should be based on a thorough risk analysis and list the areas within the institution targeted for detailed examination. The audit committee should review the internal audit department's findings and discuss any internal control issues that have arisen.

Audit committees are also looking to internal auditors to monitor the status of findings and recommendations to verify that appropriate corrective action plans are being implemented and old patterns of behavior are not being repeated. The institution should require the internal audit department to issue periodic reports regarding the status of corrective action plans, present these reports to the audit committee and possibly re-audit the affected internal controls after a certain period of time has elapsed.

If your institution does not have an internal audit function, it should consider establishing one either internally or via outsourcing.

Working with the external auditors

As an audit committee member, you will spend much of your time working with the institution's external auditors, who have been appointed by the audit committee — or the board itself — to assist in assessing the institution's financial condition and stewardship functions.

Most audit committees meet two to four times per year. At a minimum, the committee should hold one meeting with external auditors to plan the audit and one to review results. It is a best practice for internal audit to attend meetings with external auditors — and all audit committee meetings, for that matter.

The pre-audit meeting

Prior to the audit, the audit committee should meet with the external auditors to review their workplan and set expectations for the upcoming work. An auditor's workplan details its strategy for conducting the audit. The workplan identifies those areas that the auditor has targeted for the closest scrutiny and sets a schedule for the audit.

Audit committee members should review the workplan with the external auditors in light of the prior year's audit results and the audit committee's own concerns regarding business risks, internal controls and other pertinent issues. If the audit committee has concerns about a specific financial area, the external auditors' workplan should include it. If the workplan does not include that area, the audit committee must determine with the external auditors whether to add it. The audit committee must then review and approve the cost of any additional work it requests.

The pre-audit meeting is also the venue for external auditors to solicit input from the audit committee on areas of financial statement and internal control risk, including the risk of fraud. The audit committee should discuss with the external auditors any internal control issues or other issues raised by the prior year's audit. The audit committee should inform the external auditors of the steps, if any, that management has taken to resolve those issues and should seek the external auditors' opinion of those solutions.

During the pre-audit meeting (as well as the post-audit meeting), the audit committee should meet in separate executive sessions with external auditors, internal auditors and management. These executive sessions should be a standard part of the pre-audit meeting.

If an executive session deals with situations involving compliance or whistleblowing, the audit committee may want to have its own legal counsel present.

The post-audit meeting

As its name implies, the post-audit meeting is held after the external auditors have completed their fieldwork. At this meeting, the external auditors will present to the audit committee their audit results — including draft reports, supplemental financial information and related audit reports — for review and discussion. In addition, external auditors' professional standards require that they communicate the following matters to the audit committee:

- **The auditors' responsibility under GAAP**
  The external auditors must communicate their level of responsibility for reviewing and reporting on the institution's internal control structure, and determining if the financial statements are free of material misstatement. The external auditors must explain to the audit committee that an audit is designed to deliver reasonable, not absolute, assurance that the financial statements are presented fairly and in accordance with GAAP.
- **Significant accounting policies**
  The external auditors should inform the audit committee about the selection of, changes in or application of significant accounting principles (including the options that might have been available) and financial reporting practices and policies during the period being audited. Discussions should include the effects of these practices and policies — and any likely changes to them.
- **Management judgments and accounting estimates**
  Accounting estimates are an integral part of an institution's financial statements. These estimates can be particularly sensitive because of the possibility that actual amounts may differ significantly from them. The external auditors should educate the audit committee about the process employed and assumptions made by management to formulate sensitive accounting estimates, and the basis for the auditors' conclusions regarding the reasonableness of those estimates. Post-retirement benefit obligations and the allowance for uncollectible accounts related to pledges receivable are examples of significant estimates.
- **Significant audit adjustments**
  The audit committee should be informed of all significant adjustments made as a result of the audit that may not have been otherwise detected by management or staff. The external auditors must also provide the audit committee with a listing of proposed audit adjustments that were not recorded because neither the external auditors nor management considered the amounts involved to be material to the financial statements — either on an individual basis or in the aggregate.
- **Responsibility for other information in documents containing audited financial statements**
  The auditors should discuss their level of responsibility for and involvement with information in other documents containing audited financial statements such as published annual reports or debt offerings.
- **Disagreements with management**
  The external auditors should discuss any disagreements with management about matters related to accounting principles, financial reporting practices and policies, and auditing matters that could be significant to the financial statements or external auditors' report. Areas of disagreement might include application of accounting principles, judgments about accounting estimates, scope of the audit or wording of the external auditors' report.
- **Consultation with other accountants**
  If the external auditors are aware that management has consulted with other external auditors on matters pertaining to auditing, accounting or financial reporting matters, the views of those auditors should be discussed with the audit committee.
- **Major issues discussed with management prior to retention**
  The external auditors and audit committee should review any major management issues raised when they were retained, including discussions about accounting principles, financial reporting practices and policies, and auditing standards and procedures.

- **Difficulties encountered in performing the audit**
  The external auditors should inform the audit committee of serious difficulties in working with management while performing the audit. Such difficulties might include failure to provide necessary information, unreasonable delays, unavailability of client personnel or failure of client personnel to promptly complete requested schedules.

In addition, the audit committee should discuss the following topics with the external auditors:

- Comparison of actual with anticipated audit results
- Any need to expand audit procedures and the reasons for doing so
- Propriety of financial statement preparation and adequacy of footnote disclosures
- Changes in report format or note disclosures from the previous year and reasons for making those changes
- Evaluation of personnel involved in preparing and monitoring financial information
- Nonaudit services and related fees during the prior year
- The report that the audit committee chairman will present to the board

During the post-audit meeting, the audit committee should meet in separate executive sessions with only committee members present, with the external auditors, with the internal auditors and with management. These executive sessions should be a standard part of the post-audit meeting.

Again, if an executive session deals with situations involving compliance or whistleblowing, the audit committee may want to have its own legal counsel present.

Evaluating the external auditors

Part of the audit committee's responsibility is to evaluate the work of external auditors. The audit committee should consider many factors when performing this evaluation:

- **Timeliness of service**
  Your external auditors should have a strong commitment to and demonstrated track record in timely service delivery. Working with your institution to plan and execute the audit, communicating regularly with you, and responding quickly to your questions and concerns are all essential to concluding the audit promptly, as well as meeting your expectations and those of the board.
- **Ability to address issues unique to your institution's risk profile**
  The audit firm must be able to understand your institution's funding streams, cost methods, regulatory environment and general business conditions — in other words, the aspects that make up your institution's unique risk profile. Your staff should not have to teach the firm's staff how to work with colleges and universities. Instead, the audit firm should provide critical information and business advice that will help improve your institution's operations.

- **General industry knowledge**
  Auditors need experience in providing guidance and information relevant to higher education institutions and their many stakeholders. Donors, federal and state funding agencies, charity watchdogs, bonding agencies, regulators, accrediting bodies, the IRS, state charity bureaus, faculty, students, alumni and consumers all rely on your institution's financial information, and your audit firm must be able to view that information through each of those lenses. Ideally, the audit firm can demonstrate its commitment to the higher education and not-for-profit sectors by keeping abreast of new standards; contributing to thought leadership publications; and building good relationships with bankers, regulators and charity watchdogs.

- **Specific industry accounting and reporting expertise**
  The higher education and not-for-profit sectors have specific accounting requirements that an auditor should know thoroughly. Demonstrated expertise in not-for-profit accounting and higher education reporting for public and private institutions is essential.

- **Specific industry regulatory reporting and compliance expertise**
  Educational institutions must comply with numerous regulations that govern their participation in federal student financial aid programs, federally sponsored research activities, athletics programs, tax-exempt bonding and clinical activity. Accrediting and licensing bodies can also impose restrictions on academic program offerings and delivery methods. Demonstrated expertise in these areas is essential.

- **Experience with tax requirements pertinent to not-for-profits**
  Exemption from tax does not mean exemption from tax consequences. And the tax-exempt status of not-for-profits is in the spotlight — Forms 990, 990-PF and 990-T are disclosed publicly. Because retaining its tax-exempt status is essential for a not-for-profit organization, accurate reporting and tax compliance are equally essential. The auditor must have enough experience to understand the tax regulations, risks and concerns unique to not-for-profits.

- **Sufficient staffing**
  Insufficient staffing, staffing turnover or inadequately trained personnel can lead to delays or poor performance. A further consideration is whether the audit will be staffed from out-of-town offices.

- **Price**
  While price should not be the sole determining factor in your choice of auditor, it is certainly a consideration. Be sure to evaluate the proposed auditor's qualifications and value relative to the fee that is proposed.

- **Chemistry**
  The auditors' ability to build trust and have a positive working relationship is critical to a productive, professional relationship with management. Respect and rapport are essential to an effective working relationship and needed when resolving technical and business issues and providing recommendations to improve the institution's internal control environment and business practices.

- **Providing value**
  An audit is not a commodity service. Your institution's relationship objective should be far more than merely getting a signed, clean opinion from an auditor. The audit should be viewed as an opportunity to add value to the institution and reduce its risks. An audit firm should possess the breadth of industry and business knowledge to offer ongoing, meaningful insights on the external landscape, internal operations and practices, and how the institution is positioned to respond to threats and challenges. The firm should also have the capability to assist management in keeping the board and audit committee informed of significant industry trends, challenges, threats and opportunities.

The monitoring function of the audit committee

Internal control and enterprise risk monitoring

The work of the audit committee does not conclude with the issuance of the financial statements or internal audit reports. Rather, the audit committee is expected to:

- Understand the institution's internal control environment and overall risk profile
- Conclude whether effective internal controls are in place
- Monitor the progress of corrective action until the institution's internal controls are working properly and mitigating risks effectively
- Assess whether risks that might prevent the institution from achieving its objectives or maintaining its reputation have been identified
- Know how the institution mitigates these key risks

Standard frameworks have been developed to guide institutions in their understanding and assessment of effective internal control, and their ability to identify and effectively communicate enterprise-wide risks. The Committee of the Sponsoring Organizations of the Treadway Commission (COSO) and ISO are popular sources of risk management principles, guidelines and models. The COSO model has gained prominence, particularly in U.S.-based organizations. The ISO standard has become the internationally agreed standard for the implementation of risk management principles, and thus has become popular for organizations with overseas operations.

These models help define the relationships between strategic, operational, financial reporting and compliance functions, and the control attributes that must be present for effective internal control. They also create a framework for identifying risks, communicating risks throughout the institution, establishing the institution's risk tolerance, and updating and monitoring risk.

Increasingly, colleges and universities are using risk assessment processes to identify enterprise-wide strategic risks and create an institutional risk profile that identifies the critical threats to the institution's reputation and strategic goals. These risks reflect the evolution of the institution's business model, and changes in the institution's risk profile and external environment.

Management risk committees or work groups perform these risk assessments, identify mitigating factors and develop actionable plans to ensure that the critical risks are being effectively managed by the institution. The audit committee plays a key role in supporting the creation of this function and overseeing the results.

Dealing with fraud

Your external auditor should be expected to plan and perform the external audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. The external auditor is not expected to identify any possible fraud. However, the external auditor does conduct testing that may detect fraud. The external auditor is expected to identify erroneous or fraudulent activities that materially affect external financial reporting.

The external auditor's testing usually includes:

- Inquiries of management and other employees
- Inquiries relating to whistleblower complaints
- Review of related-party activity
- Review of internal control documentation
- Performance of substantive procedures that include a review of journal entries and accounting estimates
- Evaluation of the rationale for significant transactions and related accounting treatments

Management is responsible for:

- Maintaining a culture of honesty and high ethical standards
- Designing, establishing and implementing controls that prevent, deter and detect fraud
- Adopting sound accounting policies
- Establishing and maintaining internal controls that facilitate timely reporting of material financial events that affect annual and interim financial results

The audit committee is responsible for:

- Evaluating management's identification of fraud risks and creation of the appropriate tone at the top
- Verifying that management has implemented appropriate fraud deterrence and prevention measures and controls
- Considering the potential for management override of controls or other inappropriate influence over financial reporting
- Insisting on effective whistleblower policies
- Receiving regular reports of potential instances of fraud

Dealing with nonfinancial reporting and disclosures

A new area of fraud that is receiving public attention is the reporting of a host of nonfinancial data (e.g., acceptance rates and incoming class SAT/ACT scores) to regulators, rating agencies, accrediting bodies and evaluative bodies. This type of data is generated throughout the institution on a variety of hardware and software systems. The audit committee should understand if there are adequate internal control processes and management review practices to assure this data is complete, accurate and properly reported.

Importance of management's discussion and analysis

Management's discussion and analysis (MD&A) disclosures may be posted on the institution's website accompanying the financial statements or included as part of an annual report that also contains the audited financial statements, letter from the president and message from the CFO.

This narrative should serve as an educational tool for the board and institution's stakeholders regarding the financial condition of the institution.

MD&A disclosures should indicate key sources of revenue and types of expenses; trends in revenue and expense categories; key accomplishments, risks and disappointments; and any other information that management believes will assist board members in performing their fiduciary duties.

MD&A disclosures can also describe changes to institutional and student outcomes, trends in academic and student support, development statistics, future capital plans and comparisons with other institutions. The audit committee should be familiar with the sources of any information that is included in MD&A disclosures but that is not derived from the financial statements. It is important that the descriptive information and statistics do not mislead the public as to the effectiveness of the institution.

The management letter

Also accompanying the financial statements is the external auditor's management letter, which makes recommendations to enhance internal controls and related procedures.

A key audit committee function is to review the recommendations and management's response, and then to monitor the implementation of these recommendations as part of its stewardship over the institution's assets and reputation.

The management letter recommendation and implementation grid that follows depicts the type of monitoring that audit committees and management should perform.

The grid shows how the recommendations made by the external auditors and the corrective action plans developed by management could be documented. The grid presents the current status of the implementation of the recommendations, personnel responsible for implementation, deadline for full implementation and any implementation-related costs.

A similar process should be put in place for internal audit recommendations.

Management letter recommendation and implementation grid

Management letter action items for the year ended June 30, 20XX							
Action item	**Action plan**	**Due date**	**Responsible parties**	**Status**	**Completion status**	**$ from operating budget**	**$ from capital budget**
Current-year recommendations							
Comment 1							
Comment 2							
Comment 3							
Comment 4							
Prior-year recommendations							
Comment 1							
Comment 2							
Comment 3							
Comment 4							

Appendix I: Selecting the external auditors

Recommended practices

First, know that the decision is yours. The evaluation and selection of the external auditor must be made by the audit committee, not by management. The audit committee may solicit the views of management, but the responsibility for monitoring the external audit function rests with the audit committee.

Second, decide carefully based on the criteria discussed earlier whether a change is warranted. If it is, soliciting qualified audit firms to propose on performing the audit on a three- to five-year cycle is standard practice. An alternative is to consider partner rotation with your current provider. The responsibility to evaluate the services of — and possibly replace — your current external auditor should not be taken lightly.

Third, agree on the relative importance of your evaluation criteria before reviewing proposals.

Fourth, determine the critical business, financial and regulatory issues facing your institution, and agree on the size, depth of resources, industry expertise and range of capabilities that a firm must possess to address these issues.

Fifth, provide potential firms the opportunity — before they propose — to meet with management in person, review past audited financial statements and internal control letters, understand your institution's unique operating characteristics (e.g., diversified revenue sources, academic offerings, IT and operating units/segments) and establish how your institution's internal audit department (if one exists) could potentially support the external audit.

Template for RFP[1]

Description of the institution to be served

- Purpose and mission
- Governance and management structure
- History (e.g., when the institution was founded and how it has developed)
- Tax status
- Location(s); indicate where books and records are kept
- Structure of finance function (e.g., staffing, and centralized versus decentralized)
- Financial overview (e.g., amount of revenue, sources of revenue, types of expenses, and types and amounts of assets)
- Technology supporting financial operations
- Sources for additional information (e.g., a website)
- How the services requested in the request for proposal (RFP) are currently executed
- Nature of any regulatory reviews that may be upcoming or are currently underway

[1] This template outlines certain typical items to be included in an RFP. It is not tailored to specific situations and includes more items than would usually be listed in a single RFP.

Specific service(s) required

- The scope of work that the vendor is expected to perform, including deliverables to be provided
- Standards to be followed by the vendor in providing services
- Other vendor obligations to the institution, such as regular reporting, problem-solving and method of billing
- Length of the service contract

Qualifications of the prospective vendor

- Size (in terms of annual revenue, staffing or other metrics)
- Financial viability
- Commitment to higher education (e.g., thought leadership, industry sponsorship, issuance of accounting/tax updates, and continuing professional education seminars/webinars offered)
- History of successful client service
- Length of time providing specific services requested
- Experience with similar types of entities (including provision of references)
- Level of training and experience of staff members to be assigned to the engagement
- Commitment to diversity and social responsibility in the firm's delivery of services and in its governance, employment, environmental and investing practices
- Geographic proximity to the institution being audited
- Clear processes of communication and problem resolution
- Inclusion of peer review reports
- Confirmation that no disciplinary action has been taken against the firm by regulatory bodies or professional associations
- Confirmation that the vendor is independent of the entity (for audit services)
- Willingness to propose a fixed or an all-inclusive fee for the service period

Requirements of the proposal

- Transmittal letter signed by a corporate officer or authorized agent of the vendor
- Description of the firm (date founded, services provided, business philosophy or approach, quality standards)
- Location of the office to provide the requested services
- Individuals who will be responsible for delivery of the services, as well as the qualifications of those individuals (i.e., specific training, experience, and length of service with the firm and industry)
- Similar information for all other key personnel who will be responsible for service delivery
- The names and contact information for institutions of a similar type currently served by the bidder
- A comparison of the firm's proposed services with the specific services requested in the RFP
- Identification and qualifications of any subcontractors and the functions to be performed by each subcontractor
- Methodology used for pricing and fee structure
- Quote of fee(s) to provide requested services
- Approach to additional requested services and billing for such services

Decision-making process

- Contact person within the institution who is coordinating the RFP process and can respond to questions about the process and institution
- Contact person (if different) who can respond to technical questions about the services required
- Date by when the proposal must be received by the institution
- Number of copies — including electronic copies — of the proposal
- If not elsewhere specified, the criteria to be used for evaluation of proposals

Appendix II: Sample audit committee charter

Acting on behalf of the board, the audit committee is charged with overseeing all material aspects of the institution's financial reporting, internal controls, risk management and audit functions.

The audit committee's role includes a particular focus on the qualitative aspects of financial reporting and the institution processes for the management of risk and compliance with significant applicable tax, legal, ethical and regulatory requirements. The audit committee's role also includes coordination with other board committees and maintenance of strong, positive working relationships with management, internal and external auditors, counsel and other committee advisers.

The audit committee shall report this information to the board and provide its recommendations for action to be taken by the board and management in order to strengthen the institution's system of internal controls, compliance procedures and financial reporting process.

The audit committee shall oversee the internal and external auditors, and monitor management's progress in responding to the internal and external auditors' findings.

Composition

The audit committee shall be composed of no fewer than three and no more than five independent nonexecutive board members. No member of the audit committee shall be an officer or employee of, or receive any compensation from, the institution.

The board treasurer may not serve on the audit committee. The president or chancellor shall be an ex officio nonvoting member of the audit committee but must be excluded, along with other management officials, when the audit committee is in executive session.

Committee members shall have (1) knowledge of the primary activities of the institution; (2) the ability to read and understand nonprofit financial statements, including a statement of financial position, statement of activities and changes in net assets, statement of cash flows and key performance indicators; and (3) the ability to understand key operational and financial risks, and related controls and control processes. The committee shall have access to its own counsel and other advisers at the committee's sole discretion.

At least one member, preferably the chair, should be literate in nonprofit financial reporting and control, including knowledge of tax and regulatory requirements, and should have past or current employment experience in finance or accounting, or other comparable experience or background. Ideally, this individual should have specific experience with a similar institution.

Roles and responsibilities

Risks and controls

- Reviewing and assessing the institution's operating and financial risk management process, including the adequacy of the overall control environment and controls in selected areas representing significant risk
- Reviewing significant risks and exposures, and the plans to minimize or respond to them
- Assuring that management is setting the appropriate tone in communicating the importance of internal controls and establishing policies and procedures to mitigate risk
- Reviewing and assessing the institution's system of internal controls for detecting accounting and financial reporting errors, fraud and defalcations, legal and tax code violations, and noncompliance with the institution's code of conduct — in that regard, reviewing the related findings and recommendations of the internal and external auditors, together with management's responses

- Determining whether internal control recommendations made by internal and external auditors have been implemented by management
- Making certain that the internal and external auditors keep the audit committee informed about fraud, illegal acts, deficiencies in internal control and other audit-related matters
- Determining which aspects of internal control and compliance procedures are being tested annually by the internal and external auditors
- Understanding the nature of significant deficiencies and material weaknesses reported with the financial statements and reportable findings under Government Auditing Standards
- Reviewing with legal counsel any matters that may have a material effect on the financial statements
- Reviewing the results of the annual audits of trustees' and officers' expense accounts, and management prerequisites prepared by the internal or external auditors
- Identifying best practices, and developing and recommending corporate governance principles applicable to the institution

Financial reporting

- Reviewing with management and the external auditors the results of the annual audit and related footnotes, including any difficulties or disputes with management, any significant changes in the audit plans, the rationale for (and quality of) adoptions of and changes in accounting principles, and soundness of accounting estimates requiring significant judgments
- Assessing whether the annual financial statements and related footnotes reflect appropriate accounting principles
- Reviewing the MD&A disclosures and concluding as to their reasonableness based on the audit committee's knowledge of the institution
- Reviewing and assessing the key financial statement issues and risks, their effect or potential effect on reported financial information, the processes used by management to address such matters, related auditors' views and the basis for audit conclusions
- Reviewing recent professional and regulatory pronouncements, and understanding their effect on the institution's financial statements
- Reviewing the management letter and monitoring the institution's compliance with its recommendations
- Approving changes in important accounting principles and the application thereof in both interim and annual financial reports
- Advising financial management and the external auditors that they are expected to provide a timely analysis of significant current financial reporting issues and practices

Compliance with laws and regulations

- Reviewing the effectiveness of the institution's system for monitoring compliance with laws and regulations
- Satisfying itself that all regulatory compliance matters have been considered in the preparation of the financial statements
- Reviewing the IRS Forms 990 and 990-T and all of their disclosures, especially those regarding executive compensation, fees paid to vendors, activities unrelated to the institution's exempt purpose and transactions with related entities
- Reviewing the findings of any significant examinations by regulatory agencies
- Reviewing any state funding and cost reports filed

Internal audit

- Ascertaining that the institution has the appropriate structure and staffing to carry out its internal audit responsibilities effectively
- Reviewing and approving the annual internal audit plan as recommended by internal audit based upon a comprehensive internal audit risk assessment
- Approving any changes to the approved annual internal audit plan
- Receiving and acting upon the reports presented by internal audit
- Evaluating the effectiveness of internal audit personnel, including the head of internal audit
- Concurring in the appointment, replacement, reassignment or dismissal of the head of internal audit

External audit

- Selecting and retaining the institution's external auditors
- Approving the external auditors' fees
- Reviewing and approving the external auditors' proposed audit scope and approach
- Reviewing the performance of the external auditors and recommending their retention or discharge
- Reviewing and confirming the external auditors' assertion of their independence in accordance with professional standards
- Reviewing and approving the engagement of the external auditors to perform services over $X in fees— including consulting services — unrelated to the audit

Reporting responsibilities

- Reporting to the board at least annually with appropriate recommendations regarding the audit committee's activities and any key external audit issues
- Ascertaining whether the internal and external auditors have communicated issues and concerns to each other for appropriate follow-up and action
- Confirming with the internal and external auditors that they will report all relevant issues to the committee in response to agreed-upon expectations and as required by their professional standards
- Reviewing any submissions to the institution's whistleblower hotline
- Reporting to the board any reported conflicts of interest or related-party transactions

Other responsibilities

- Meeting with the external auditors, internal auditors and management in separate executive sessions at least twice annually
- Confirming that significant findings and recommendations made by the internal and external auditors are received, discussed, and acted upon appropriately and promptly
- Reviewing and updating the audit committee charter
- Discussing with management the enterprise-wide risk assessment process and management action plans
- Understanding the control procedures to ensure that nonfinancial data reported to regulatory, accrediting and evaluative bodies is accurate and complete
- Reviewing and approving the institution's conflict-of-interest, code-of-ethics and whistleblower policies
- Reviewing and determining the appropriate response to reported conflicts of interest, related-party transactions and whistleblower complaints
- Conducting or authorizing investigations into any matters within the committee's scope of responsibilities; the committee will be empowered to retain independent counsel and other professionals to assist in conducting any investigation
- Providing an annual performance assessment of the committee, comparing the work of the committee with the requirements of its charter

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