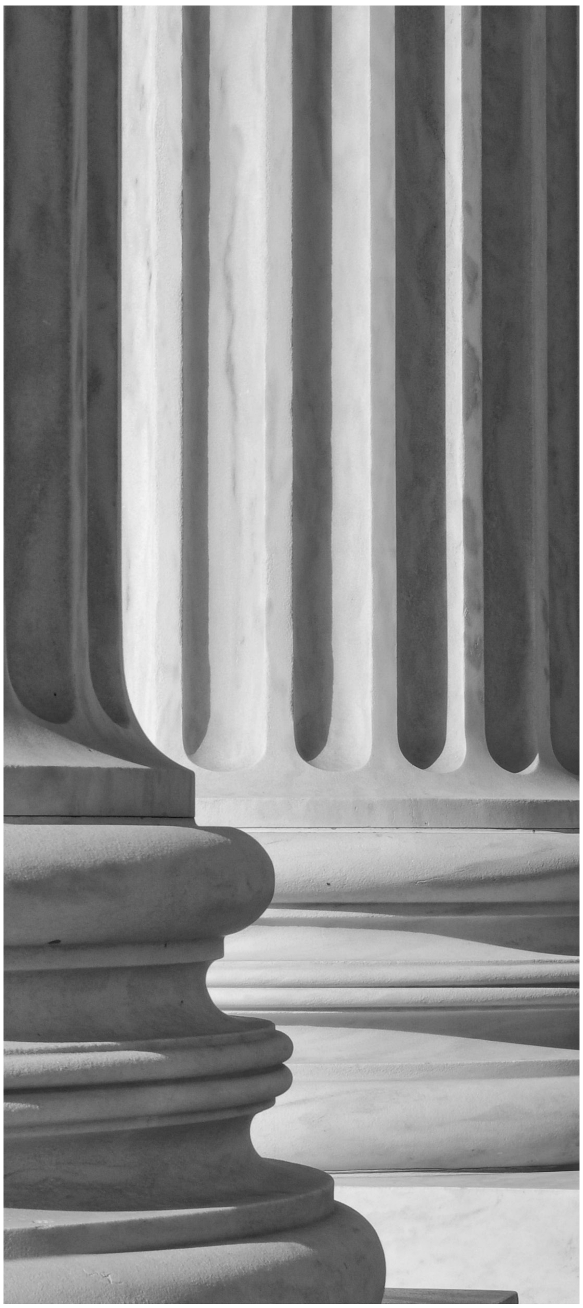
2012 Higher Education Update

Trends and Accounting Changes

January 2012



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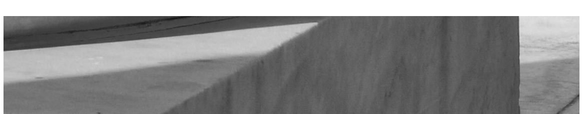

2012 Higher Education Update

EXECUTIVE SUMMARY

CapinCrouse's Higher Education Update identifies and discusses the key trends currently affecting Christian higher education. This year's edition starts with a look at the topic at the top of almost everyone's mind — the impact of the current economy. We then explore six major themes influencing Christian higher education today: the effect of regulation, the trend in tuition and related discounts, the current discussion about the charitable contribution deduction, the role of social policy in the public arena, the student debt bubble and, lastly, what some are calling the "graying of the presidency." Finally, we'll look at recent accounting changes and update you on the major issues in financial reporting.

We've made many recommendations and suggestions throughout this update, with the goal of stimulating thought and discussion on your campus.

The outlook for the economy can be summed up in the variety of scenarios and "bets" being made on the chances of staying out of a double-dip recession. They range from 50/50 to one in three. Though there are what Andrew Tilton from Goldman Sachs refers to as "tailwinds," he also notes "impediments."

Our recommendations include having a healthy debate on your campus regarding:

1. Modest to low increases in tuition and fees
2. Careful analysis of your investment return expectations for endowment and a potential downward shift for endowment spending to preserve capital
3. Intentional, ongoing analysis of programs and their economic impact on the campus

The first of the six trends covered is the impact of expanded regulation. It's no surprise to anyone watching higher education these days that we are burdened with regulation from many sources: federal, state, local, and even international, for those schools engaged in international activities. Is it really possible to comply with the over 200 regulations currently on the books? Some would argue that it's not. But how do you assess the risks involved with noncompliance? We suggest that you:

1. Devote adequate time and resources to identifying all significant regulations,
2. Seek to build a culture of compliance across the entire campus by providing information to key stakeholders in your institution, and
3. Maintain reporting on the level of compliance with the key regulations.

We recommend studying and using the award-winning work on compliance done by the Catholic University of America and ACE (American Council on Education).

The second trend we cover here gets a lot of discussion in higher education circles: the issue of discounting and how much is too much. In our view, the issue is not the discount itself or the relative percentage. The real issue is whether your institution is generating enough "net tuition" each year to maintain a profit margin at the bottom line of the income statement. Because the bottom line is the key to continued financial health, we recommend that you:

1. Maintain enough net tuition to generate a healthy net income, as suggested by the authors of the Strategic Financial Analysis for Higher Education guide from KPMG and Prager Seally, and
2. Insure effective real-time communication on financial aid offers and acceptances during the critical spring and summer months.

We next cover the tax policy debate going on in Washington, D.C. and the history and impact of the charitable contribution deduction. We liked the suggestions the Evangelical Council for Financial Accountability put forward on this issue and use them here:

1. Engage your legislators
2. Lobby to keep the charitable contribution deduction intact
3. Stay abreast of proposed options by following the discussion at www.ecfa.org or the Commission on Accountability and Policy for Religious Organizations website at www.religiouspolicycommission.org

Our next topic concerns the current and seemingly anti-religious social policy climate. Some schools have lost their "religious school" status and have been forced to comply with additional regulations. There are also regulations that appear to force religious organizations into policies and practices that would violate deeply held religious convictions and moral principles. Our recommendations here are excerpted from Kevin Theriot's paper, "Protecting Catholic Colleges from External Threats to Their Religious Liberty:"

1. Be careful about deviating from your "historic religious ties"
2. Exercise caution when accepting federal funds
3. Consult your legal counsel now with regard to upcoming healthcare law changes that might run counter to your religious principles and moral values

Student debt is discussed next and we point out that the next asset bubble may be about to burst. We had dot com, we had housing, and we may now be facing the collapse of student debt. The Pew Charitable Trust has done exceptional work on this with their project on student debt (www.projectonstudentdebt.org). Their recommendations focus on the problem of additional private debt being taken on by students. They recommend:

1. Requiring credit counseling before certifying private loans
2. Formalizing policies and practices aimed at reducing student private loan usage

Finally, we end with the "graying of the presidency." While this issue is starting to garner more attention, it's probably not getting enough attention from the people who need to focus on it the most: current presidents nearing retirement and those getting ready to take on another task. We recommend reading CapinCrouse's Successful Leadership Transitions white paper, which outlines steps to guide your institution through an effective transition, and then giving us a call. We will be pleased to help with any transitions you are encountering.

The current accounting trends are interesting. We now have a new body, the Nonprofit Advisory Council, advising the FASB board just for nonprofits. The Council has organized itself into three groups studying a single topic, with some overlap. The projects are:

1. Net Asset Classification Discussion Group – The group noted that the current format of unrestricted, temporarily restricted, and permanently restricted net asset clarification may have outlived its usefulness. They suggest some form of disclosure that focuses on two main subclasses of net assets, donor-restricted and other.
2. Management Discussion and Analysis Discussion Group – They are studying the need for more commentary to make the nonprofit financial statement a better financial information tool.
3. Liquidity and Financial Health Discussion Group – This group is focused on the reporting of liquidity and financial health in the financial statements.

In other accounting trends, we continue to monitor the Accounting Standards Updates and the FASB Exposure Drafts and projects. Those include:

1. Update No. 2011-04 Fair Value Measurement (Topic 820)
2. Update No. 2011-07 Health Care Entities (Topic 954)
3. Update No. 2011-08 Intangibles (Topic 350)
4. Update No. 2011-09 Compensation: Retirement Benefits in Multiemployer Plans
5. Leases Exposure Draft
6. Revenue Recognition Exposure Draft
7. Financial Instruments Exposure Draft
8. FASB Disclosure Framework Project

We feel very privileged to have the opportunity to survey the landscape and point out the key trends and changes. We hope our review and suggestions will help improve the vision and accuracy of your strategic forecasting.

2012 Higher Education Update

TRENDS AND ACCOUNTING CHANGES

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OVERVIEW

CapinCrouse's Higher Education Update identifies and discusses the key trends currently affecting Christian higher education. This year's edition starts with a look at the topic at the top of almost everyone's mind — the impact of the current economy. We then explore four major themes influencing Christian higher education today: the effect of regulation, the trend in tuition and related discounts, the current discussion about the charitable contribution deduction, and the role of social policy in the public arena today. Finally, we'll look at recent accounting changes and update you on the major issues in financial reporting.

We've made many recommendations and suggestions throughout this update, with the goal of stimulating thought and discussion on your campus. We feel very privileged to have the opportunity to survey the landscape and point out the key trends, and we hope that our review and suggestions will help improve the vision and accuracy of your strategic forecasting.

ECONOMIC OUTLOOK

Whether it is strong or weak, the U.S. economy has always played an important role in the viability of institutions of higher education. Major moves in investment markets, major changes in prices of key commodities, and payroll, consumer confidence, unemployment rates, and other important economic factors are key to the vitality of schools. The economy also affects school administrators' strategic outlook and thinking.

Our read of the general economic outlook is synthesized from a variety of sources and statistics that we will quote here. We are pretty certain that no one set of economists has it right all of the time, so we read a variety of sources and want to deliver to you the benefit of that analysis.

The most positive report comes from The Conference Board's 2011 third quarter economic forecast for the U.S. economy. "The U.S. economy is uncomfortably close to contracting, with a 50-50 chance of falling into recession," the report authors write, noting that "the key silver lining is that if it does tip into a downturn, it is likely to be short and shallow."[1] They go on to say that we have had a very tepid recovery, but that is also a good sign:

> The benefit of so little recovery is that, absent an unexpectedly large downward shock, there isn't that much room to fall. On the other hand, we likely will not see a sharp upturn in economic activity, coming out of recession.[2]

Meanwhile, in "The Outlook for the US Economy," Andrew Tilton, Senior US Economist at Goldman Sachs, lists the impediments to growth, cites "economic tailwinds" that will propel us forward, and gives us the firm's take on the outlook for inflation.

The impediments to growth listed in the white paper include gasoline prices that "soared in late 2010 and early 2011, driven by market optimism about global growth and turmoil in the Middle East."[3] Indeed, the consumer price index for gasoline jumped 33.3% in the last 12 months.[4]

Another impediment Tilton notes is fiscal tightening at the federal level over the next couple of years. The new congressional "super committee" was supposed to take aim at trimming $1.2 trillion in spending from the federal budget. The 12-member committee — six Democrats and six Republicans from the House of Representatives and Senate — needed to come up with a plan and vote on it by November 23. As we all know by now, the "super committee" was not so super and failed. The political finger pointing has new vigor and the outlook is more uncertain than ever. Tilton's October 2011 white paper also mentions the fiscal stress in Europe as an impediment.

While The Conference Board gave the economy a 50-50 shot at staying out of a double-dip recession and a Goldman Sachs economist saw the good and the bad, the Morgan Stanley folk had a more dire view. In their Global Economic Forum Review, economist Ted Wieseman wrote:

> The two key downside risks remain fiscal policy gridlock in Washington and the ongoing crisis in Europe. We continue to see little reason to believe that the partisan rancor in Washington will ease any time soon. Our baseline assumption remains that the super committee fails, and there is no agreement on extending or adding to fiscal stimulus for next year. This would lead to a significant hit to consumers' disposable income at the start of next year from the expiration of the payroll tax cut that we think could knock 1Q GDP growth below 1%.[5]

And Moody's Analytics lowered its outlook in August, saying it "sees significantly weaker prospects for the economy than just a month prior as the economy struggles to avoid another recession." They reported that "the odds of a renewed recession over the next 12 months, already one in three, will increase if stock prices continue to fall."[6] As of mid-January that has not materialized and the Dow is rising… at least for now.

[1] The Conference Board, "The Conference Board Economic Forecast for the U.S. Economy," October 2011. Available for download at http://www.conference-board.org/pdf_free economics/2011_10_121.pdf
[2] Ibid.
[3] Andrew Tilton, "The Outlook for the US Economy," Goldman Sachs Asset Management White Paper, August 2011.
[4] Malik Crawford, Jonathan Church, Darren Rippy, Editors, "CPI Detailed Report, Data for September 2011," Bureau of Labor Statistics, September 2011.
[5] Ted Wieseman, "Review and Preview," Morgan Stanley, Global Economic Forum, accessed November 8, 2011, http://www.morganstanley.com/views/gef/archive/2011/20111018-Tue.html
[6] "Moody's lowers US economic outlook through 2012", Bloomberg Businessweek, accessed October 19, 2011, http://www.businessweek.com/ap/financialnews/D9P4OVNO0.htm

"Economic Tailwinds" Promoting Growth

As mentioned earlier, economist Andrew Tilton at Goldman Sachs noted some "economic tailwinds" that could contribute to growth for the remainder of 2011 and 2012. One of these potential tailwinds is the easing of U.S. household debt to levels not seen since the 1980s, with debt service at between 11% and 12% of disposable income, which is where it was in 1985. Another is that two sectors of the economy that normally run in cycles, housing and autos, are set to recover after a relatively long and steep decline.

The markets saw a strong run up in October 2011 that has continued into the new year, propelled by breaking European news of the large haircut taken on Greek debt at 50% and the domestic GDP numbers coming in for the third quarter at an annual rate of 2.5%. A tailwind, indeed.

Inflation Outlook

Tilton also notes that while prices increased in late 2010 and 2011, they have declined recently due to worries over global economic growth rates. He writes that Goldman Sachs believes "core inflation will remain very benign," and notes the presence of excess capacity in the form of currently high housing vacancies and excess manufacturing capacity. This, along with the Federal Reserve's commitment to keep interest rates low, will contribute to keeping inflation at bay.[7]

Summary

In all this analysis, the best we see is the "look for the silver lining" position, which points out that we are so far down, we can only see up. While that may be true and might give some comfort, there are still significant trends that could create that "unexpected large downward shock" The Conference Board warned about.[8]

So how does this translate to institutional policy decisions? **We recommend serious consideration of the following:**

1. **Modest to low increases in gross tuition and fees.** The level of uncertainty in the economy and the resulting uncertainty about the job market puts students and their families in an uncomfortable place as they look at making a commitment to four or more years of education. Anything you can do to remove some of that uncertainty and ease some of the pain of rising tuition and fees would be a positive sign to potential students. "As the out-of-pocket costs of a college education go up faster than incomes, it's pricing low and medium income families out of a college education," said Mark Kantrowitz, publisher of financial aid sites FinAid.org and FastWeb.com.[9] At some point, those in the affected middle class may stop paying attention to private higher education institutions' appeals to apply.

   We are also starting to see articles that even refute the value of a college education, since the cost is now so high and the job market does not seem ready to add jobs that will yield the level of pay needed to support a lifestyle and the related college debt service maintained by so many. "That magical and much-quoted $1 million earnings premium [for college graduates], which originated with the Bureau of Labor Statistics some years ago, is apparently the exception rather than the rule," Anne Fisher wrote on CNNMoney.com. She notes that according to analysis by researchers at PayScale.com, "out of 554 four-year schools, only 40 (36 private colleges and 4 state universities) — or fewer than 10% — have delivered a net return on investment of $1 million or more, over the course of grads' careers, than a high school diploma alone."[10]

2. **Careful analysis of your investment return expectations for endowment and a potential downward shift for endowment spending to preserve capital.** The latest data available from last year's endowment study appears to support this. The Chronicle of Higher Education reported that "many institutions with the smallest endowments, below $25-million, lowered their spending rates, for an average of below 4 percent." In the same article, John Walda, president of the National Association of College and University Business Officers (NACUBO), observed that "the values of most endowments in 2010 remained below their 2007 levels, many by more than 20 percent. The values probably will not fully rebound this year or next, even if financial markets continue to rise. And long-term earnings on endowments — which averaged just 3.4 percent over the past decade — are not keeping up with spending and inflation."[11] A November 2011 joint press release from Commonfund Institute and NACUBO quoted Walda and Commonfund Institute executive director John S. Griswold saying, "The average endowment is still at only 86 percent of its value in FY2007, using return data from past NCSE reports and a 5 percent spending rate, and longer-term returns for five and ten-year periods are only 5.0 percent and 5.5 percent, respectively — not significantly higher than the spending rate for many institutions. It will take several more years of positive returns for endowments to recover fully from the crisis."[12]

3. **Intentional analysis of programs and their economic impact on the campus on an ongoing basis.** No institution of higher education these days, even the truly well endowed, can afford sparsely enrolled programs that do not carry their costs or do not contribute strongly to important strategic objectives. "The best time to plan for resource allocation is when things are going well," noted Larry Goldstein, a frequent contributor to the annual NACUBO Higher Education Accounting Forum, during his talk on effective resource allocation at the

[7] Andrew Tilton, "The Outlook for the US Economy."
[8] The Conference Board, "The Conference Board Economic Forecast for the U.S. Economy."
[9] Annalyn Censky, "Surging college costs price out middle class," CNNMoney.com, accessed November 8, 2011, http://money.cnn.com/2011/06/13/news/economy/college_tuition_middle_class/index.htm
[10] Anne Fisher, "Is a college degree really worth $1 million?" CNNMoney.com, accessed November 8, 2011, http://money.cnn.com/2010/09/07/news/economy/college_degree_worth.fortune/index.htm?iid=EL
[11] Jeffrey Brainard, "Endowments Regain Ground With 12% Returns," The Chronicle of Higher Education, accessed November 8, 2011, http://chronicle.com/article/Colleges-EndowmentsEarned-12/126071
[12] "Preliminary Data Indicate Higher Education Endowments Earned Investment Returns Averaging 19.8% in FY 2011," (Press release). Commonfund Institute and NACUBO, November 7, 2011 accessed November 12, 2011, http://www.commonfund.org/InvestorResources/CommonfundNews/Pages/2011NCSEPrelimData.aspx

Forum this year. Goldstein also advised that institutions of higher education:

- Continually link and integrate planning, resource allocation, and assessment
- Focus on achieving the institution's mission while honoring its values
- Sustain "financial equilibrium"
- Create a campus-wide committee to direct the process
- Be sure to incorporate measurable data on your enrollment and market as well as "qualitative inputs," such as your institution's culture and values.[13]

Robert Dickeson's updated work on prioritizing academic program and service spending, *Prioritizing Academic Programs and Services: Reallocating Resources to Achieve Strategic Balance*, is also helpful in this process.

Out of the seven key postulates Dickeson presents in his book, numbers 2, 3, and 4 are particularly applicable to our recommendation on program evaluation:

2. Academic programs have been permitted to grow, and in some cases calcify on the institutional body without critical regard to their relative worth.
3. Most institutions are unrealistically trying to be all things to all people in their quest for students, reputation, and support rather than focusing their resources on the mission and programs that they can accomplish with distinction.
4. There is growing incongruence between the academic programs offered and the resources required to mount them with quality, and most institutions are thus overprogrammed for their available resources.[14]

Now that we've discussed the economic outlook, let's look at the current business trends in higher education.

HIGHER EDUCATION BUSINESS TRENDS

There are a number of important themes influencing how much success colleges have in maintaining good net income margins and, as a result, adequate financial health. This list below is not the complete set. But after discussions with a number of finance officers at small colleges, we feel they are among the most significant.

1. **The Impact of Regulatory Mandates** "Trends in College Spending," a report of the Delta Cost Project supported by the Lumina Foundation for Education, cites a steady reduction in the overall percentage of funds allocated to administration for private colleges.[15] One of the most pressing issues on the minds of top administrators today, however, is the significant and continued rise in the level of regulatory mandates.

In their final observations to the U.S. Commission on the Future of Higher Education, the Office of General Counsel staff for the Catholic University of America, a 4,500 student undergraduate institution in Washington, D.C., wrote:

> The list of federal statutes which have some applicability to higher education is long, now more than 200 such laws and growing… It is probably fair to say there is not one institution in the country that is able to be in complete compliance with all of these federal laws. The problem is not that institutions don't want to comply. The volume, complexity and constant change in the regulations make it impossible to do so completely.
>
> At the same time, the "80/20" rule applies here as elsewhere — the bulk of complaints and regulatory compliance burdens come from perhaps 10 per cent of these laws. We have picked a few examples from our own experience that seem to represent unnecessarily burdensome regulations.[16]

This analysis was written during 2006. In the intervening years, we have experienced the continued push of additional regulation with the Higher Education Act (HEA) Reauthorization, the increased level of interest by the IRS in the 990 filing requirements, and the commitment by the IRS's Tax Exempt Bonds (TEB) Division to expand the TEB compliance presence in the tax-exempt bond and tax-credit bond market through increased use of compliance check initiatives and correspondence examinations. Although most of the HEA regulations have been in place for a short period, there are still some areas of compliance that will be required into the near future.

In the 2010 edition of *Prioritizing Academic Programs and Services*, Dickeson observes that "the mood of Congress (between 2008 and 2010), as reflected in the new provisions of the reauthorization, was to shift oversight of higher education from self regulation to federal regulation."[17]

And a recent article in *Trustreeship* magazine noted that "the 2008 reauthorization of the Higher Education Opportunity Act and the rules that accompanied it in 2009 and 2010 have given significantly more authority to the federal government in academic decision making."[18]

The article is an interview with Judith Eaton, president of the Council for Higher Education Accreditation (CHEA), who shared some wisdom for college and university board members. When asked how boards can prepare to respond

[13] Karen Craig, Bryan Dickson, and Sue Menditto, "Changeups Keep on Coming," National Association of College and University Business Officers, accessed November 8, 2011, http://www.nacubo.org/x12024.xml

[14] Robert C. Dickeson, *Prioritizing Academic Programs and Services: Reallocating Resources to Achieve Strategic Balance* (San Francisco: Jossey-Bass Higher and Adult Education, 2010), pg. 15.

[15] Donna M. Desrochers and Jane V. Wellman, "Trends in College Spending, 1999-2009," a report of the Delta Cost Project, 2011, pg. 26.

[16] Craig W. Parker, Esquire and Margaret L. O'Donnell, Esquire, "Some observations on the Federal regulation of higher education," The Catholic University of America, April 2006.

[17] Dickeson, *Prioritizing Academic Programs and Services*, pg. 13.

[18] "What Does the "Federalization" of Accreditation Mean for Boards and Institutions?" *Trusteeship*, May/June 2011. Available at http://www.chea.org/pdf/A%20Question%20For%20MayJune%202011.pdf.

to the demand for more public information about student learning outcomes, Eaton answered:

> By providing more information. The climate in which we operate is no longer satisfied with descriptions of institutional resources and practices, e.g., the number and credentials of faculty and "assessment" processes. The future credibility of higher education rests squarely on providing information about results: what students learn and how the institution performs. Boards and presidents would serve their institutions well by developing key indicators of institutional performance — such as student success with educational goals, graduation, transfer, entry to graduate school, or job placement — providing evidence that these indicators are met, and making this information not only public but readily accessible.[19]

In addition to the national regulations weighing on administrators, those pursuing global educational expansion opportunities are facing additional layers of regulation. The 2011 Higher Education Accounting Forum featured a session on global administrative and regulatory issues. As summarized by NACUBO, the panel advised:

> One of the most fundamental issues that institutions face is finding out what activities they might be involved in internationally. Key to addressing this is creating open communication across the institution that allows for early identification of global activities. In addition, creating reporting mechanisms, somewhat similar to phone trees, is helpful. For example, if the provost's office is contacted with regard to a global project, the provost would then also alert the controller's office and the legal office to ensure that they are kept in the loop.
>
> While there are many issues to be addressed when doing business globally, some pose greater risks than others. Among these is hiring and paying individuals in foreign countries. Each country has its own rules regarding hiring, paying, and withholding tax for the following types of workers:
>
> - **U.S. expatriates** — U.S. citizens working for the institution in a foreign country.
> - **Host-country nationals** — citizens of the country in which the institution is doing business.
> - **Third-country nationals** — citizens of another country working in a second country for the institution.
> - **Independent contractors** — nonemployees working on behalf of the institution.
>
> [Presenters] Holmes, Piccolo, and Lammey recommended that institutions understand the rules for the specific countries where their organizations are doing business and ensure that an appropriate infrastructure is in place to avoid violations and potential fines. For example, in many foreign countries it is illegal to make payments in a currency other than the local currency. To overcome this hurdle, some schools have used prepaid cards in the local currency, some have used PayPal, and some have outsourced the payment to an in-country entity that acts as an agent for the institution.
>
> Presenters cautioned that careful attention be paid to laws of both the United States and the individual countries. In particular, the panel highlighted the Foreign Corrupt Practices Act, the U.S. Export Control Act, and the Clery Act. With regard to the Clery Act, the institution needs to determine the extent of its control over the foreign location to determine whether crimes committed in that location must be included in the school's crime report.
>
> The panel concluded with a list of hot topics including:
>
> - Student and employee tracking — especially in the wake of the recent earthquake and tsunami in Japan.
> - Immigration — visas and work permits.
> - Expatriate taxation.
> - Employee-independent contractor classification.
> - Data security in the European Union.[20]

Summary

Clearly, regulatory changes are burdensome and difficult to assess and manage in total. Our research and reading leads us to a few recommendations:

1. Spend adequate time and resources to identify all significant regulations
2. Establish plans to coordinate campus-wide communications related to all significant regulations
3. Maintain dashboard reporting accountability for regulatory compliance

For an example of good centralized communication, including regulatory requirements and performance reporting, see http://counsel.cua.edu. The site is a collaborative effort between the American Council on Education (ACE) and The Catholic University of America's Office of General Council, and includes a review of the federal regulations. We also recommend reviewing the site's compliance calendar, which won a NACUBO Innovation Award in 2009, and the pages on policies.

THE IMPACT OF DISCOUNTING AND THE NEED FOR NET REVENUE GROWTH

A 2011 survey by *Inside Higher Ed* asked over 600 college and university business officers, including nearly 200 at private four-year colleges, about the two most important issues confronting their institutions over the next two to three years. A large percentage (41.6%) said that rising tuition and affordability is a key issue. The next most important issue was inadequate enrollment/tuition revenue (32.0%), followed by the rising discount rate for tuition (28.1%).[21]

These three responses all have one single issue in mind, and it's one that gets asked every year during the budget cycle: *How much should we charge for tuition (including rate hikes on tuition, fees and auxiliaries)?* The next related question is*: How will that change impact recruiting, financial aid and, ultimately, the net revenue generated?*

[19] Ibid.
[20] Karen Craig, Bryan Dickson, and Sue Menditto, "Changeups Keep on Coming."
[21] Doug Lederman, "Maintenance Over Management: A Survey of Business Officers," Inside Higher Ed, accessed November 11, 2011, http://www.insidehighered.com/news/survey/maintenance-over-management-survey-business-officers

Discounting became a way of life for private colleges and universities during the recession. The latest NACUBO Tuition Discounting Survey reported that net revenue from tuition slowed down or reversed the growth in the last couple of years.[22] And a recent *Inside Higher Ed* survey of college and university presidents found that "rising tuition/affordability" (42.2% percent) and "increased competition for students" (35.3%) were the top concerns of chief executives at private nonprofit institutions. So, business officers and presidents seem to agree. Rising tuition and affordability is a critical issue. In order to maintain a level of affordability and to continue to attract students in an increasingly competitive environment, discounting has become the tool of choice for many schools. Even so, three in 10 private college leaders surveyed said their tuition discount rates are "dangerously high."[23]

In a summary of the NACUBO Tuition Discount Survey, *Inside Higher Ed* noted that assistance to full-time, first-year students through grants and other forms of need-based and merit aid "hit an all-time high of 42.4% in 2010, a jump from about 39% in 2007."[24] The report estimated that 88% of students at the institutions surveyed received some institutional aid, and those students paid about half of the college or university's sticker price.

Increasing the discount rate impacted the growth in net tuition revenue. In its summary of the NACUBO survey, *Inside Higher Ed* wrote, "While net revenues grew at about 5% during five of the years between 2001 and 2007, tuition revenue dropped 0.3% percent in 2008, and grew just 1.8% in 2009 and 2.8% in 2010. That means that institutions did not gain nearly as much revenue as their tuition increases would suggest, and that many institutions saw gains in tuition revenue that lagged the inflation rate."[25]

The NACUBO discounting survey included 381 private, not-for-profit institutions inquiring about tuition discounting practices in 2009 and 2010. The survey found that more money was "spent on institutional aid and a larger number of students receiving aid, both of which created financial difficulties for some institutions."[26]

The survey notes that increases in discounting "have come at a cost to a large number of institutions. Net tuition revenue has recovered for some, **but the rate of growth in net revenue remains below the average achieved before the onset of the downturn.**"[27] The NACUBO report notes that "many institutions have implemented hiring freezes and other austerity measures to make up the resulting budget gaps."[28]

This strategy pays off financially when enough students pay the sticker price. But when too few students pay sticker price, and too many students need large aid packages, or enrollment goals aren't met, tuition dependent colleges and universities are compromised financially. Last year Moody's Investors Service reported that 15% of private institutions could face stagnant or falling revenues for the 2011 fiscal year because increases in discount rates outpaced increases in tuition rates.[29]

As *Inside Higher Ed* noted in the article "Discounting the Bottom Line:"

> While tuition discounting is common among private institutions, some colleges have not embraced the high-cost, high-discount model and have benefited; officials at these institutions say their strategy decreases volatility. And some organizations have begun documenting the drawbacks of discounting. But if a college or university cannot meet enrollment goals without discounting, proponents say it makes more sense to discount to fill the seats and get what revenue they can from discounted tuition.
>
> "It's possible that institutions could have had greater losses in net tuition revenue instead of the small gains this year had they not increased the discount rate," said Natalie Pullaro, manager for research and policy analysis for NACUBO and the report's author.[30]

The report's findings help illustrate the delicate balance that colleges and universities have to strike when discounting tuition and some of the problems that arise from the practice during tough economic times.

As noted earlier, the NACUBO 2010 Tuition Discounting Survey found that about 87.5% percent of first-time, full-time undergraduates received institutional grants in fall 2010, a jump of about 5 percentage points from 2007 and 10 percentage points from 2001.[31] The report attributes the jump to more families with financial need during the past few years. About 71% of institutional aid was given out to students who met financial need, while about 29% percent was awarded on non-need criteria.[32] Some critics of discounting say money is often given to students who don't actually need assistance, and in 2008 almost 42% percent of discounting aid was given without regard to financial need.[33]

[22] The 2010 NACUBO Tuition Discounting Study (TDS) Report is available through NACUBO's Online Research portal. If your institution participated in the 2010 TDS, the online report, charts, and presentation on trends from institutions participating for 10 consecutive years are available for free. Access to the login can be found at http://www.nacubo.org/Research/NACUBO_Tuition_Discounting_Study.html

[23] Doug Lederman, "Perspectives on the Downturn: A Survey of Presidents," Inside Higher Ed, accessed November 8, 2011, http://www.insidehighered.com/news/survey/president2011

[24] Kevin Kiley, "Discounting the Bottom Line," Inside Higher Ed, accessed November 12, 2011 http://www.insidehighered.com/news/2011/05/23/nacubo_survey_finds_increased_tuition_discounting_led_to_financial_problems_during_the_recession

[25] Ibid.

[26] Ibid.

[27] Kevin Kiley, "Discounting the Bottom Line"

[28] NACUBO, "2010 Tuition Discounting Study Report", Page 16

[29] Erin Ortiz, Leah Ploussiou Chatzigiannis, "Tuition Challenges Continue for Many U.S. Universities, but Majority Forecast Growth", Moody Investor's Service, December 16, 2010

[30] Kevin Kiley, "Discounting the Bottom Line"

[31] NACUBO, "2010 Tuition Discounting Study Report," pg 9.

[32] Ibid.," pg. 5.

[33] Jack Stripling, "Slashing Prices," Inside Higher Ed, accessed November 9, 2011, http://www.insidehighered.com/news/2010/03/31/discounting

The report notes that since a peak in 2008, however, the average percentage of tuition covered by financial aid per student actually dropped, which suggests that colleges and universities had to lower the amount they gave to each student to help cover a larger number of students.[34]

Average Tuition Discounting Rates, All Institutions:[35]

Year	Average Discount Rate (first-time, full-time freshman)	Average Discount Rate (all undergraduates)
2000	37.3%	33.6%
2001	37.9%	34.2%
2002	38.5%	34.7%
2003	37.9%	33.9%
2004	38.1%	34.3%
2005	38.0%	34.3%
2006	38.8%	35.2%
2007	39.3%	34.9%
2008	39.9%	36.7%
2009	41.6%	36.1%
2010	42.4%	37.1%

While the total amount spent on institutional aid for freshmen rose between 2008 and 2009, the average amount institutions spent per student actually dropped slightly. "This finding suggests that during the height of the economic crisis a number of survey participants were shifting their grant dollars away from the larger population of undergraduates to cover some of the increased aid directed at freshmen," the report states.[36] Colleges and universities could have been shifting money away from upperclassmen to ensure that first-year students enrolled.

The NACUBO report also shares anonymous comments from college budget officers about how they coped with shortfalls, and the responses varied widely. One official noted that his college increased institutional aid 14% percent for 2010 – 2011, while tuition only rose 5%. Many say they enacted cuts and hiring freezes and increased tuition rates and enrollment numbers in other areas to ensure that student need was met.[37]

Pullaro said the percentage that most institutions discounted tuition clustered in the high 30s and low 40s, but a few colleges were significantly higher or lower. Baccalaureate institutions tended to discount tuition the most — an estimated 44.3% — while doctoral/research universities discounted tuition an average of 38.6%.

Because colleges and universities did discount tuition at greater rates, the report notes, they likely averted the greater financial calamity that could come with lower enrollment, since many of these institutions are heavily dependent on tuition revenue.

"The survey results do suggest that increasing discount rates may have benefited some institutions," the report states. "Undoubtedly, a number of institutions would have experienced declines in student enrollment if they had not increased grant spending at the height of the recession. That is, colleges and universities may have faced even greater financial difficulties if they had not reacted to the financial constraints facing students and families by raising their institutional grant expenditures."

Because some institutions have increased enrollment or tuition rates to compensate for increased discounting, the report notes that some may have positioned themselves to see greater returns in the future. But the report also observes that "it may be some time before institutions see the year-to-year gains in net tuition revenue they experienced before the beginning of the economic downturn."[38]

Summary

Because net revenue growth is slowing and in some cases reversing, it's critical to make proper budget adjustments on the expense side. Close annual tracking of financial aid budgets — and keeping offers in line with amounts budgeted — is key to making or breaking your annual financial plan. Given the trends in and significance of this area, we recommend:

1. Real-time communication of financial aid offers against budget targets at the cabinet level during the spring and summer months. If you use dashboard reporting, this is a legitimate data point for your dashboard.
2. Paying attention to discounts, but paying more attention to net revenue trends and the related changes on the expense side. Ensure that net income in the range of 2% to 4% per year is planned on, as suggested by KPMG and Prager Sealy in its guide to higher education financial analysis.[39]

THE IMPACT OF CERTAIN TAX POLICY AND SOCIAL POLICY INITIATIVES RELATED TO PRIVATE COLLEGE DISCRIMINATION

Tax Policy: Contributions

Overview of Charitable Contributions

On October 14, 2011, the Joint Committee on Taxation issued a 42-page report, "Present Law and Background Relating to the Federal Tax Treatment of Charitable Contributions." The report states that charitable giving by individuals, foundations, estates, and corporations reached $290.89 billion in 2010. Religious organizations received the largest share of donations in 2010, $100.63 billion, which accounted for over one-third of all charitable contributions. Education got the second-largest share at $41.67 billion, totaling 14% of total contributions.[40]

History of the Charitable Contribution Deduction

It's helpful to look at the history behind the charitable contribution deduction. The following is from the Joint Committee on Taxation (with our emphasis added):

> The income tax charitable deduction was first introduced by the War Revenue Act of 1917, and accompanied rate

[34] NACUBO, "2010 Tuition Discounting Study Report"
[35] Ibid., pg. 37 and 39.
[36] Ibid., pg. 11.
[37] Ibid., pg 17, 18.
[38] Ibid., pg. 19.
[39] Phil Tahey, Ron Salluzzo, Fred Prager, Lou Mezzina, and Chris Cowan, *Strategic Financial Analysis for Higher Education*, KPMG, Prager, Sealy & Co. (Attain, 2010), pg. 128.
[40] Joint Committee on Taxation, "Present Law and Background Relating to the Federal Tax Treatment of Charitable Contributions," October 14, 2011, pg. 1-2.

increases in the Federal income tax. The rate increases were enacted to help fund the United States' World War I effort, and legislators feared that the increases would reduce individuals' income "surplus" from which they supported charity. It was thought that a decrease in private support would cr*eate an increased need for public support and even higher tax rates, so the deduction was offered as a compromise.* To ensure that individual taxpayers could not eliminate their tax liability through the deduction, it was capped at 15 percent of taxable income.

Supporters of the deduction also argued that the incidence of any income tax without the deduction would fall at least partially on the charities themselves, as individuals would donate only the after-tax value of their before-tax intended gifts. Additionally, the deduction was viewed as an efficient way to distribute public money to charities, as it cut out the government middlemen. *Many believed charities could deliver social services better than the government and that it was appropriate for individuals rather than the government to decide which charities to support.* Finally, some argued that money donated to charity should not be considered income at all, and thus should not be taxed.

The income tax charitable deduction has undergone many changes since the War Revenue Act of 1917. Significant changes include allowing an unlimited deduction to taxpayers who donated more than 90 percent of their taxable income in the current year and in each of the previous 10 years in 1924; changing the measure of the deduction to adjusted gross income and the introduction of the standard deduction in 1944; and removing the unlimited deduction in 1976. For a brief period beginning in 1981, nonitemizers were allowed to take the deduction.

The Tax Reform Act of 1986 ended that practice because of the increased standard deduction, the administrative burdens of substantiating nonitemizers' contributions, and the belief that the practice allowed nonitemizers a double deduction for their contributions (i.e., because the standard deduction assumes a certain amount of charitable contributions).

The Revenue Act of 1935 made the charitable deduction available to corporations, but the deduction was limited at that time to five percent of the corporation's net income. Despite concerns in earlier debates that charitable giving by corporations would be *ultra vires* (i.e., beyond the powers of the corporation), the deduction was finally allowed as a means to reduce the level of tax increases needed to provide services to those affected by the Great Depression.[41]

Bringing this discussion into the present day, there appear to be two arguments against the charitable contribution deduction, as noted by the Joint Committee on Taxation:

People may find charitable giving gratifying because they enjoy making someone else happy, they feel relief from the guilt of not giving, or they enjoy the recognition that accompanies donations. If people experience such a "warm-glow" from giving, then donors can be said to benefit from their gifts. In this case, the donation is, at least in part, a personal expenditure and a deduction for the full amount of the donation should not be allowed under a comprehensive income tax system.

A second, separate rationale for the deduction for charitable contributions depends on the role of charitable organizations and the type of benefits those organizations provide. Charitable organizations often provide goods and services to select classes of charitable beneficiaries rather than to the public at large. For example, donations to a college may benefit select students and faculty at a college...[42]

Those arguing for the charitable contribution deduction make three observations, as noted by the Joint Committee on Taxation:

1. A patron of the arts who donates artwork may derive direct satisfaction from that donation, but because the donation allows the greater public to also view the artwork and enjoy it, a public good is also attained.
2. Some charitable organizations provide services and goods that would otherwise be provided by the government. These charitable gifts, then, reduce the cost of government to taxpayers as a whole. "In this view, the tax deduction for contributions is seen as equivalent to deductions permitted for many State and local taxes," the Joint Committee noted.[43]
3. "The third rationale for the charitable contribution deduction is that many charitable organizations provide goods or services with significant spillover benefits to the public at large," the Joint Committee wrote. "For example, charitable organizations may choose to provide benefits that improve the health of individuals suffering from certain diseases, such as through the provision of vaccinations."[44]

We discussed this issue with several people close to the debate. They noted that while there are some who argue against the charitable deduction, and while the so-called congressional "super commitee" is responsible for finding $1.2 trillion in new tax revenue or cost savings, **there is still widespread support for the charitable deduction.**

Several witnesses who testified before the Senate Finance Committee at a public hearing on October 18, 2011 predicted reductions in charitable contributions if the deduction was limited or eliminated. Brian A. Gallagher, President and CEO of United Way, stated, "I urge the committee to preserve the charitable contribution deduction for all donors." He noted that the proposed White House cap could reduce charitable giving from $5.6 billion to $2.9 billion per year. This loss could have a very harmful effect on the ability of non-profits to serve those in need. Diana Aviv, president and CEO of Independent Sector, echoed the same concerns. "A 2010 study by the Center on Philanthropy at Indiana University found that 85% of high net worth households donated to basic needs charities in 2009, compared with 31% of other taxpayers," Aviv noted. She went on the point out that charities providing assistance to the needy frequently receive gifts from higher-income donors targeted by the White House reduction tax savings for charitable gifts.

[41] Ibid., pg. 4-5. Emphasis ours.
[42] Ibid., pg. 32.
[43] Ibid., pg. 32 -33.
[44] Ibid., pg. 33.

Others testified about the significant public good provided by the presence of the charitable community, and the significant additional cost the government would incur if this private sector was to decrease in scope and its ability to meet needs due to reduced funding from private contributions. Stories about first responders and those doing service long after the government sector left the scene of disasters were clearly moving testimony.

Summary

Through its training and webinars, ECFA is suggesting that everyone, including colleges, take the following steps related to this debate:

1. Engage legislators. Tell them your story. Use quantifiable terms to tell them about the public good enjoyed as a result of your work.
2. Lobby for the position of keeping the charitable contribution deduction intact. ECFA points out that lobbying in self-defense is perfectly legitimate. It is not an illegal expenditure when it is in self-defense and the level of expenditure is in proportion to the size of the organization. (It cannot constitute a "significant portion" of your total expenditures.)
3. Know the options being discussed and how they may affect you. You may want to follow the discussion on the ECFA website (www.ecfa.org).

SOCIAL POLICY

The key social policy issues affecting religious private higher education focus on one main issue:

> *What constitutes a religious college, enabling it to take advantage of the impact of religious entity exemptions to certain laws and regulations while keeping it unique and able to carry out its vital mission in harmony with its values?*

Federal and state laws are increasingly being used to coerce religious institutions into actions and commitments that violate deeply held religious convictions and moral principles.[45] Some of these laws require employee and student health insurance that covers contraception, and mandate employee benefits for same-sex couples.

In "Protecting Catholic Colleges from External Threats to Their Religious Liberty," a white paper in the Studies in Catholic Higher Education series, Kevin Theriot wrote that:

> …the major forms of these threats [are] related to:
>
> - acceptance of federal student aid and grants, thus triggering federal Title IX's sex discrimination prohibitions and federal research grant conditions;
> - Title VII's prohibitions on employment discrimination;
> - the recently enacted Patient Protection and Affordable Care Act healthcare overhaul; and
> - various state-level laws and regulations.[46]

Meanwhile, William Armstrong, a former U.S. Senator from Colorado who is now president of Colorado Christian University, wrote a letter to the Education Department on July 30, 2010, cautioning that new state oversight rules for colleges and universities would "almost guarantee that states will have to cope with noisy arguments over teaching methods, degree requirements and culture wars over textbooks, evolution versus Intelligent Design, phonics versus whole language, campus ROTC, climate change, family policy, abortion, race, gender, sexual orientation, etc."[47]

So the battleground is clear and attention to this issue is important for all Christian colleges — Mainline Protestant, Evangelical, Catholic and Orthodox alike. Theriot's white paper does an outstanding job of reviewing the issues and measures that might prove helpful in fending off the accusation that a college is not "religious enough." He concludes the paper with the following 10 factors to watch. These are the factors courts would use in determining the religious or secular nature of an organization:[48]

1. **Whether the entity operates for a profit** This factor is not an issue for most secondary schools, but there are some for-profit colleges and universities. "Nothing in the statute or case law says a for-profit corporation can not [sic] be a 'religious corporation,' but every reported claim for that status by a for-profit corporation has been denied…"[49] Nonprofit status definitely weighs in favor of being considered a religious organization.
2. **Whether it produces a secular product** Many religious schools offer secular degrees in addition to religious. This does not preclude them from being considered religious institutions. For instance, Samford University offers a plethora of secular degrees, but was still considered a religious institution because, among other things, its chief purpose was "the promotion of the Christian Religion throughout the world by maintaining and operating ... institutions dedicated to the development of Christian character in high scholastic standing."[50]
3. **Whether the entity's articles of incorporation or other pertinent documents state a religious purpose** All indications are that the governing documents of an organization are important to it being considered religious. No cases were found where an organization was deemed religious even though no religious purpose was stated in its

[45] David E. Bernstein, The Law of Sex Discrimination (Chicago: University of Chicago Legal Forum, 1999), pg. 133-134.
[46] Kevin Theriot, "Protecting Catholic Colleges from External Threats to Their Religious Liberty," The Center for the Advancement of Catholic Higher Education, Studies in Catholic Higher Education Series, January 2011, pg. 3.
[47] Ibid., pg. 10.
[48] The following 10 items are excerpted from Theriot, pg. 11 – 13.
[49] George W. Dent, Jr., Civil Rights for Whom? Gay Rights Versus Religious Freedom, 95 Ky. L. J. 553, 569 (2006-2007), quoted in Theriot, pg. 11.
[50] Killinger v. Samford Univ., 113 F.3d, pg. 199 (11th Cir. 1997), quoted in Theriot, pg. 11.

founding documents. On the other hand, Samford's charter reflected its chief purpose of promoting the Christian Religion throughout the world, and that was a significant factor in the court's determination that the university was religious.

4. **Whether it is owned, affiliated with or financially supported by a formally religious entity such as a church or synagogue** Though not determinative, this factor certainly figures strongly into the calculation when assessing whether a school is religious. The Court found it significant that Samford University received seven percent of its annual budget from the Southern Baptist Convention.

5. **Whether a formally religious entity participates in the management, for instance by having representatives on the board of trustees** This factor is very helpful for determining a school is religious if it is not directly affiliated with a church or other religious body. For instance… a Jewish Community Center was considered a religious organization even though it was not directly affiliated with any synagogue, because several rabbis were advisory, non-voting members of its board.

6. **Whether the entity holds itself out to the public as secular or sectarian** This is one of the most important factors. A school in Hawaii that required its teachers to be Protestant was not religious, due in part to the fact that the school's introductory pamphlet and course catalogue did not list any religious purpose of the school…

7. **Whether the entity regularly includes prayer or other forms of worship in its activities** Students at Samford University are required to attend chapel — which figured favorably in the court's determination that it is a religious organization…

8. **Whether it includes religious instruction in its curriculum, to the extent it is an educational institution** Sectarian schools must be careful to ensure that religious courses do something more than just teach about religion — which is allowed even in public schools. For instance, this factor weighed against the Hawaii school that was found not to be religious because its curriculum "consist[s] of minimal, largely comparative religious studies…."[51] Whereas, Samford University actually has a divinity school that trains clergy.

9. **Whether its membership is made up by coreligionists** In the school context, this factor obviously has to do with the composition of the student body and faculty. It is not necessary that students and teachers be limited to individuals of a particular religion. Although Samford students are required to attend chapel, the court made no mention of a requirement that they be Southern Baptist, and determined the school was religious anyway. And only instructors who taught religion courses were required to subscribe to a particular statement of faith…

10. **Consistent compliance with religious beliefs** Courts have held that a school or entity is no longer religious, even though it once was, because of lack of effort to comply with its original religious teachings. For instance a court found that a home for troubled youth originally established with a religious purpose and governed by church-member trustees was presently secular because it no longer included religion in its programming and attendance at religious services was optional. Likewise, a school in Hawaii originally established as a Protestant institution was not religious because "the record reveals the purpose and emphasis of the School have shifted over the years from providing religious instruction to equipping students with ethical principles that will enable them to make their own moral judgments."[52]

This factor may be particularly significant for universities and colleges that are affiliated with a particular denomination that specifically proscribes religious tenants that must be followed. For instance, Catholic schools should adhere to the Canon Law requirements for their institutions, including the Church's Apostolic Constitution *Ex corde Ecclesiae*, which applies directly to Catholic universities.

Summary

To summarize this key issue, we'll turn once again to Theriot's white paper. It's critical that you keep the following considerations in mind:

1. Religious institutions of higher education need to be careful about deviating from their "historic religious ties." Doing so, Theriot notes, could put an institution "in danger of losing its ability to claim that it is a religious employer exempted from civil rights legislation disallowing even religious discrimination."

2. To reduce regulation, Christian institutions should "firmly maintain their religious identities and should exercise caution when accepting federal funds or allowing their students to accept federal financial assistance," Theriot writes.

3. Under new requirements, religious institutions must provide health insurance to their employees. "It is unclear how this new law will affect schools and other religious organizations that object to certain types of healthcare, such as abortion and in vitro fertilization," Theriot observes. He recommends that schools start consulting with their legal counsel as soon as possible to identity any conflict.

[51] EEOC v. Kamehameha Schools/Bishop Estate, 990 F.2d at 463, quoted in Theriot, pg. 12.
[52] EEOC v. Kamehameha Schools/Bishop Estate, 990 F.2d at 462, quoted in Theriot, pg. 12.

4. "Finally," Theriot writes, "direct funding from the federal government may contain some prohibitions on a school's ability to hire faculty and recruit students that agree with its religious teachings. The procurement criteria for each direct grant should be examined closely to be sure the school is not foregoing its ability to maintain its religious character."[53]

STUDENT DEBT BEST PRACTICES

Student debt is getting a lot of attention these days in newsletters, periodicals, and major news outlets. The rising amount of debt combined with the high unemployment rate is indeed adding to the "Misery Index" for many graduating students and their families.

A few of the recent headlines:

Student loans outstanding will exceed $1 trillion this year — *USA Today*, October 25, 2011

Sharp Uptick in Federal Student Loan Default Rates — *USA Today*, October 25, 2011

Unfilled Expectations: Recent College Graduates Struggle in a Troubled Economy — John J. Heldrich Center of Workforce Development, May 18, 2011

In the early 1990s, less than half of graduates left college with loans to repay; now nearly two-thirds of students at four-year colleges and universities have student loan debt by the time they graduate. And the amount of outstanding loans has increased sharply, even after accounting for inflation. The Pew Charitable Trust's research on college debt and practices that both help and hurt the situation is collected on Trust's website on student debt at http://projectonstudentdebt.org/. We've excerpted the Trust's recommendations on debt best practices for colleges to follow:

- Require counseling before certifying private loans for all applicants if resources allow, and for at least those who have not maximized their use of grants and federal student loans.
- Formalize policies and practices aimed at reducing private student loan usage.
- Coordinate between offices, especially the financial aid and bursar's offices, to track payments from uncertified private loans, and use the information to quickly contact and counsel the borrowers.
- Do not include private student loans in financial aid offers, which can give the false impression that private loans are a form of financial aid.
- Use available tools to speed up the federal loan process, so students who need quick access to loan funds are not left only with private loan options.
- Track outcomes: the number of students who applied for and took out private student loans, how much they borrowed, whether they maximized federal loans first, and what kind of counseling or outreach, if any, they received.
- Share both promising practices and actual outcomes with other colleges and the broader field.[54]

HIGHER EDUCATION LEADERSHIP TRANSITION

"We're seeing the graying of the presidency, which inevitably sooner or later is going to mean there will be successors and new presidents," said Molly Corbett Broad, president of the American Council on Education, in a recent article in The Chronicle of Higher Education. The American Council on Education reported four years ago that the average higher education president was 60 years old.[55] "I do think it's an important issue for American higher education, because it's also happening at a point of such significant change," Broad added. The article discusses the need for grooming successors, but laments a significant lack of mentoring.

The CapinCrouse LLP *Successful Leadership Transitions* white paper, authored by Dr. David J. Gyertson, discusses the fact that the average tenure of the top leadership is growing shorter due to a number of stressors. "All these factors are now converging to create a "perfect storm" — an unprecedented leadership vacuum and demand for quality leaders," Gyertson wrote.[56]

And a 10-year study of theological school presidents performed by the Auburn Center for the Study of Theological Education notes that "the most striking finding of this study was the failure of many boards and other supervisors of seminary chief executives to hold up their part of the partnership with the president. Boards could improve if they paid more attention to their relationship with the president at various points in the cycle of the presidency."[57]

The CapinCrouse publication lays out seven steps to guide your institution through a successful transition. You can request a complimentary copy of this report by calling any CapinCrouse office or contacting us online at www.capincrouse.com.

Summary

This is probably a good time to think about and plan for the inevitable transition of a key executive, especially if retirement is not being actively discussed. We also advise having an emergency game plan, or at least a set of steps, prepared in case of an untimely transition. One important component of this is documenting the key points of information and interest that need to be passed from one president to another.

ACCOUNTING TRENDS AND ISSUES

Not-for-Profit Advisory Committee

Much of the accounting industry is buzzing these days with discussions about international accounting standards and the Blue Ribbon Panel's recommendation to form a new standards setting board for private companies. Fortunately, the not-for-profit community is not being ignored as the rest of the accounting world reviews and revises its reporting standards to stay current with the times. In October 2009, the Financial Accounting Standards Board (FASB) announced the establishment of the Not-for-Profit Advisory Committee (NAC). The NAC is intended to serve as a standing resource for the FASB in obtaining input

[53] Theriot, pg. 14.
[54] Matthew Reed, "Critical Choices: How Colleges Can Help Students and Families Make Better Decisions about Private Loans," The Institute for College Access & Success, July 2011, pg. 3.
[55] Jack Stripling, "The Graying Presidency," The Chronicle of Higher Education, accessed November 10, 2011, http://chronicle.com/article/The-Graying-Presidency/129140/
[56] Dr. David J. Gyertson, Ph.D., "Successful Leadership Transitions for Christian Higher Education and Other Faith-Based Organizations," CapinCrouse LLP Higher Education Leadership Series, June 2011, pg. 3.
[57] Barbara G. Wheeler, G. Douglass Lewis, Sharon L. Miller et al, "Leadership That Works: a Study of Theological School Presidents," Auburn Studies No. 15, December 2010.

from the not-for-profit sector on existing guidance, current and proposed technical agenda projects, and longer-term issues affecting those organizations.

FASB anticipates that the NAC will provide an important discussion forum for critical issues and a key vehicle for hearing perspectives from the not-for-profit sector. In addition to providing focused input from the sector, the NAC is intended to help the Board and staff communicate recent and other existing guidance, current and proposed projects, and other issues of importance.

"The establishment of the NAC solidifies the FASB's commitment to ensuring that the views of the not-for-profit sector are heard in the development of standards," said Robert Herz, chairman of the FASB, in the October 22, 2009 news release. "We anticipate that enhanced participation from not-for-profits will greatly assist the Board in understanding and appropriately considering the issues and needs of the sector, especially insofar as they differ from those of public and private business entities."[58]

The NAC is comprised of 12 to 15 individuals from the not-for-profit sector, including not-for-profit financial report users, preparers, practitioners, and those with backgrounds in academia and law. Large and small not-for-profit organizations representing a wide spectrum of interests — including higher education, healthcare, public charities, and others — are represented. The committee was formed in early 2010 and the first meeting took place in the middle of 2010. The FASB anticipates the NAC will meet two or three times per year, with meetings made open to the public to the extent possible. The latest meeting, in October 2011, yielded substantive discussion around three key initiatives:

1. Revisiting current net asset classifications, and how they may be relabeled or redefined, in conjunction with improving how liquidity is portrayed in a not-for-profit's statement of financial position and related notes
2. Creating a framework for not-for-profit directors and managers to provide commentary and analysis about the organization's financial health and operations, somewhat similar to the "Management Discussion and Analysis" provided by publicly traded companies in their annual reports, to help them bring context to their financial story
3. Improving the statements of activities and cash flows to better communicate financial performance, including measures of operations

One welcome caveat heard by the committee from many stakeholders was the caution against layering on new requirements without also focusing on ways to streamline the existing presentation.

Net Asset Classification Discussion

The discussion about net asset classification at the recent NAC meeting yielded recommendations and discussion around the following ideas:

- Using two classifications (donor restricted and other) to describe the classifications of equity. It was noted that there is confusion about the term unrestricted (which really just means "not donor restricted"). The idea was to include a breakdown of types of restrictions (for example, time-only, purpose, and perpetuity) on the balance sheet, with additional detail in the notes. Similarly, include a breakdown of other net assets (for example, net investment in plant, quasi-endowment, other key board designations, undesignated) on the balance sheet, with any necessary detail in the notes.

- The committee noted that donor restrictions are generally very important, but the distinction between temporarily and permanently restricted net assets, at least as currently defined, has probably outlived its usefulness because of (1) the "hodgepodge" of restrictions (especially short-term versus long-term) found in temporarily restricted net assets, and (2) the changes brought about by the Uniform Prudent Management of Institutional Funds Act (UPMIFA). They suggested using the term "other net assets" rather than "unrestricted net assets." This is because many stakeholders believe that, due to the existence of other legal restrictions in some instances, "unrestricted" is somewhat less accurate than "not donor-restricted."
- They noted that unrestricted endowments should not be lumped together with donor endowments in the balance sheet or statement of activities, but perhaps only in a note. It was also suggested that the more detailed disclosure of donor-restricted net assets in the notes could include sub-categories such as the following, with beginning and ending balances for each:
    - Time-restricted-only: perhaps by year within that
    - Purpose-restricted: minimally into capital versus program (and perhaps by year within the latter)
    - Perpetuity: minimally into endowment versus other

Since many credit and other analysts, rightly or wrongly, often use the net asset class distinctions as part of their assessment of a not-for-profit's liquidity, a project to revise the net asset classes might best go hand-in-hand with a project to improve the reporting of liquidity, which is one of the other subgroups.

Somewhat related to this, as well as to the reporting of endowment, the committee suggested that it may be desirable to further segregate the net asset balances related to outstanding pledges from those related to funds on-hand when disaggregating restricted net assets into sub-categories such as those listed above.

[58] "FASB Establishes Not-for-Profit Advisory Committee," (Press release). Financial Accounting Standards Board, October 22, 2009. Accessed November 10, 2011, http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176156520393

Management Discussion and Analysis

The second topic taken on by the NAC at its most recent meeting was improving the financial reporting model by Management Discussion and Analysis (MD&A). A properly prepared MD&A can go a long way in bridging the gap between the financial numbers, which in a not-for-profit organization are only part of the story that needs to be told, and the key accomplishments and issues affecting the organization financially and programmatically. The committee did not stick to the specific topic of an MD&A report, but expanded to a few other topics that influence an understanding of an organization.

The committee focused on making improvements in:

1. Management's discussion and analysis (MD&A) of an entity's financial position and the results of its operations for the period
2. Reporting on an entity's major segments or lines of business, which includes the objective of depicting or describing how the entity's various program costs and other expenses relate to its various sources of revenue and support
3. Reporting of expenses by both their nature and function and whether that should be required of all not-for-profit entities as part of any of the following:
    - Management commentary
    - Basic financial statements
    - Notes to financial statements
    - Supplementary information or in other ways
    - Other non-GAAP means of reporting, including the use of non-financial metrics that relate to entity performance

Committee members acknowledged that because the FASB has not addressed MD&A-like reporting for other types of entities, some constituents may express concerns about broadening the scope of FASB's activities. Nonetheless, they noted that MD&A-like reporting is a long-standing financial reporting practice among public companies (under SEC mandates), is required by the GASB for state and local governmental entities (Statement No. 34, *Basic Financial Statements — and Management's Discussion and Analysis — for State and Local Governments),* and is included by the IASB in the recently issued "best practice" guidance for management commentary. Moreover, the FASB's Concepts Statement No. 4, *Objectives of Financial Reporting* by *Nonbusiness Organizations*, which was issued in 1980, has long recognized the importance of management's explanation and interpretations as a significant part of useful financial reporting.

Committee members also observed that MD&A-like reporting by healthcare systems, colleges and universities, and other not-for-profit organizations is increasing, but the content, scope, and depth of analysis provided to their donors, bond holders, and other constituents vary greatly. Members noted a need for guidance that would mitigate the diversity they see in current practice.

The consensus of the Management and Discussion Subgroup was to recommend that MD&A be required supplemental information in a general-purpose financial report, and that it be placed before the financial statements and notes.

The subgroup noted that this approach is similar to the GASB's requirement for state and local governments. They suggested that MD&A contain four sections:

a. Introduction and Overview

b. Financial Health

c. Operations

d. Liquidity

Improving the Financial Reporting Model for Not-For-Profits: Liquidity/Financial Health

This subgroup of the committee considered ways to better reflect liquidity or other key measures of financial health on the balance sheet or in the notes, or both.

They formed two recommendations to improve the information provided about liquidity:

1. Information is needed that allows users to evaluate the basic liquidity position of the organization and readily identify and understand other non-donor restrictions (such as reserves designated by the board of directors, lease commitments, and other items). Specifically, users need better information about whether and when assets convert to cash, the extent of restrictions, and the matching of outflows (obligations) and resources that are flowing in to meet the obligations.
2. Certain users need information about how net assets relate to funds available for operations and debt service. Specifically, some users may need further analysis of the subcomponents of unrestricted net assets and temporarily restricted net assets.

This committee subgroup focused more on short-term liquidity than on other key measures of financial health. Based on the feedback about users' information needs, the subgroup expressed its belief that:

- Liquidity is a key indicator of financial health;
- Information about liquidity is of high interest to many users (donors, grantors, lenders, suppliers, and accrediting and oversight bodies); and
- The application of guidelines on reporting liquidity in the financial statements needs improvement.

Some of the liquidity issues identified, particularly in assessing the longer-term adequacy of reserves, overlap with the topic of financial health. The subgroup also decided to first focus its recommendations about liquidity on the balance sheet date (point in time) and then consider whether and how to expand that information (intra-period and, possibly, prospective).

Overall, this subgroup developed three areas of recommended improvements:

- Current net asset classification scheme and related disclosures

- Liquidity and reserves narrative
- The relationship between investments and endowments

Members suggested that the improvements could be implemented through a combination of education, clarification of existing GAAP requirements, and the addition of new GAAP requirements. The existing guidance on liquidity in GAAP is broad, conceptual guidance focused on providing information through either balance sheet presentation or disclosure. The Subgroup 3 members observed that the guidance does not appear to be applied (or enforced) in practice, however.

The subgroup concluded that overall, the improvements should be related to a mix of balance sheet presentation, additional disclosures within the financial statements, and MD&A-type information. The members of this subgroup also considered the relationship between the improvements and the information provided in the existing cash flow statement, and observed that trends in the cash flow statement can be helpful in identifying what may be a contributing factor to an impending liquidity problem even if the concern is not immediate (short-term).

The cash flow statement was not a primary focus of this subgroup's work because it seems to involve more MD&A-type information and provides a longer-term (annual) view of historical cash use, rather than a short-term focus on what cash is available or might be needed for operations and debt service.

Summary

The three NAC subgroups have significant input in the standard-setting process. We recommend that you review these suggestions and build pro forma models, especially where the details of implementation are bound to be complex. Even though these suggestions are not required, some schools have already begun implementing one or more of them. We are seeing more MD&A and more liquidity and operational measurements each year.

ACCOUNTING STANDARDS UPDATES (ASUs)

The list of ASUs issued over the last two years is long. There were 29 issued in 2010 and another 12 in 2011. Fortunately, only a small number of ASUs this year affect not-for-profit organizations, including colleges and universities. You should be aware of the following standards updates:

Update No. 2011-04—Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs

This ASU was designed to converge fair value measurement and disclosure guidance in U.S. GAAP with the guidance in the International Accounting Standards Board's concurrently issued IFRS 13, *Fair Value Measurement*.

The amendments in ASU 2011-04 do not modify the requirements for when fair value measurements apply; rather, they generally represent clarifications on how to measure and disclose fair value under ASC 820, *Fair Value Measurement,* including the following revisions:

- The concepts of highest and best use and valuation premise are relevant only for measuring the fair value of non-financial assets and do not apply to financial assets and liabilities.
- An entity should measure the fair value of an equity-classified financial instrument from the perspective of the market participant that holds the instrument as an asset.
- An entity that holds a group of financial assets and financial liabilities whose market risk (that is, interest rate risk, currency risk, or other price risk) and credit risk are managed on the basis of the entity's net risk exposure may apply an exception to the fair value requirements in ASC 820 if certain criteria are met. The exception allows such financial instruments to be measured on the basis of the reporting entity's net, rather than gross, exposure to those risks.

Premiums or discounts related to the unit of account are appropriate when measuring fair value of an asset or liability if market participants would incorporate them into the measurement (for example, a control premium). However, premiums or discounts related to size as a characteristic of the reporting entity's holding (that is, a "blockage factor") should not be considered in a fair value measurement.

The following new disclosures related to an entity's fair value measurements are required:

- For Level 3 fair value measurements:
    - Quantitative information about unobservable inputs
    - Description of the valuation processes
    - Qualitative discussion about the sensitivity of the measurements
- Information about the use of a non-financial asset when it differs from the asset's highest and best use
- The level of fair value hierarchy for assets and liabilities that are not measured at fair value but whose fair value is required to be disclosed

Nonpublic entities are exempt from certain disclosures, including those for transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for those transfers, and qualitative discussion about the sensitivity of Level 3 measurements.

For public entities, the amendments in the ASU are effective prospectively for interim and annual periods beginning after December 15, 2011 (that is, the quarter ending March 31, 2012 for calendar-year entities). Nonpublic entities are required to adopt the amendments prospectively for annual periods beginning after December 15, 2011 (that is, the fiscal year ending December 31, 2012 for calendar-year entities).

Early adoption is not permitted for public entities; however, nonpublic entities may early adopt in interim periods beginning after December 15, 2011.

Update No. 2011-07—Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities (Included for its future implications to higher education)

Some health care entities recognize patient service revenue at the time the services are rendered, regardless of whether the entity expects to collect that amount. Constituents have raised concerns, however, that such accounting practices result in a gross-up of revenue for amounts the entity doesn't actually expect to collect. And because health care entities make their own judgments regarding adjustments to revenue and bad debts, those judgments differ and are hard to compare, making analysis difficult for financial statement users.

To provide information that will assist financial statement users in assessing an entity's sources of net revenue and changes in its allowance for doubtful accounts, the FASB has issued Accounting Standards Update (ASU) 2011-07, Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities (a consensus of the FASB Emerging Issues Task Force).

This ASU requires health care entities that recognize significant amounts of patient service revenue at the time services are rendered, even though they do not assess the patient's ability to pay, to present the provision for bad debts related to patient service revenue as a deduction from patient service revenue (net of contractual allowances and discounts) on their statement of operations. This represents a change in the presentation of certain health care entities' statements of operations, as the provision for bad debts will be reclassified from an operating expense to a reduction from revenue (net of contractual allowances and discounts).

Health care entities are also required to provide enhanced disclosure about their policies for recognizing revenue and assessing bad debts. Further, the ASU requires disclosures of patient service revenue (net of contractual allowances and discounts) as well as qualitative and quantitative information about changes in the allowance for doubtful accounts.

For public entities, the amendments in ASU 2011-07 are effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2011, with early adoption permitted. For nonpublic entities, the amendments are effective for the first annual period ending after December 15, 2012, and interim and annual periods thereafter, with early adoption permitted. The amendments to the presentation of the provision for bad debts related to patient service revenue in the statement of operations should be applied retrospectively to all prior periods presented. The disclosures required by the amendments in the ASU should be provided for the period of adoption and subsequent reporting periods.

Update No. 2011-08—Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment

This standards update is intended to simplify how both public and nonpublic entities test goodwill for impairment. ASU 2011-08 permits an entity to first assess qualitative factors to determine whether it is "more likely than not" that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350, Intangibles—Goodwill and Other. The more-likely-than-not threshold is defined as having a likelihood of more than 50%.

ASU 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance.

Update No. 2011-09—Compensation—Retirement Benefits—Multiemployer Plans (Subtopic 715-80): Disclosures about an Employer's Participation in a Multiemployer Plan

The FASB issued this update to address concerns from various financial statement users about the lack of transparency in an employer's participation in a multiemployer pension plan. Financial statement users have requested additional disclosure to increase awareness of the commitments and risks involved with participating in multiemployer pension plans. The amendments in this ASU require additional disclosures about an employer's participation in a multiemployer pension plan. Previously, disclosures were limited primarily to the historical contributions made to the plans.

ASU 2011-09 applies to nongovernmental entities that participate in multiemployer plans. For public entities, ASU 2011-09 is effective for annual periods for fiscal years ending after December 15, 2011. For nonpublic entities, ASU 2011-09 is effective for annual periods for fiscal years ending after December 15, 2012. Early adoption is permissible for both public and nonpublic entities. ASU 2011-09 should be applied retrospectively for all prior periods presented.

Employee Benefit Plans: Loans to Participants

Currently, participant loans in a defined contribution pension plan are classified as an investment, in accordance with the defined contribution pension plan guidance in FASB Accounting Standards Codification paragraph 962-325-45-10. Also, Subtopic 962-325 requires most investments held by a plan, including participant loans, to be presented at fair value. In practice, most participant loans are carried at their unpaid principal balance plus any accrued but unpaid interest, which is considered a good faith approximation of fair value.

To clarify how loans to participants should be classified and measured by defined contribution pension benefit plans, the FASB has issued a proposed ASU, *Plan Accounting Defined Contribution Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Pension Plans — a Consensus of the FASB Emerging Issues Task Force.* It has been subsequently finalized. This guidance requires that loans to participants be classified as notes receivable from participants, segregated from the plan investments. The classification of participant loans as receivables is intended to acknowledge that participant loans are unique from other investments in that a participant taking out such a loan essentially borrows against its own individual vested benefit balance. (It should be noted, however, that the Department of Labor continues to require participant loans to be included as an investment on the supplemental schedule of assets held (measured as the unpaid principal balance plus any accrued but unpaid interest) to be included with the audited financial statements.)

Further, the ASU requires participant loans to be measured at their unpaid principal balance plus any accrued but unpaid interest, rather than at fair value. One reason for this conclusion is that participant loans cannot be sold by the plan. Further, if a participant were to default, the participant's account would be reduced by the unpaid balance of the loan, and there would be no effect on the plan's investment returns or any other participant's account balance.

FASB EXPOSURE DRAFTS

LEASES

According to the Grant Thornton International Business Report, as many as 54% of global businesses "are not aware of, and are therefore unprepared for, one the most significant global accounting changes in the past decade: the virtual elimination of off-balance sheet leases."[59]

"Leasing is an important source of financing for many companies," the report notes. "Currently, operating leases do not appear on the balance sheets of organizations. The proponents of these new rules think that there can be distortion of the true assets used by, and related liabilities of, those companies."[60]

What was broken in the accounting for leases? Three things come to mind:

1. Under the existing rules, the dividing line between a capital lease and an operating lease is complex and murky. It is the kind of thing only an accountant with the right spreadsheet would be able to evaluate. The current rules are an "all or nothing" approach that has led to large groups of lease arrangements with terms that approach — but do not cross — the "bright lines" in the accounting standards that would require capitalization. Indeed, lease structuring to meet various accounting goals has developed into an entire industry. As a result, new lease agreements had to be evaluated closely before execution to determine the accounting impact. In cases where that evaluation was not done ahead of time, there were sometimes surprises… especially when balance sheet ratios were close and the addition of a capital lease moved a ratio in the wrong direction (e.g. more "debt" than what is allowed).
2. The presence of a two-tier system of accounting for leases allowed the presence of commitments for lease payments to be made off the balance sheet when it came to operating leases. It would be like financing the purchase of a significant asset, only the liability never hits the books. One might argue that the asset did not hit the books either. Some also argue that the operating lease commitments were already in the notes to the financial statements, so why the angst over the lack of balance sheet presentation?
3. Current lease accounting is based on SFAS 13. Since being issued in 1976, SFAS 13 has been amended nine times and subjected to numerous interpretations, technical bulletins and issuances by the EITF. Most admit that the current rules-based standards are overly complex.

The "Old Rules"

Leases are classified into two categories under the current lease accounting guidance: capital leases and operating leases. You answer four questions to ascertain the right category:

- Does title of the asset transfer at the end of the lease?
- Does the lease contain a bargain purchase option?
- Is the term of the lease at least 75% of the economic useful life of the asset?
- Is the current value of the future minimum lease payments at least 90% of the fair market value of the asset?

If any of these questions gets a "yes" answer, the lease must be capitalized and recorded on the balance sheet. If the answer to all four questions is "no," it can be categorized as an operational lease and the lease payments can be expensed.

How Were the Rules "Fixed?"

The main idea behind the changes to the lease accounting guidance is that:

- A lessee would recognize a right-of-use asset representing its right to use an underlying asset during the lease term, and a liability for the obligation to make lease payments. The lessee would amortize the right-of-use asset over the shorter of the expected lease term or the useful life of the underlying asset. The lessee would incur interest expense on the liability to make lease payments.
- A lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease. The approach applied depends on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease.

Who Would Be Affected?

The proposed requirements would affect any entity that enters into a lease, although there are some exemptions specified in the exposure draft:

- Leases of intangible assets (see FASB ASC Topic 350)
- Leases to explore for or use minerals, oil, natural gas, and similar non-regenerative resources (see FASB ASC Topic 930 and Topic 932)
- Leases of biological assets (see FASB ASC 905)
- Leases between the date of inception and the date of commencement of a lease if they meet the definition of an onerous contract (see IAS 37 Provisions, *Contingent Liabilities and Contingent Assets*)

Lessee Accounting

On the date a lease begins, the lessee's financial statements would recognize a right-of-use asset and a liability to make lease payments. A lessee would be required to measure:

- The liability to make lease payments at their present value,

[59] Roy Harris, "Awareness of Huge Lease-Accounting Shift is Low," CFOworld, accessed November 10, 2011, http://www.cfoworld.com/accounting-standardsifrs/23709/awareness-huge-lease-accounting-shift-low
[60] Grant Thornton International Business Report 2011

discounted using the lessee's incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee.

- The right-of-use asset at the amount of the liability to make lease payments, plus any initial direct costs incurred by the lessee.

In order to determine the present value of lease payments, a lessee would include:

- An estimate of contingent rentals payable. If the contingent rentals depend on an index or a rate, the lessee would determine the expected lease payments using readily available forward rates or indices. If forward rates or indices are not readily available, the lessee could use the prevailing rates or indices.
- An estimate of amounts payable to the lessor under residual value guarantees. If residual value guarantees are provided by an unrelated third party, they would not be considered lease payments.
- An estimate of expected payments to the lessor under term option penalties. Under the proposed standard, the exercise price of a purchase option included in a lease is not considered a lease payment and the purchase option is not included in determining the present value of lease payments payable.

The lessee determines the lease term by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease. During the term of the lease, the lessee must reassess the carrying amount of the liability to make lease payments arising from each lease if facts or circumstances indicate that there would be a significant change in the liability since the previous reporting period.

A lessee distinguishes changes in contingent rentals and expected payments under term option penalties and residual value guarantees that relate to current or prior periods from those that relate to future periods. Recognition of these changes is reflected in net income for changes related to current or prior periods, and an adjustment to right-of-use-asset for changes that relate to future periods.

Subsequent Measurement

After the date a lease begins, the lessee would measure the liability to make lease payments at amortized cost using the interest method, and the right-of-use asset at amortized cost.

Impairment

A lessee should apply FASB Topic 350: *Intangibles-Goodwill and Other* at each reporting date to determine whether the right-of-use asset is impaired. Any impairment loss would be recognized in accordance with Topic 350.

Proposed Accounting by the Lessor

On the date that a lease begins, a lessor would assess whether a lease is accounted for by the performance obligation approach or the derecognition approach. The assessment is based on whether or not the lessor retains exposure to significant risks or benefits associated with the underlying asset either:

- During the expected term of the lease; or
- After the expected term of the lease by having the expectation or ability to generate significant returns by releasing or selling the underlying asset.

Performance Obligation or Derecognition

If a lessor retains exposure to significant risks or benefits associated with an underlying asset, the proposed standard says the lessor should apply the performance obligation approach to the lease.

If a lessor does not retain exposure to significant risks or benefits associated with an underlying asset, the lessor should apply the derecognition approach to the lease. Once an accounting approach is chosen for an asset, it may not be changed after the date that the lease begins.

Performance Obligation Approach

The performance obligation approach would likely be appropriate when a company's business model is primarily to generate a return from the active management of the underlying assets, either from leasing those assets to multiple lessees during their life, or from use or sale of the asset at the end of the lease. The lessor may also generate a variable return during the term of the lease by accepting payments that are contingent on the usage or performance of the underlying asset. In that business model the principal risk is asset risk.

The measurement of the lease liability in the performance obligation approach is based on the proposals in FASB's exposure draft Revenue from Contracts with Customers. Therefore, an entity should:

- Measure the lease liability at the amount of customer consideration on initial recognition
- After initial measurement, remeasure the lease liability to reflect the extent to which it has satisfied the obligation to permit the lessee to use the underlying asset
- Treat changes in uncertain consideration as changes in the original transaction price

The lessor satisfies the performance obligation by permitting the lessee to use the underlying asset continuously during the lease term. This means that the lessor satisfies the performance obligation on a continuous basis. Accordingly, the lessor should:

- Measure the lease liability at the present value of lease payments receivable.
- Remeasure the lease liability at the end of each reporting period to reflect satisfaction of that obligation.
- Adjust the lease liability for any change in the right to receive lease payments resulting from a reassessment of the lease term, amount of contingent rentals, or expected payments under term option penalties and residual value guarantees to the extent that those lease payments relate

to unsatisfied obligations. This mirrors the accounting by the lessee, which adjusts the right-of-use asset for any changes in the lessee's liability to make lease payments relating to future periods.

- Recognize in profit or loss any change in the right to receive lease payments resulting from a reassessment of amounts receivable under contingent rentals, or expected payments under term option penalties and residual value guarantees, to the extent that those lease payments relate to satisfied obligations.

Derecognition Approach

The derecognition approach would likely be appropriate when a company's business model is primarily the provision of finance, because the profit of that business is derived from interest income and the principal risk associated with the business is credit risk.

When applying the derecognition approach, the lessor derecognizes only the portion of the underlying asset that it transferred to the lessee. Any remaining portion of the carrying value of the underlying asset will be allocated to a residual asset. The lessor recognizes gains and losses at the start of the lease that relate only to the rights transferred to the lessee.

After the lease begins, the lessor should reassess the carrying amount of the right to receive lease payments arising from each lease if facts or circumstances indicate that there would be a significant change in the right to receive lease payments made since the previous reporting period.

For example:

Assume that a lessor enters into a lease for a computer with a fair value of $3,300, a carrying amount of $2,500 and a useful life of four years. The lease is for three years at $1,200 per year and the interest rate on the lease is 10%. Assume the most likely lease term is three years and the present value of the lease payments is $3,000. The carrying value of the computer would be allocated to the amount to be derecognized by taking the carrying amount times the ratio of the fair value of the lease payments to be received over the fair value of the underlying asset. Assume that amount is determined to be $2,275.

The first entry would be to record the present value of the lease payments:

Lease receivable	$3,000
Revenue	$3,000

The portion of the asset derecognized would be recorded as a debit to cost of sales and the remainder of the carrying value would be allocated to the residual asset with the credit to the former asset, as shown below:

Cost of sales	$2,275
Residual asset	$ 225
Underlying asset	$2,500

As cash payments are received during the lease term, the lease receivable would be reduced and interest income would be recognized.

Lease Term

Under the proposed standard, a lessee or a lessor would determine the lease term as the longest possible term that is likely to occur, taking into account the effect of any options to extend or terminate the lease. At each subsequent reporting date, the term of the lease would be reassessed if the facts or circumstances indicate that there is significant change. For the lessee, recognition would be as an adjustment to the right-of-use asset. For the lessor, it would be by either derecognition of a portion of the residual value or as a performance obligation with an adjustment to lease liability.

An example: An entity has a lease that has a non-cancelable 10-year term, and an option to renew for five years at the end of 10 years, and another option to renew for an additional five years at the end of 15 years. Assume that the entity determines the probability for each term as shown below.

There is a 60% chance that the term will be 15 years, which is the longest possible term more likely than not to occur.

Therefore, the lease term is 15 years.

Lease Term	Probability	Cumulative Probability
10 years	40%	100%
15 years	30%	60%
20 years	30%	30%

Reassessment of Lease Term

The proposed standard says a lessee should adjust the carrying amount of the right-of-use asset to reflect changes in the measurement of the related liability to make lease payments arising from the reassessment of a lease term. In contrast, entities recognize changes in most other liabilities in profit or loss. In the view of FASB and IASB, the proposal to adjust the right-of-use asset for changes in the related obligation is justified because a change in the assessed lease term represents the lessee's expectation to acquire more or less of the right to use the underlying asset.

Measurement

Under the proposed standard, contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in a lease would be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique.

Lessees and lessors would remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments, or in the right to receive lease payments, arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period.

Changes in contingent rentals and expected payments under term option penalties and residual value guarantees need to be reassessed.

When a lessee exercises a purchase option, it terminates the lease and purchases the underlying asset. Thus, the exercise price of the option is not a lease payment and should not be included in the measurement of assets and liabilities arising from a lease. FASB and IASB propose that purchase options should not be accounted for until they are exercised. However, bargain purchase options are considered when determining if a transaction is a lease, a purchase, or a sale. Initial direct costs are incremental costs directly attributable to negotiating and arranging a lease. The exposure draft proposes that lessees and lessors should capitalize initial direct costs by adding them to the carrying amount of the right-of-use asset and the right-to-receive lease payments, respectively.

Contingent Rentals

Changes in amounts payable under contingent rental arrangements, term option penalties, and residual value guarantees arising from current or prior periods should be recognized in profit or loss. All other changes, such as those arising from expectations about future periods, would be recognized as an adjustment to the lessee's right-of-use asset.

Subleases

In a sublease, an intermediate lessor enters into a leasing arrangement as both (a) a lessee, leasing an underlying asset from a head lessor, and (b) a lessor, subleasing the same underlying asset to a sublessee for the same or shorter term. An intermediate lessor, as a lessee in a head lease, would account for the assets and liabilities arising from the head lease in accordance with the lessee model proposed in the exposure draft. Similarly, the intermediate lessor, as a lessor in a sublease, would account for the assets and liabilities arising from the sublease in accordance with the lessor model proposed in the exposure draft.

Short-Term Leases

A short-term lease is defined as a lease for which the maximum possible lease term, including options to renew or extend, is 12 months or less. A lessee or lessor may apply the following simplified requirements to short-term leases:

- At the date of inception of a lease, a lessee that has a short-term lease may elect, on a lease-by-lease basis, to measure, both at initial measurement and subsequently:
  - The liability to make lease payments at the undiscounted amount of the payments
  - The right-of-use asset at the undiscounted amount of lease payments plus initial direct costs

The amortization of the undiscounted asset would mirror the lease payments as they become due as charges in the income statement:

- At the date of inception of a lease, a lessor that has a short-term lease may elect, on a lease-by-lease basis, not to recognize assets and liabilities arising from a short-term lease in the financial statement, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other FASB guidance and would recognize lease payments in the income statement over the lease term.

It is important to remember that the term of the lease is the longest possible lease term that is more likely than not to occur.

For example, if a lessee entered into a lease with an initial lease term of 12 months (or less), and included options to renew for five additional 12-month terms, the lease must be accounted for using the number of years more likely than not to occur. The FASB included the "longest possible lease term that is more likely than not to occur" in the proposed standard so that entities will not structure a one-year lease with additional one-year options to renew, when the real intent was to enter into a 15-year lease; but to ensure lease amounts reflect the true substance of the lease and the likely lease term. Entities must understand all possible lease terms and prepare an analysis to determine the longest possible lease term that has more than a 0% chance of occurring.

Contracts that Contain Both Service and Lease Components

Many contracts contain service components and lease components. Some of these contracts may be primarily service contracts with embedded lease components, whereas others may be primarily leases with attached services, such as maintenance services.

Both lessees and lessors should account separately for a distinct service component in a contract that contains both service and lease components. This approach ensures that the service element of a lease is accounted for on a basis that is consistent with the proposals in the joint FASB/IASB exposure draft, *Revenue from Contracts with Customers*.

An entity should consider all concurrently negotiated contracts with another entity when allocating lease and service components. If a lessee or a lessor using the performance obligation approach is unable to allocate the payments, the whole contract should be treated as a lease. However, it would be rare to be able to identify a distinct service component and yet not be able to allocate the payments between the components.

Transition

The exposure draft establishes the date of initial application at the beginning of the first comparative period presented in the first financial statements in which the entity applies the new guidance. **An entity should recognize and measure all outstanding contracts within the scope of this guidance as of the date of initial application using a simplified retrospective approach as described in paragraphs 90 – 96 of the exposure draft.**

An entity should adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had been applied from the beginning of the earliest period presented.

The summary of the latest major decisions reached at the March 2011 meeting is as follows:

Definition of "Lease Term"

The original exposure draft proposed defining the lease term as the longest possible lease term that is more likely than not to occur. This would require lessees and lessors to assess the likelihood of the occurrence of possible lease terms based on various factors. The Boards have now tentatively agreed to define the lease term as the non-cancelable period, plus any options where there is a significant economic incentive to extend or not terminate the lease. Examples of "economic incentives" include bargain renewal rates, penalty payments for cancellation or non-renewal, and economic penalties such as significant customization or installment costs. In many cases, this new definition would result in shorter lease terms than under the original exposure draft proposals.

Variable Lease Payments

The exposure draft would require estimating variable lease payments (for example, contingent rent, residual value guarantees, and termination penalties) using a probability-weighted expected outcome approach. Under such an approach, contingent rents, including amounts based on performance (e.g., sales made at a leased retail property) or usage (e.g., mileage use on a leased vehicle), would be estimated and included in the asset and liability on the balance sheet.

The Boards have tentatively decided that variable lease payments should include lease payments:

- That are based on an index or rate
- For which the variability lacks commercial substance
- That meet a high recognition (e.g., "reasonably certain") threshold

Variable lease payments that depend on an index or a rate would be initially measured based on the spot or prevailing rate. The high recognition threshold would result in some performance- and usage-based contingent rents being excluded from lease-related assets and liabilities.

Definition of a Lease

The exposure draft defines a lease as a contract in which the right to use a specified asset is conveyed, for a period of time, in exchange for consideration. It included two principles to help assess whether a contract contains a lease:

- The fulfillment of the contract depends on providing a specified asset or assets
- The contract conveys the right to control the use of a specified asset for an agreed period of time

It is likely the Boards will refine and clarify the definition of a lease to more clearly distinguish the difference between a lease and a service arrangement. The Boards discussed clarifying the principles related to the definition of a specified asset and the assessment of whether a contract conveys the right to control the use of a specified asset.

The Boards are also considering excluding contracts that involve the use of assets that are only incidental to the delivery of a service, and have deferred a decision on how leases of internal-use software and leases of inventory will fit into the scope of the standard.

Remaining Timeline

The FASB met in mid-October to discuss a number of the outstanding issues related to this new pronouncement. The list of issues was long. The next steps are to reissue the exposure draft during the first quarter of 2012, then issue the statement in the second half of 2012 or 2013. Because this is such a significant change, we expect the effective date to allow plenty of time to evaluate and prepare. Jeff Mechanick from FASB has estimated the updated effective date to be no earlier than 2015 and possibly later.

The redeliberations will include measurement simplification, including those related to renewal options, contingent rent, and the issue related to choosing between the performance obligation or the derecognition approach.

Observations and Recommendations

Most higher education entities have numerous leases. They include automobiles, scientific and education-related equipment, physical plant equipment, computer equipment, telephone system and related equipment, real property, and others. It is important for schools to begin identifying these existing leases and the related lease terms now. Identifying the potential impact of the new rules on debt covenants, Department of Education financial viability ratios, and bond ratings will also be important.

We recommend that you collect the following items of data. These are vital to the computations that will need to be made under the new rules:

1. Underlying leased assets, including their fair value

2. The presence of service components in leases and the identification of any that have separate pricing for the service component
3. Renewal options and residual guarantees
4. Lease terms and asset useful life data
5. Prepayment and incentive data
6. Variable payment terms (to be excluded from computations if they are in-substance fixed or based on an index or specified rate)

REVENUE RECOGNITION

The revenue recognition project is another of the so-called convergence (FASB and IFRS) projects. Like the lease exposure draft, it's also received a groundswell of commentary. This exposure draft received approximately 900 comment letters. Because of the volume and significance of the feedback, FASB and the International Accounting Standards Board announced in June 2011 that they will re-expose the proposed standard on revenue recognition. It's expected that the revised exposure will be issued in the third quarter of 2011, with a 120-day comment period. This pushes the expected timeline for issuing a final standard into 2012.

NACUBO commented that "although there is no formal due process requirement to re-expose the standard, the Boards indicated that it was appropriate "given the importance of the revenue number to all companies and the need to take all possible steps to avoid unintended consequences." In addition to questions on specific aspects of the revised proposals, the Boards intend to seek feedback on the extent to which the revised requirements are understandable, and to ensure that the requirements have not created unintended consequences for specific contracts or industries."[61]

Project Objectives

The stated objectives for this project include:

1. Remove inconsistencies and weaknesses in existing revenue recognition guidance and practices
2. Provide a more robust framework for addressing revenue recognition issues
3. Improve revenue recognition practices across entities, industries, jurisdiction, and capital markets
4. Simplify the preparation of financial statements by reducing the number of requirements to which entities must refer

The basic framework for the revenue recognition concepts are summarized by the following major components. Each of these components was discussed at length and the exposure draft addresses each in detail. As we mentioned, these concepts have been controversial. While the overall approach to revenue recognition included in the exposure draft, as noted below, has not been changed by the Boards in their redeliberations, certain aspects of each part of the approach have changed — and in some cases those changes have been significant.

The basic framework of the project concepts is as follows:

- Identifying the contract(s) with the customer;
- Identifying the separate performance obligations in the contract;
- Determining the transaction price;
- Allocating the transaction price to performance obligations; and
- Recognizing revenue when performance obligations are satisfied.

The core principle that the Boards are trying to achieve can be described as an attempt to depict the transfer of goods or services to customers in **an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.**

Fortunately, two types of normal transactions in higher education have been scoped out:

- Donations
- Collaborative agreements (which would include many grants and research contracts)

So what specific types of transactions might this impact?

Tuition and Fee Revenue

The most significant implications of the proposed standard for higher education will likely be associated with uncollectible student accounts. Under both existing U.S. GAAP and IFRS, uncertainties associated with receivables collection are viewed as "day 2" loss contingencies associated with a recognized asset (accounts receivable). Under the proposed standard, the potential that an account will not be collected is dealt with in measuring the amount of revenue and contract asset or receivables initially recorded. **Bad debt expense would no longer be recognized at the time services are rendered for those accounts not expected to be fully collected.** Instead, the type of analysis historically employed in establishing an allowance for uncollectible accounts will be used as a tool in evaluating the amount of revenue to initially recognize. **Any changes in the amount of consideration expected to be received are reflected as income or expense, rather than as an adjustment to revenue.** The proposed standard does not specify where subsequent changes should reside on the face of the income statement or whether they should be reflected separately in operations.

The proposed standard provides that the transaction price for the revenue should be adjusted for the customer's credit risk (ability to pay) by recognizing the consideration expected to be collected, based on a probability weighted basis. Because most schools have determined collectibility, there is normally an expectation for the probability of collections. There's currently a lag between the recognition of the total amount of revenue and the estimation of potential bad debts. This change would essentially eliminate what is sometimes called

[61] "FASB to Re-Expose Proposed Standard on Revenue Recognition," National Association of College and University Business Officers, accessed November 10, 2011, http://www.nacubo.org/Business_and_Policy_Areas/Accounting/Accounting_News/FASB_to_Re-expose_Proposed_Standard_on_Revenue_Recognition.html

the "back door tuition discount." It should be noted that this area of the proposed standard received significant comment.

Here's an example of how this might work:

Possible Collection Amounts	Probability	Probability Weighted Amounts
$0	1%	$0
$2,500	1%	$150
$5,000	3%	$150
$7,500	5%	$375
$10,000	10%	$1,000
$25,000	80%	$20,000
		$21,750

College X has 1 student and charges each student $25,000 tuition. They have historical information available for how much tuition would be collected from their students. Based on the historical experience with students, the following outcomes have been identified:

Given this illustration, the tuition recognized as revenue would be $21,750, not $25,000. If the collection amount was ultimately less than $21,750, a bad debt expense would be charged.

The latest revisions to the exposure draft consider a simplified approach to this accounting, to yield a most likely amount, rather than one based on a probability weighted approach. This would allow the school to estimate the most likely amount of tuition that will be collected, and use that one estimate rather than multiple estimates based on collection probability.

In the redeliberation draft, the concept was switched from "the amount that will be collected" (taking out the collection risk) to "the amount that the organization is entitled to."

Effective Date

As with the leases project, the Boards have committed to re-expose this pronouncement. This re-exposure will push back the expected issuance of a final standard until sometime in late 2012. The effective date will probably be no earlier than 2015 for public companies, and there will likely be incremental delay beyond that for non-public companies.

Observations and Recommendations

This proposal will affect higher education in two areas: the impact of the credit quality assessment on the amount of revenue to initially recognize, and the timing of revenue recognition for research contracts. If your school receives revenue from the federal government or state or local governments that have uncertainty about the amounts to be reimbursed or distributed, those amounts will also have to be evaluated.

ACCOUNTING FOR FINANCIAL INSTRUMENTS

This exposure draft seeks to provide an improved and consistent model for the recognition, measurement, and presentation of financial instruments by increasing transparency through the use of fair value. The ASU proposes that many financial instruments be valued at fair value, without eliminating amortized cost information. This ASU applies to all entities and all financial instruments and hedge transactions, with the exception of promises to give for not-for-profit organizations. Compensation and deferred compensation obligations are also scoped out, along with benefit plans, leases, consolidated subsidiaries, and a few others. As with the leases and revenue recognition proposals, this one has garnered much attention and feedback, including approximately 2,800 comment letters.

This pronouncement was expedited after the global financial crisis in 2008, as noted in the introduction in the exposure draft document:

> Before the global economic crisis, both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) had begun a joint project to revise and improve their respective standards on accounting for financial instruments. The global economic crisis further highlighted the ongoing concern that the existing accounting model for financial instruments with its inherent gaps and inconsistencies is inadequate for today's complex economic environment. In the aftermath of the global economic crisis, effective financial reporting has become the subject of worldwide attention, with a focus on the urgent need for improved accounting standards in a number of areas, including financial instruments. As a result, to support well-functioning global capital markets many investors, preparers, and even high-level governing bodies urged as a top priority the development of a single converged financial reporting model for financial instruments that provides investors with the most useful, transparent, and relevant information about an entity's exposure to financial instruments.

So what is a financial instrument? It's defined as "any contract that provides an entity with either a right to receive cash or an obligation to pay cash."

This standard update will affect several lines in a college financial statement, including:

- U.S. Government Loan fund
- Student loans receivable
- Split interest agreements
- Annuities payable
- Amounts due other remaindermen

Bonds and Notes Payable

An exception to the general rule of valuing all financial liabilities at fair value is provided for certain situations involving an entity's own debt. Under this exception, an entity can irrevocably elect at issuance to measure certain types of its own debt at amortized cost, assuming measuring the debt at fair value would create or exacerbate a "measurement attribute mismatch" between assets and liabilities. A measurement mismatch exists when the liability is linked to an asset that is measured at amortized cost (like bonds payable that were used to finance property and equipment) or the liability is owed by an entity that has less than 50% of its assets measured at fair value on a recurring basis.

Effective Date

The FASB decided that certain aspects of the proposed measurement guidance should be effective for nonpublic entities with less than $1 billion in consolidated total assets as of the beginning of their fiscal year, four years after the effective date for all other entities. This will provide time for smaller entities to transition to the comprehensive model of accounting for financial instruments. It will also allow the Board to consider findings from its post-implementation review, which is tentatively scheduled for two to three years after the initial effective date.

The Board also considered several criteria to determine which entities should have a delayed effective date. In outreach performed by the FASB staff, many constituents communicated that a delayed effective date should be based on the consolidated asset size of the entity. These constituents noted that regulatory agencies have different requirements for entities of different sizes, thus acknowledging different levels of sophistication.

The Board acknowledges both:

- The need for all entities to develop the infrastructure to effectively remeasure core deposit liabilities in accordance with the proposed guidance, and
- The need for all entities to gain experience in estimating fair value of loans and loan commitments in accordance with the exit price notion in Topic 820, before it becomes the primary measurement attribute for loans and loan commitments.

The Board believes that the costs, including resources associated with both developing the infrastructure and implementing appropriate systems related to these aspects of the measurement guidance, would be more significant for nonpublic entities subject to the deferral of the effective date.

As of the writing of this white paper, it is difficult to predict the implementation dates. As stated above, we expect smaller and nonpublic entities to get a reprieve on the timing of implementation.

DISCLOSURE FRAMEWORK PROJECT

It is clear to anyone who has either read or prepared financial statements lately that there is an enormous increase in the volume and complexity of the footnotes (disclosures) required by existing and new FASB pronouncements. The FASB project lead-in to the statement on disclosures states:

> The first objective is to establish an overarching framework to improve the effectiveness of financial statement disclosures. Effectiveness would be achieved by focusing on matters that are most important to users of each entity's financial statements and by presenting them in an order and format that promotes clear communication. The desired results are a net reduction in disclosure volume and a net increase in the utility of the information disclosed.
>
> The second objective is "to seek ways to better integrate information provided in financial statements, Management Discussion & Analysis (MD&A), and other parts of a reporting entity's financial reporting package." The intention is to promote meaningful communication and avoid repetition wherever possible. Achieving that objective will require that the Board first develop the framework envisioned in the first objective.

One experienced higher education CFO has said that the FASB needs to be told they have 35 pages to capture all the disclosures and if what they are discussing goes beyond that, they need to reduce disclosures in one area to make room for another. In essence, that is the intent of this project.

CONCLUSION

These are certainly days filled with major shifts in the economy and college and university business practices, and the accounting profession continues to implement changes at a rapid rate.

We hope that this white paper, with its summary of current key issues and events, helps your institution understand and meet the changes and challenges you face.

LEARN MORE AT OUR COMPLIMENTARY WEBCASTS

CapinCrouse regularly offers webcasts on current issues for college and universities. You can learn more and register for these information sessions at www.capincrouse.com/events/webcasts/.

As always, please do not hesitate to contact us if you have questions about any of the issues raised here or if we can assist you in any way.

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With more than 700 not-for-profit organizations and 1,500 tax clients, CapinCrouse is the country's leading accounting and advisory firm primarily serving the Christian not-for-profit community.

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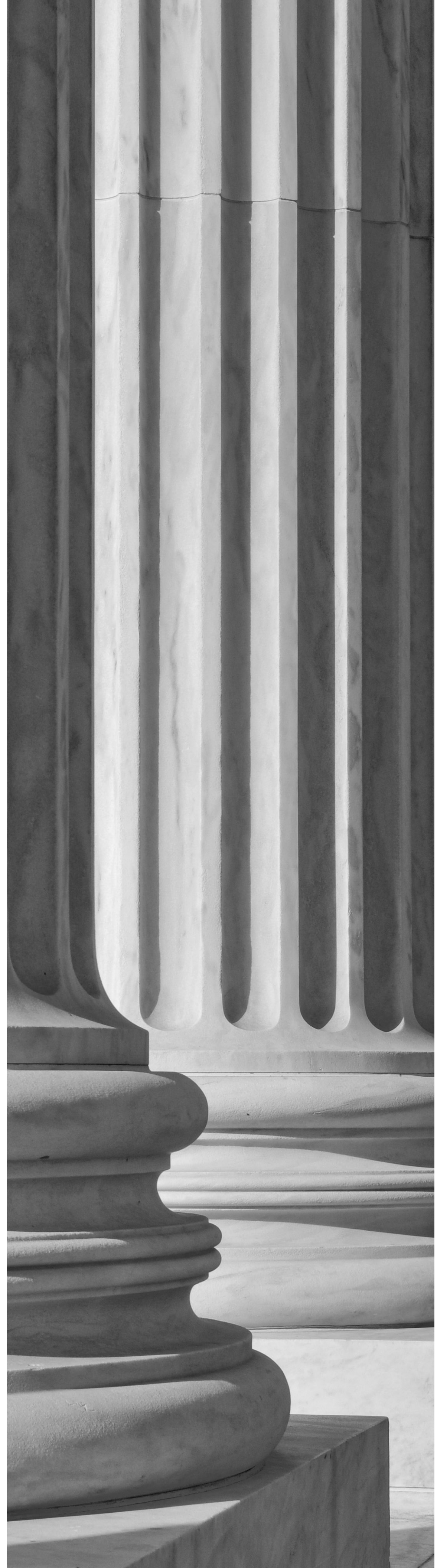

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