2013 Higher Education Update: Addendum

Trends and Accounting Changes

CapinCrouse's annual *Higher Education Update* identifies and discusses the key trends currently affecting Christian higher education. This Addendum adds the most current data available since the 2013 edition was published in late fall 2012.

ECONOMIC OUTLOOK

The key economic concern discussed in the 2013 *Update* was the impact of the so-called "fiscal cliff" discussions in our nation's capital over certain tax and spending policies. There have been significant updates on this discussion since our original publishing date.

In the first few hours of 2013, the Senate passed an amended version of H.R. 8, The American Taxpayer Relief Act of 2012, in a bipartisan vote of 89-8. Later that day, the House of Representatives approved the Senate's amended version of the H.R. 8 bill in a vote of 257-167. President Obama signed the bill into law on January 2, 2013.

The objective of this compromise was avoidance of a tax increase for the newly redefined "middle-class" and prevention — for now — of the automatic spending cuts known as sequestration. The legislation permanently extended the Bush-era tax rates for the "middle-class" while allowing increases on marginal individual income tax rates, the capital gains tax, dividend tax rates, and other Bush-era provisions for individuals earning more than $400,000 annually and joint filers earning more than $450,000. The legislation also delayed automatic spending reductions totaling approximately $110 billion for two months.

The effect of this legislation on education includes the following provisions:

- The Individual Retirement Account (IRA) charitable rollover was extended through December 31, 2013
- Coverdell Education Savings Account contribution provisions were extended
- Employer Provided Educational Assistance provisions (Section 127) were extended, providing up to $5,250 per employee for educational assistance
- The expanded student loan interest deduction (Section 221) was made permanent, allowing an "above-the-line" deduction of up to $2,500 for such interest expenses
- The American Opportunity Tax Credit (AOTC) of $2,500 was extended five years
- The "above-the-line" deduction for qualified tuition and related expenses was extended through December 31, 2013, allowing taxpayers within certain income limitations to deduct up to $4,000 of qualified expenses

While the individual tax breaks listed above should have some positive impact, we are still waiting to see what will happen to the mandatory expense reductions known as sequestration. The affected programs include the National Science Institute of Health and the National Science Foundation, both of which provide funding for higher education programs through grants. The Pell Grant program, however, has escaped the cuts and is currently protected from sequestration cuts for one more year.

Finally, the legislation extended unemployment insurance benefits and stopped a planned cut in Medicare physician payments. It did not, however, extend the 2% payroll tax holiday enjoyed from 2009 forward. As a result, payroll taxes went up at least 2% for everyone.

What is the impact of all this on the 2013 economy and beyond? In the latest predictions, the Conference Board is projecting a gross domestic product (GDP) increase of 1.3% and the Blue Chip Economic Indicators Report anticipates GDP growth ranging from 3.6% to 1.8%.[1] Meanwhile, the most recent report for the fourth quarter of 2012 showed that GDP actually declined 0.1%. So the economy is still growing, but very slowly.

One potentially promising statistic for homeowners is that the overall inventory growth of new homes is not keeping pace with the development of households, so the overall supply is shrinking. This is starting to drive prices up in a number of markets.

Impact on Recommendations

The recommendations we made in the 2013 *Update* for thoughtful action on tuition and fees, cost controls, and endowment spending rates remain unchanged. In fact, the lack of robust economic growth and the accompanying lackluster employment growth creates a continued tight environment for enrollment growth and robust endowment returns needed to fund programs. Finding revenue and controlling costs will be critical going forward as it seems more of the same anemic economic health is on the near and mid-term horizon.

On the endowment income issue, the recently released 2012 National Association of College and University Business Officers-Commonfund endowment study revealed exactly the scenario we predicted in the 2013 *Update*. The two-year run of gains stopped with 2012 and the average return actually went negative, yielding a negative 0.3%. This was a drastic drop from 2011's 19.2% return on average. The 10-year average return on all endowments fell to 6.2%. As an *Inside Higher Education* article on the release of the endowment study data noted:

> The study also questions whether, in the long run, institutions will be able to continue to spend from their endowments at the rates they traditionally have, about 4.5 percent to 5 percent of the funds' total value. To manage that and keep up with inflation, institutions need returns of about 7.4 percent annually.
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> Only the wealthiest have been able to average returns of that level over the past 10 years, with much of that coming before the recession. Over all, 10-year returns averaged 6.2 percent annually, and 5-year returns averaged only 1.1 percent. As a result of the weak growth, the proportion of endowments that colleges and universities spent in 2012 was 4.2 percent, the lowest rate of the last decade. It was as high as 5.1 percent in 2003.[2]

Finally, if you find yourself in a financial crisis and needing to deal with major cost adjustments or even program closure, we echo the thoughts expressed by Janice M. Abraham, Robb Jones, and Constance Neary from United Educators in a recent *NACUBO Business Officer* magazine article on dealing with difficult economic decisions, including program closure:

> To prevent problems associated with program closure, ensure that your administration has:
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> - Involved faculty in the review and decision to close a program.
> - Explored and documented alternatives to closing the program.
> - Provided a clear and concise description of the institution's financial condition to the proper spokesperson and outlets.
> - Consulted legal counsel with experience in reductions in force, if termination of employment is contemplated.
> - Used the program closure as an opportunity to restructure and reorganize.
> - Involved and trained administrators and staff involved in communicating messages to affected employees, students, and community.
> - Established provisions to help and support terminated employees as well as those remaining in positions at the university.
> - Included guidance in the employee handbook along with a workable definition of financial exigency, if faculty termination is being considered.
> - Stated in the student handbook that the institution reserves the right to terminate and reduce programs when deemed necessary.
> - Established a plan to "teach out" enrolled students by enabling them to complete their academic program before it closes, or assisting in their transfer to other institutions.
> - Recognized that closing a program is not inexpensive, but if done well, reputational damage can be minimized, and you can focus on the institution's ongoing mission.[3]

DEVELOPMENTS ON THE DISRUPTIVE INNOVATION FRONT

If you've had time to watch what's happening with "massively open online courses" (better known as MOOC's), you will have noticed a significant increase in discussion on this topic over the last 12 months. Between September 1, 2012 and February 1, 2013 alone there were 28 articles posted in just the *Chronicle of Higher Education*. A review of mainstream publications such as the *New York Times,* the *Wall Street Journal*, and *Forbes* magazine shows that they too are littered with articles and essays about this phenomenon.

If you've missed the hype so far, you may want to watch the "Epic 2020" video available at http://epic2020.org/. Writing about this video in the College Education Blog, Martin Van Der Werf says:

> Will higher education collapse in [the manner shown in the video]? No, this is far too simplistic. But are there grains of truth and seeds of nightmares in this? I would argue Yes. This video should inspire a mixture of guffaws, inspiration, and feelings of dread in just about anyone who watches it. So, if nothing else, [Epic video creator] Sams has succeeded in starting a dialog that any college thinking seriously about its future needs to have.[4]

We agree. The Epic video is a really a conversation starter at best, but it does contain some salient predictions based in current facts.

The following summary from the *Chronicle of Higher Education* provides a good introduction to MOOC's:

> **What are MOOC's?**
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> MOOC's are classes that are taught online to large numbers of students, with minimal involvement by professors. Typically, students watch short video lectures and complete assignments that are graded either by machines or by other students. That way a lone professor can support a class with hundreds of thousands of participants.
>
> **Why all the hype?**
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> Advocates of MOOC's have big ambitions, and that makes some college leaders nervous. They're especially worried about having to compete with free courses from some of the world's most exclusive universities. Of course,

we still don't know how much the courses will change the education landscape, and there are plenty of skeptics.

These are like OpenCourseWare projects, right?

Sort of. More than a decade ago, the Massachusetts Institute of Technology started a much-touted project called OpenCourseWare, to make all of its course materials available free online. But most of those are text-only: lecture notes and the like. Several colleges now offer a few free courses in this way, but they typically haven't offered assignments or any way for people who follow along to prove that they've mastered the concepts. MOOC's attempt to add those elements.

So if you take tests, do you get credit?

So far there aren't any colleges that offer credit for their MOOC's. But some MOOC participants can buy or receive certificates confirming their understanding of the material.

Who are the major players?

Several start-up companies are working with universities and professors to offer MOOC's. Meanwhile, some colleges are starting their own efforts, and some individual professors are offering their courses to the world. Right now four names are the ones to know:

edX
A nonprofit effort run jointly by MIT, Harvard, and Berkeley.

Leaders of the group say they intend to slowly add other university partners over time. edX plans to freely give away the software platform it is building to offer the free courses, so that anyone can use it to run MOOC's.

Coursera
A for-profit company founded by two computer-science professors from Stanford.

The company's model is to sign contracts with colleges that agree to use the platform to offer free courses and to get a percentage of any revenue. More than a dozen high-profile institutions, including Princeton and the U. of Virginia, have joined.

Udacity
Another for-profit company founded by a Stanford computer-science professor.

The company, which works with individual professors rather than institutions, has attracted a range of well-known scholars. Unlike other providers of MOOC's, it has said it will focus all of its courses on computer science and related fields.

Khan Academy
A non-profit organization founded by MIT and Harvard graduate Salman Khan.

Khan Academy began in 2006 as an online library of short instructional videos that Mr. Khan made for his cousins. The library—which has received financial backing from the Bill and Melinda Gates Foundation and Google, as well as from individuals—now hosts more than 3,000 videos on YouTube. Khan Academy does not provide content from universities, but it does offer automated practice exercises, and it recently debuted a curriculum of computer science courses. Much of the content is geared toward secondary-education students.

Udemy
A for-profit platform that lets anyone set up a course.

The company encourages its instructors to charge a small fee, with the revenue split between instructor and company. Authors themselves, more than a few of them with no academic affiliation, teach many of the courses.[5]

With that background, consider some of the *Chronicle of Higher Education* headlines posted recently:[6]

American Council on Education Will Review Some MOOC's for College Credit
November 13, 2012

In a pilot project, the council will consider five to 10 Coursera offerings and certify them if it finds them equivalent to courses taught by an accredited college.

Facing Backlash, Minnesota Decides to Allow Free Online Courses After All
October 20, 2012

Princeton and Stanford can rest easy now that Minnesota higher-education officials have backed away from threats to track down dozens of universities like them for offering free online courses in their state without permission.

San Jose State U. Says Replacing Live Lectures With edX Videos Increased Test Scores
October 17, 2012

In an effort to raise student performance in a difficult course, San Jose State University has turned to a "flipped classroom" format, requiring students to watch lecture videos produced by MIT.

U. of Texas System Is Latest to Sign Up With edX for Online Courses
October 15, 2012

The University of Texas system will join Harvard, MIT, and Berkeley to offer massive open online courses through edX, university officials announced.

Coursera Announces Big Expansion, Adding 17 Universities
September 19, 2012

Coursera announced 17 new college partners, nearly doubling the number that have agreed to use the company's platform to offer MOOC's.

Google Releases Open-Source Online-Education Software
September 13, 2012

Google has taken what its officials call an "experimental first step" into online education, releasing open-source software called Course Builder in hopes that universities will use it to deliver free online courses.

MOOC's Could Hurt Smaller and For-Profit Colleges, Moody's Report Says
September 12, 2012

MOOC's could improve the financial prospects of leading universities while posing financial challenges to lesser-known institutions and for-profit colleges, Moody's Investors Service predicts.

Gates Foundation Offers Grants for MOOC's in Introductory Classes
September 11, 2102

The Bill and Melinda Gates Foundation is circulating to colleges and universities a request for proposals for MOOC's that focus on gateway courses.

A First for Udacity: a U.S. University Will Accept Transfer Credit for One of Its Courses
September 6, 2012

Colorado State University's online Global Campus decided to accept transfer credits for the computer-science course after a faculty panel reviewed it.

And those are just a few of the headlines. Still, there are plenty of skeptics and those who are moving cautiously and in synch with their institution's values and mission to provide a personal, "incarnational" teaching experience. Those who are being cautious have active discussions underway at top administrative and board levels.

We continue to recommend that you actively monitor the changes in the revolutionary times we are currently in, and include your top administrators and board in these discussions. By all means, stay true to your values and mission, but recognize the world is a different place now and will continue to change at a rapid pace. Schools that ignore these massive changes may find that in 10 years they are completely obsolete or even out of business.

REGULATION

Another key trend facing higher education is the rapid increase in regulation. The most pressing area to update you on is the changes occurring in health care. These are the areas currently getting the most rulemaking attention:

- Additional Medicare Tax
- Fees on Health Insurance Policies and Self-Insured Plans for the Patient-Centered Outcomes Research Trust Fund
- Shared Responsibility for Employers Regarding Health Coverage
    - An applicable large employer that fails to offer minimum essential coverage that is affordable and of a minimum value is subject to an assessable payment
- Standards Related to Essential Health Benefits, Actuarial Value and Accreditation
    - Cost-sharing rules set annual maximum limits for a participant's deductible and out-of-pocket expenses. Once the limits are reached, the plan is responsible for additional, eligible expenses for the remainder of the plan year.
- HHS Notice of Benefit and Payment Parameters for 2014
    - The proposed Transitional Reinsurance Program requires health plans to pay a fee to help fund initial operating years of the Exchanges
- Incentives for Nondiscriminatory Wellness Programs in Group Health Plans

As you can tell from the titles of the proposed rules above, not only are there new taxes on employees, but the additional fees being imposed on health plans will obviously be passed through to participants as well. Health care is going to get very expensive for many employers. The information about this is courtesy of Guidestone and additional details are accessible at www.guidestone.org.

GOVERNANCE

The Association of Governing Boards (AGB) released its first-ever Survey of Higher Education Governance late in the fall of 2012. It is subtitled, "Who's Minding the Gap Between Higher Education and the Public?" A major finding in this study was that there was a large gap between governing board members' view of their college and the public view when it comes to various issues. The AGB suggested that board members need to narrow that gap by:

1. Taking the public views seriously — really listen
2. Asking hard questions about cost, quality, and value
3. Being sure of the data that supports the answers to 1 and 2 above
4. Acting on what you learn
5. Learning to explain higher education costs, pricing, and value issues clearly[7]

This will likely mean some discussions at the board level that have not taken place previously. Most board members surveyed felt as if most of the problems related to cost and value in higher education in general were very real... but just not so real at their institution. Instead, they said their institutions are doing all they can to manage costs and produce value.

CONTRIBUTIONS

The contribution deduction took only a glancing blow during the fiscal cliff discussions. A little-known provision floated during the Clinton Administration was adopted as part of the fiscal cliff deal. This provision, known as the Pease Amendment (after Ohio congressman Donald Pease), reduces the amount of an individual taxpayer's itemized deductions by 3% of the difference between a taxpayer's income and the threshold numbers in the bill ($250,000 for single taxpayers and $300,000 for joint filers). So a couple earning $400,000 would reduce their itemized deductions by $3,000 ($400,000 income, less the $300,000 threshold times the 3%). When this reduction in itemized deductions is taxed at the new tax rates, the impact is truly minimal. In addition, those with higher earnings now get more value for the deductions to charity they do get as the tax rates are higher, so in most cases it is probably not enough to alter the contribution decision-making process.

A broader look at recent research on contributions in higher education reveals the following trends:

- There was a 4.8% increase in charitable contributions in 2011 (source: Council for Aid to Education)
- There was a 5.2% increase in inflation-adjusted charitable contributions to educational institutions between 2009 and 2011 (Center on Philanthropy at Indiana University)
- Giving by bequest in 2011 was up 8.8% over 2010 (Center on Philanthropy at Indiana University)
- Individual endowed gifts and bequests (excluding annual fund contributions) totaled $5.49 billion, down 30% from $7.9 billion in 2008
- Participation rates by alumni in contributions slowed 28% over the last decade (Council for Aid to Education)

These and other data lead us to encourage our clients to be diligent and creative in this important aspect of the revenue-generation process. This data led the authors of *NACUBO Business Officer* magazine to recently make the following recommendations:[8]

1. **Make fundraising a priority** – Do not let this area rest on past laurels
2. **Prepare for stiffer competition** – Because of the rapid growth in charitable organizations, it is harder to get your message through the fundraising noise in the marketplace
3. **Cast a wider net** – See the role of contribution decisions made by women[9]
4. **Forget "one size fits all"** – Today's donors are very different from the Baby Boomer and "Greatest Generation" donors[10]

AUDITING ISSUES

While the following issues will not directly impact the daily work of the college administrator, these changes will affect the way auditors interact with the school and may impact the fees paid for audit firm services.

First, the good news. The Office of Management and Budget recently released its latest review of audit standards in its "Cost Principles, Audit and Administrative Requirements for Federal Awards" report.[11] Generally speaking, this document will reduce the testing done for some federal aid programs and simplify the guidance. Some smaller colleges and seminaries may find that they no longer need to engage an audit firm to do the A-133 audit for federal financial aid, as the threshold for an audit rose in this proposal from $500,000 in expenditures to $750,000. Early drafts suggested an even higher threshold. The proposal may also reduce the number of findings that are required to be reported by raising the threshold for reporting findings from $10,000 to $25,000. It also reduces the compliance requirements that will require testing from 14 to 6, although agencies may be allowed to request that certain of the deleted compliance procedures be added as Special Tests and Provisions when they consider the requirement essential to the program.

The bad news is the new so-called "clarity standards" that auditors will be required to follow for all audits ending after December 15, 2012. These standards were supposed to clarify and simplify the format of audit standards. In certain cases, however, they went beyond clarification to setting new standards. These new standards will change the following aspects of the audit engagement and in some cases may increase work and perhaps fees, depending on the audit firm's historical interpretation and methodology:

1. Engagement letter changes
2. Level of procedures to support the review of compliance with laws and regulations
3. Communication of "Other Deficiencies" in addition to significant deficiencies and material weaknesses
4. Review of service auditor work
5. Increased work to review prior auditor work
6. Increased work for audits of groups where the primary auditor does not audit the entire group
7. Audit Report language changes
8. Evaluation of reclassification entries to determine if they are adjustments to correct material misstatements

ACCOUNTING STANDARDS UPDATE

In another recent update, on February 7, 2013 the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2013-03, *Financial Instruments (Topic*

825): *Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities.*

The FASB states:

> This Accounting Standards Update (ASU) clarifies the scope and applicability of a disclosure exemption that is specific to private companies and not-for-profit organizations that resulted from the issuance of Accounting Standards 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.*
>
> The Update clarifies that the requirement to disclose "the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)" does not apply to private companies and nonpublic not-for-profit organizations for items that are not measured at fair value in the statement of financial position, but for which fair value is disclosed. The amendments will be effective upon issuance.[12]

CONCLUSION

We hope you found the 2013 *Higher Education Update* and this Addendum helpful. Please continue to watch our website at www.capincrouse.com for updated tax and accounting pronouncement news.

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NOTES

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