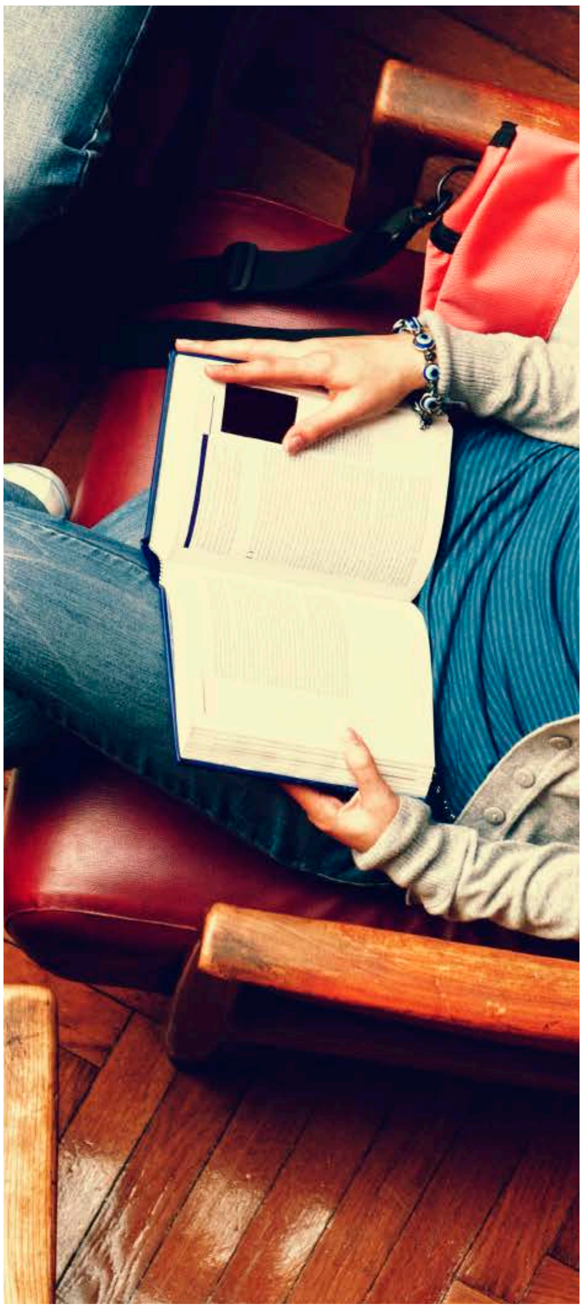
2013 Higher Education Update

Trends and Accounting Changes

January 2013



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TRENDS AND ACCOUNTING CHANGES

EXECUTIVE SUMMARY

CapinCrouse's annual *Higher Education Update* identifies and discuses the key trends currently affecting Christian higher education. The 2013 edition starts with an examination of the issue that remains at the top of everyone's mind: the impact of the current economy. The key economic concern this year is the impending "fiscal cliff," shorthand for a "perfect storm" of issues that could create anything from a minor economic impact to the rebirth of recession. We provide recommendations for dealing with this uncertain economic future, including insight on:

- Tuition increases
- Cost controls
- Endowment spending

The *Update* then turns to the key business trends in higher education today. We review five areas:

- The need for revenue optimization
- The impact of what is becoming commonly known as "disruptive innovation"
- The effect of increased regulation
- Institutions' governance and leadership needs
- Trends in charitable contributions

It will be very difficult for many campuses to gain financial strength through further cuts in expenses. While we do review the need for cost control, the real future advantage will be gained through creative revenue enhancements. This will require campus leaders to be creative, aware of opportunities, and willing to act with expediency. This section also notes that health care reform and municipal securities regulation (for those with bond financing) will be important regulation changes to monitor.

The final section covers accounting changes and reviews the "big three" convergence exposure drafts, the latest Accounting Standard Updates, Not-for-Profit Advisory Committee activities, and a few miscellaneous proposals. This includes proposals on accounting for donated securities (where the sale of such goes in the statement of cash flows) and donated services between affiliated organizations.

We are 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 implementation of your institution's strategic plans.

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ECONOMIC OUTLOOK

Economic uncertainty, related to lingering effects of the 2008 recession, may impede strategic thinking, planning, and budgeting by emphasizing short-term actions to strengthen finances. – Kent John Chabotar, July 2012[1]

Will we run the economy and our colleges' fortunes over the fiscal cliff? Will our elected officials be able to break the deadlock and partisanship in Washington and craft a reasonable and responsible plan to keep us from economic freefall?

College business officers and top management are asking these and related questions. This is one of the major issues facing our economy, and its impact could be significant.

"Fiscal cliff" is shorthand for the "perfect storm" of issues that may create anything from a minor economic impact to the rebirth of recession. This perfect storm includes:

1. The end of the 2% payroll tax cut for workers
2. The beginning of the large tax increases needed to fund the Obama health care plan
3. The automatic spending cuts agreed to as part of the 2011 debt ceiling deal
4. The sunset of Bush-era tax cuts that began in the period from 2001 to 2003

Where will this take us? There are a few observers willing to forecast the possible impact. Financial writer Thomas Kenny notes that "the most likely result is another set of stop-gap measures that would delay a more permanent policy change until 2013 or later." Kenny adds, "While the combination of higher taxes and spending cuts would reduce the deficit by an estimated $560 billion, the CBO [Congressional Budget Office] estimates that the policies set to go into effect would cut gross domestic product (GDP) by *four* percentage points in 2013, sending the economy into a recession (i.e., negative growth)."[2]

Chief economists at many major financial institutions are anticipating a reduction in growth, as seen in this brief review of the positions held by several key economists:

J.P. Morgan – Michael Feroli

Figure 1 (below) shows that J.P. Morgan is looking for a best case of 0.5% reduction in GDP growth in the first quarter of 2013, followed by a 0.3% reduction in the second quarter from the effects of the fiscal cliff.[3] The worst case, of course, is a 3.5% reduction in GDP, or a rebirth of recession that could last into the second half of 2013.

Morgan Stanley – Vincent Reinhart

In reporting on Reinhart's perspective, *The New York Times* writes: "All told, the political gridlock in the United States, along with the continuing debt crisis in Europe, will shave about half a percentage point off growth in the second half of the year, estimates Vincent Reinhart, chief United States economist at Morgan Stanley."[4]

Survey of Blue Chip Economists

Blue Chip Economic Indicators, a monthly survey of top U.S. business economists, recently found that analysts believe "the threat of higher taxes and sharp spending cuts in 2013 is likely to depress U.S. growth over the rest of the year," according to *The Wall Street Journal* MarketWatch. "Nearly nine in 10 economists questioned expect worries about a so-called fiscal cliff to cause businesses to reduce investment in the remaining months of 2012," the article notes, adding that "hiring is also likely to remain lackluster, keeping the nation's unemployment rate above 8%."[5]

FIGURE 1

Outcome		1Q13E	2Q13E	3Q13E	4Q13E	FY13E
Base Case:		1.5%	2.3%	2.5%	3.0%	2.0%
Scenario 1:	**(A to C) assumes that Congress and the White House agree to the following...** Maintain: (i) Sunsetting of lower and middle income Bush tax cuts (ii) Sunsetting of upper income Bush tax cuts (iii) Expiration of pay roll tax holiday (iv) Expiration of emergency unemployment benefits But this lapses... (v) Sequester	1.0%	2.0%	2.5%	3.0%	1.8%
	Δ vs. Base Case (bps)	-50	-30	0	0	-20
Scenario 2:	**The fiscal cliff (falling off)...** Assumes all measures lapse for 6 months in 2013... (i) Sunsetting of lower and middle income Bush tax cuts (ii) Sunsetting of upper income Bush tax cuts (iii) Expiration of pay roll tax holiday (iv) Expiration of emergency unemployment benefits (v) Sequester	-2.0%	-1.5%	1.0%	2.5%	0.2%
	Δ vs. Base Case (bps)	-350	-380	-150	-50	-180

Source: J.P. Morgan, Michael Feroli

Indeed, logic would tell us that this cake is already baked. Most businesses had to finalize their 2013 plans in an era of uncertainty — and most smart business people refrain from holding an overly optimistic outlook when so much is unknown about the political environment, taxes, and the economy in general. As a result, we won't see aggressive moves to hire or expand, because the incentives just aren't there. It also means a tentative posture on capital expenditures, which further hinders job creation and the economy.

In prior economic updates we have spent time discussing inflation projections, housing, and unemployment. Because of the significant impact of the "fiscal cliff" and the unknown political environment, any other projections seem like pure conjecture.

We hesitate to speculate on whether we will have a healthy or sick economy moving forward. We are watching the major bond-rating agency outlook statements, however, and they are generally negative as it relates to all colleges except the strongest diversified, market-leading institutions. Moody's in particular cites the negative outlook as a result of the following:[6]

1. **Lower demand as a result of a flight to quality and/or affordability** – In "Industry Outlook: U.S. Higher Education Outlook Mixed in 2012," Moody's notes that "median freshman yield rates (percentage of accepted freshmen who chose to enroll) at both private and public universities have steadily declined over the past five years, highlighting increased competition." The report goes on to state that "the trend of declining yield is particularly notable for the lower rated private colleges which are increasingly competing with lower-cost public colleges and feeling the most pressure to slow tuition and offer more tuition discounting."[7]

2. **Rattled consumer confidence and an "intense spotlight" on college affordability** – The Moody's report cites "persistently high unemployment" (still above 8%) and "still depressed home equity" as issues that have shaken the confidence of students and families. The Outlook also discusses the rise in student loan default rates and notes that excessively high rates could not only impact reputation risk, but could also jeopardize participation in federal financial aid programs.[8] Most of the intense scrutiny on the loan default rate is aimed at the for-profit trade school sector, but that does not mean private Christian colleges are immune to scrutiny.

3. **Pressure on non-tuition revenue sources such as state appropriations, fundraising, and investment that drives endowment income** – Some states are still reporting falling tax receipts and as a result, some are still making cuts to higher education funding. Notably, nine states made fiscal 2012 mid-year program cuts in higher education.[9]

4. **Liquidity and debt structure risk** – In our practice we have seen numerous debt restructurings over the last year. These sometimes incur high interest rate swap termination fees, however, and some institutions are reluctant to not only pay those out now, but also forgo the positive swing in the valuation should interest rates begin to rise. Moody's reports that universities have taken several measures to improve liquidity, including:

   - Adding to operating lines of credit
   - Selling illiquid private equity commitments on the secondary market
   - Reducing unfunded capital commitments[10]

Given all of these economic factors and uncertainties, we recommend that your institution consider the following:

1. **Tuition and fees** – Many families are feeling the economic squeeze in a very real way. Last year we reported that the "level of uncertainty in the economy and the resulting uncertainty about the job market

puts students in an uncomfortable place as they look at making a commitment for four or more years of college education."[11] Our recommendation? Do all you can to hold down costs and thus tuition and fee increases, thereby easing the pain of families paying for college education. New articles about the student debt problem are written every week. There are increasing reports of students with excessive debt who give up and never even complete their programs, along with the usual reports of debt-strapped students struggling to pay their loans while holding very important, but low-paying, jobs like social workers, missionaries, and teachers.

Consider this headline on a press release from ApplyWise.com, a website for families preparing to apply to college:

> **Survey Finds 56% of Families with College-Bound Teens In Worse Financial Condition than Two Years Ago**
>
> *Parents Polled by NextStepU and ApplyWise.com Say Higher Education is a Priority, but 22% of Respondents Have Not Saved Money Toward Child's College Tuition*[12]

The release notes that "the majority of families polled are going to struggle harder than ever to pay for their child's college education." Comparing 2010 survey results with 2008 data, the company said that "results indicate that when selecting schools, parents say they are now less influenced by a college's reputation and the look and feel of the campus, and more likely to select a school based on the availability of financial aid."[13]

Unleashing an army of well-trained, articulate young people ready to take the Gospel to the ends of the earth is one of the key objectives of Christian higher education. But unleashing people in bondage to personal debt may only result in muted efforts.

2. **Cost control** – We recommend that you study the literature on cost control and actively implement relevant cost-saving strategies. An uncertain economy creates the need to be as lean as possible to generate margin. Sources for ideas on cost control include:

    - "2010 Private Colleges and Universities Financial Conditions Survey," Association of Governing Boards of Colleges and Universities (AGB), www.agb.org
    - "25 Ways to Reduce the Cost of College," The Center for College Affordability & Productivity, www.centerforcollegeaffordability.org
    - "The financially sustainable university," Bain & Company, www.bain.com
    - Business Officer Recession Series, National Association of College and University Business Officers (NACUBO), www.nacubo.org/Business_Officer_Magazine/Current_Issue/Recession_Series.html

3. **Endowment and other investment returns and spending** – Make sure your investment committees are being served well by investment counsel. Your investment committee should have good benchmark data from relevant studies, such as the annual NACUBO-Commonfund Study of Endowments, to evaluate manager returns. We continue to recommend spending rate evaluation. As noted in the 2011 NACUBO-Commonfund Study of Endowments, the trailing 12-quarter average return for all endowments (including the very large ones) was only 3.1%.[14] A spending rate of even 4% will eventually deplete endowment principal in this environment. While it will be several months before the 2012 endowment study is available, our informal read of our current client base of over 60 colleges tells us that the two-year run of good gains in 2010 and 2011 stopped with fiscal 2012.

BUSINESS TRENDS AND ISSUES

This year's edition of the *Higher Education Update* focuses on three key issues:

- Revenue optimization
- Disruptive innovation
- Regulation

We also provide an update on some of the issues and trends mentioned in last year's edition, including:

- Governance and leadership
- Charitable contribution revenue stream

We'll start by taking a look at revenue optimization, which is critical for today's higher education institutions.

REVENUE OPTIMIZATION

You can't cut yourself to prosperity. Sustainable growth comes from sustained growth on the top line and consistent management of the variable cost of that top line, and then making sure you get margin by growing. – Michael Burke, CFO, New York University Langhorne Medical Center, 2010[15]

Net tuition is dropping or flat in too many private Christian colleges. It is troubling to read some of the reactions college presidents and CFOs had when asked about current trends in the broader higher education industry. The trade publication *Inside Higher Ed* conducts a survey of college chief business officers and presidents each year. In this year's Chief Business Officer report, almost half (49.4%) of private higher education CFOs assessed the business model for less selective and less differentiated schools — everyone except the top-ranked schools nationally, like Harvard and Yale — as "unsustainable and must change."

In the report, 67.4% of business officers surveyed ranked the rising discount rate as the most important issue facing private colleges. Nearly the same number, 67.2%, said the second-most important issue is the limitations the market is placing on the ability to raise tuition and fees.[16]

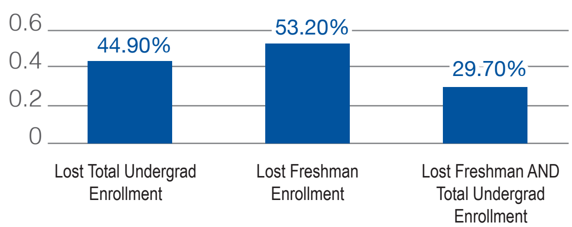
Indeed, the latest NACUBO Discounting Study reports that while discounting strategies have been used to increase enrollment, the data suggests that "*this strategy is no longer working effectively at a large number of colleges and universities*." The discount rate had been somewhat stable since 2001, but since 2007 it has been rising each year. It reached 42% in 2010 for first-time freshmen, and was estimated to have risen to 42.8% in 2011.[17]

The NACUBO Discounting Study also reports that "*Despite the recent increases in discount rates, a large proportion of independent institutions appear to be having trouble enrolling new and continuing students*." Among the institutions participating in the study, 53.2% suffered a loss or had no increase in the number of first-time, full-time freshmen students. Nearly one-third saw declines in both first-time freshmen and total enrollment.[18] This clearly is not a good omen for schools that are so heavily dependent on tuition and fee revenue for survival.

FIGURE 2

NACUBO Discounting Study

Percentage of Participating Institutions that Lost or Maintained Enrollment from Fall 2010 to Fall 2011



This downward enrollment trend is a recent development. Roger L. Geiger and Donald E. Heller, both senior scientists at The Pennsylvania State University Center for the Study of Higher Education, report that enrollment at all schools rose 25% from 2000 to 2008 (the most recent year for which data was then available).[19] "The nation has also increased the participation rate in higher education," Geiger and Heller write. "In 1970, 33 percent of all 18 to 24 year-olds who had graduated from High School were enrolled in postsecondary education. By 2008, this rate had increased by 47 percent (National Center for Education Statistics, 2010a table 204)."[20]

So what happened in that last couple of years that caused us to end up with a reported enrollment drop? We believe four factors are in play:

1. **Gains by the for-profit sector** – This sector of higher education grew from virtually nothing in 1975 to 8% of the total sector by 2008,[21] and is likely a bigger piece of the piece of the pie now.

2. **Gains by aggressive private colleges that have proactively established online and adult study programs in various locations around the country** – We are aware of at least one college that dropped a degree program after their on-campus enrollment declined significantly. This occurred after another private college in a different state opened an extension and offered online courses that were designed, priced, and marketed well. The first school could no longer compete on either quality or price. While this is anecdotal, it does reflect real issues being experienced in the face of stiff competition.

3. **Stagnant economy and rising costs** – As noted in the table below, the percentage of median income used to pay for college mushroomed from 18% in 1980 to a whopping 44% in 2009.[22] It might be higher today, with real wages stagnant or falling due to a poor economy and the continuing rise in college costs.

FIGURE 3

Tuition Prices as a Proportion of Median Income by Sector, 1980 and 2009

	1980 (in 2009 $)		2009	
Sector	**Tuition**	**% of Median Income**	**Tuition**	**% of Median Income**
Private non-profit 4-year	$9,419	18%	$26,273	44%
Public 4-year	$2,094	4%	$7,020	12%
Community college	$1,018	2%	$2,544	4%
For-profit	NA	NA	$14,174	24%

4. **Economic uncertainties leading shifts to other forms of education** – A key result of these uncertainties is that fundamental shifts in the decision-making process are underway. Private colleges may have to understand that the pool of potential "traditional" students has suddenly become much smaller and the competitive landscape more challenging.

   A detailed study commissioned by the Lumina Foundation, "Fifty Years of College Choice: Social, Political and Institutional Influences on the Decision-Making Process," states that "In the coming years, we may see two distinct faces of the college-choice process: While we may laud the social progress made in the past 60 or 70 years because of the increased number of women, low-income students and students of color now enrolled, a closer examination of students' destinations will reveal one set of choices for low and moderate-income students and a distinctly different set of destinations for middle and upper income students."[23]

   For the vast majority of middle- to lower-income students, these new choices may include online degree programs, online non-degree (competency-based) programs that are more vocational in nature, community colleges, public colleges, or possibly no college at all due to the high costs.

So What Does All of This Mean for Revenue Optimization?

Revenue optimization is critical to long-term success. Constantly cutting costs to match ever-decreasing revenue streams is nothing more than a slow liquidation. Indeed, revenue optimization is the "tool of choice" for today's business officers, according to the 2012 *Inside Higher Ed* survey. Over 70% of those surveyed believed it is very important to increase revenue over the next two or three years.[24] Eventually, cost reductions reach a "tipping point" and the institution is viewed by too many to be the short, skinny kid that no one wants as part of their team.

Measure and Maximize Recruiting and Retention

We cannot over-emphasize the importance of maximizing the effectiveness of the resources you spend to attract the type of student who will attend your school. No one these days can afford to just throw money at recruiting and retention solutions. It is important to question the effectiveness of the discounting process and insure marketing and admissions efforts are productive by maintaining clear analytics on expenditure and results.

Most colleges do not have enough funds available to spend money on students who have little chance of completing a program at the institution. Just under half (47.3%) of the business officers participating in the *Inside Higher Ed* survey agreed that reducing the discount rate was either important or very important (a 6 or 7 on a 7-point scale where 7 is most important).[25]

Alternative Educational Programs

Because the notion of online education and non-degree programs is gaining favor — at least with consumers, if not the academy itself — it may be time to investigate how this fits into the overall mission of your institution. It's also key to ask whether the mission of education really limits your efforts to degree-granting only. Or is your focus actually on the whole person and the effectiveness of that whole person operating in their sphere of influence?

Alternative Potential Student Populations

It's important to think broadly about your potential customer base. Many seminaries today are rethinking this issue carefully, and those that are not, should be. Enrollment growth opportunities for seminaries, for example, are coming from a broader view of who will benefit from the graduate programs, and some are finding growth opportunities among non-white constituencies.

Craig Engel, Senior Vice President at Noel-Levitz, a higher education enrollment consulting group, offers the following advice on enrollment challenges and focusing your efforts on middle as well as top-tier students:

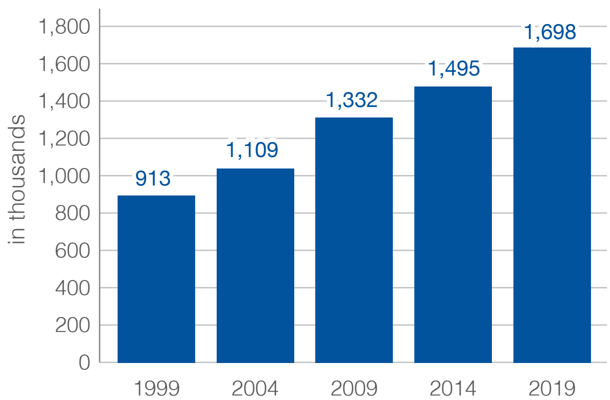
> The institution should conduct research to determine the impact of raising standards on their previous class or two (how many students that were admitted and/or enrolled would consequently not be admitted/enrolled by raising the standard). In addition, research should be conducted to determine how retention will be impacted (typically increased) with a change in standards. Other data I would review would be the ACT EIS (Enrollment Information Services) or The College Board EPS (Enrollment Planning Service) to see what their current market share is for students who are in the new ACT range, and how that will need to change in order to grow new student enrollment.
>
> Once these first two steps are completed, strategies must be designed and implemented to increase the funnel with additional inquires, applicants, and admits. Strategies that can help include:
>
> - Segmenting search to target upper profile students with different messages
> - Increasing scholarship levels (while still maintaining net revenue needs)
> - Targeting out-of-state students or students outside of traditional markets
> - Targeting high school honors programs
> - Holding a scholarship recognition day
> - Placing more emphasis on academics and faculty in recruitment communications and on the Web site
> - Stressing off-campus opportunities such as internships and study abroad
> - Promoting graduate school placements and outcomes
> - Developing high profile academic majors, pre-professional programs, or new majors and programs to support enrollment growth
>
> Keep in mind that implementing these approaches can also raise additional challenges and concerns:
>
> - Increasing the admissions criteria will likely change your competition.
> - Increasing your admissions criteria will likely result in lower yields.
> - These changes could affect referrals from high school counselors, as students they have referred to your institution in the past may now not be admissible. This could affect alumni referrals as well, and both instances highlight the importance of communicating changes in admission criteria to key groups who provide referrals.
>
> If you focus on raising the academic profile by focusing on the middle two quartiles, this will eliminate students from the bottom quartile. Also, this could affect certain student populations (legacy and full-pay, to cite two examples).[26]

As it relates to alternative student populations, consider the following data on Asian students provided on the Noel-Levitz blog by Beth Richter, Associate Vice President for Retention Solutions:

> In the coming years, Asian American students and Pacific Islanders are projected to be one of the fastest-growing student segments enrolling in higher education (along with Latinos). According to the latest CARE (Commission on Asian American and Pacific Islander Research in Education) report, college enrollment of AAPI's (Asian Americans and Pacific Islanders) will increase nearly 30 percent between 2009 and 2019:[27]

FIGURE 4

College enrollment of Asian Americans and Pacific Islanders, 1999–2019 (actual and projected)



Note: Actual data, 1999-2009; projected data, 2014 and 2019.
Source: U.S. Department of Education, Common Core Data;
U.S. Department of Education, IPEDS

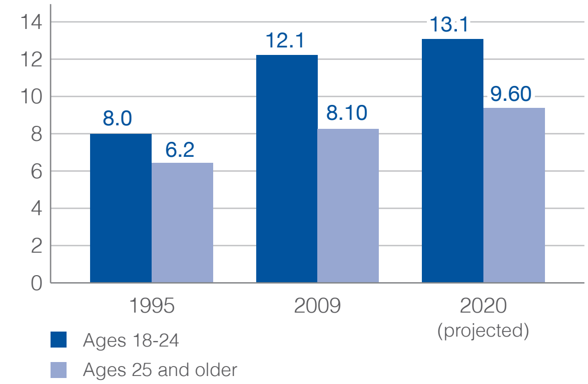
This blog post cautions that "students [in this population] carry many risk factors that are correlated with lower persistence and completion, including part-time enrollment, delayed enrollment (average age is 27.3 years), and working full-time while enrolled. Southeast Asians and Pacific Islanders in particular have very high rates of attrition."[28]

Further, over a third (35.6%) of business officers at private baccalaureate colleges who participated in the *Inside Higher Ed* survey thought recruiting more international students was an important or very important strategy to maximize.[29]

When it comes to adult learners, a study by the Department of Education provided the following information:[30]

FIGURE 5

College enrollment by age (in millions of students)



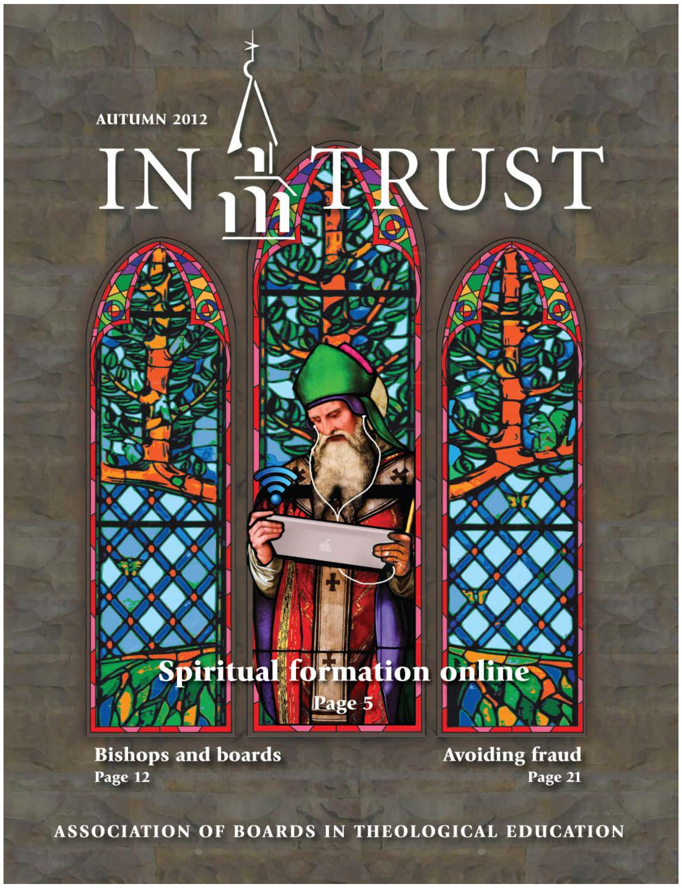
Another Noel-Levitz blog post cites two factors driving this trend:

> First, after a dramatic 32 percent increase in high school graduates between 1996 and 2008, high school graduates are expected to decline nationally by 3 percent between 2008 and 2021.
>
> Second, while enrollment among traditional-aged students is expected to increase by 9 percent between 2009 and 2020, enrollment among students 25-34 may see a 21 percent increase and students 35 and older a 16 percent increase.[31]

Recommendations:

1. Make well-researched and well-informed decisions on tuition discounts to enable net tuition growth. Consider using specialist firms that consult on revenue management, such as Scannel and Kurz or Noel-Levitz.
2. Recognize that we are in a transformation of higher education as we know it. Prepare to make strategic decisions that align with your mission.
3. Vet opportunities carefully, but act quickly as you identify them.

DISRUPTIVE INNOVATION



Autumn 2012 issue of InTrust Magazine, with illustration by Geoffrey Isley

Much ink has been spilled and lengthy discussion has taken place over the subject of "disruptive innovation" in higher education. Disruptive innovation is innovation that improves a product or service in ways that the market does not expect, typically by lowering the price or designing for a different set of consumers. These innovations and the resulting technologies are normally cheaper, simpler, and smaller, and frequently more convenient to use.[32]

Many today think the onset of both for-profit education and online education — and their various combinations and related technologies — is setting the stage for a broadly distributed disruptive innovation experience for higher education. The opinions of business officers, presidents, analysts, higher education writers, and other observers on this subject range widely. Some think, "Disruption, what disruption?"[33] Others believe that, as Clayton Christensen and Henry J. Eyring write, "The combination of disruptive technology and increased focus on educational outcomes opens the door to new forms of competition, particularly from the private sector."[34] Others think it is "a situation ripe for disruption," a concept Christensen has extensively researched and written about in *The Innovator's Dilemma*.

Richard Ekman, President of the Council of Independent Colleges, notes:

> The inconvenient truth is that traditional forms of higher education remain educationally more effective for most students than the new models. To propose the substitution of a wholly online degree for a campus-based college education… without clarifying what the online program will not include misleads young people and their parents to believe that the two are equivalent.[35]

He also argues, however, that while the evidence points to superior student performance in the "traditional institution," there are still instances — "when local circumstances warrant radical change" — where disruptive approaches will succeed. Ekman also cites the work of the National Center for Academic Transformation as it applies to technological delivery of giant introductory lecture courses.

So, how is the small, non-selective/non-elite college supposed to react to this? Are certain business officers correct in observing that there are no disruptions currently threatening small private colleges? Or are we indeed at the beginning stages of the disruption Christensen describes, when technological shifts allow new, nimble competitors to enter a market with a low-cost new product that is generally ignored or dismissed by the older, established entities in the industry? Only time will tell. As the sage philosopher Yogi Berra once said, "It's risky to make predictions — especially about the future."

While predictions may not be in order, staying dialed in to this subject and successfully applying both strategic and tactical solutions will put the small Christian college in a position to react as needed. It is also important to recognize the landscape and understand where those local circumstances that Ekman speaks of exist.

It would indeed be a mistake to overreact to the latest wave of innovation and abandon tested systems for the lifeboats of new technologies. These have limited ability to deliver the educational experience that most small Christian colleges are in business to provide. Indeed, perhaps this place in history will provide a pivot point for schools that may double down on their stated missions and not be set adrift by the lure of new technology and public opinion.

Perhaps we can learn some lessons from schools taking an integrated approach. Some seminaries are making strides in this area. The Autumn 2012 issue of *InTrust* magazine contains an article titled, "Can you do spiritual formation online? Why yes, it's being done already." The article contains spiritual formation examples from a number of venues and gives illustrations of how this seemingly low-tech activity is being done in a high-tech environment.[36]

A group we are working with has shared resources and ideas on this topic extensively over the last several months, starting in April 2012. The following is from a comment one of the members posted on the group's private blog. This will give you a sense of what some Christian higher education leaders are thinking:

> I just finished a very interesting book called *Change or Die* by Alan Deutschman. He looks at what it takes to change for people and organizations. He talks some about IBM, which is one of the rare examples of an organization that did change, and is still changing. The president given a mandate for change was Lou Gerstner. One thing he discovered was that IBM staff were creating as many or more new ideas than companies like Oracle and Cisco, but they were not turning those new ideas into businesses. I will quote Deutschman here: "What were the root causes of this frustrating situation? The main problem was that IBM focused on protecting what it already had. The company rewarded executives for the short-term results from the tried-and-true businesses. The leaders were reluctant to devote attention, resources, time, or talent to rolling the dice. Everything was based on the current period, not on the future."

So it is with higher education on many campuses, and in the halls of the support organizations that serve higher education institutions, it seems.

Recommendations:

1. Stay informed and well-read on all sides of this issue. Debate on this issue will continue. Many institutions will stay the course, while others will move boldly.
2. Sort out the best thoughts and ideas and look for opportunities to make positive changes while staying true to the mission of your institution.

REGULATION

In a recent article in NACUBO *Business Officer* magazine, Kent Chabotar, president of Guilford College in Greensboro, North Carolina, lists nine pressure points that will affect higher education chief financial officers over the next 10 years. Four relate to regulation:

- Government reporting requirements on tuition increases will prompt closer management of the cost increases that drive up tuition rates
- Government health initiatives may lead to higher costs and new regulations, in addition to the inflationary costs of health benefits
- New reporting rules from Congress will increase the overall workload of business officers and their staff
- Tax-free debt market regulations and credit ratings could make debt financing more costly[37]

Reporting requirements on tuition increases are not new this year. It is now relatively easy to look at college data on the new College Navigator website, located at http://nces.ed.gov/collegenavigator. The site also includes a link to the U.S. Department of Education College Affordability and Transparency Center, which lists schools with the highest and lowest gross and net costs. You can access that site directly at http://collegecost.ed.gov/.

Health Care Reform Regulations

We are now in the second year of the health care reform legislation. The only significant new requirement to implement in early 2013 for the 2012 calendar year is the W-2 reporting requirement. Many of the key provisions go into effect in 2014, however.

An April 2012 International Foundation survey of employers, including nonprofit organizations, found that 47.2% are planning to implement changes to make plans compliant with the legislation. Of those, 39.1% are developing current-year plans and 37.3% have multi-year approaches. The survey also noted that 47.2% have conducted an analysis to determine how health care reform legislation will impact their health care plan costs.[38] Informal discussions with CFOs who have done research in this area indicate that costs will increase. Of the nearly 1,000 respondents in the International Foundation's Health Care Reform Survey, a majority (69.6%) expected that the legislation will raise their costs in 2012 and beyond. The range of expected increases ran from 1% to 4%.[39]

Municipal Security Regulations

One new area of regulation on the horizon is the municipal security provisions currently being studied. Many college debt portfolios include bond issues that were offered through a municipality or similar organization.

Municipal security issuers like colleges have always been subject to the anti-fraud provisions of federal security laws. They are, however, generally exempted from the U.S. Security and Exchange Commission's (SEC) periodic reporting and registration requirements that would include 10-K reporting.

It appears this might be changing, according to input contained in the Report on the Municipal Securities Market released by the SEC on July 31, 2012. While the "Tower Amendment" to the Securities Exchange Act of 1934 prohibited the SEC and the Municipal Securities Rulemaking Board (MSRB) from requiring issuers to file documents in connection with the issuance, sale, or distribution of municipal securities, the recent enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act required a study of municipal securities disclosure. This study was also required to make recommendations on the advisability of the repeal or retention of the Tower Amendment.

GOVERNANCE AND LEADERSHIP

As we discussed in the *2012 Higher Education Update*, the average age of college presidents continues to climb. Five years ago the American Council on Education reported that the average age of college presidents was 60 years.[40] A 2012 survey by the Council of Independent Colleges (CIC), an association for small and mid-sized independent liberal arts colleges and universities, found that the average age of presidents at its more than 600 member institutions was 60.3 years.[41] In addition, the average length of appointment for a CIC president declined from 8.5 years in 2006 to 7.1 years in 2011. So the leadership problems noted last year persist.

Successful Leadership Transitions, a CapinCrouse white paper by Dr. David J. Gyertson, lays out seven steps to guide institutions through an effective leadership transition. You can request a complimentary copy of this report by calling any CapinCrouse office or contacting us online at www.capincrouse.com.

CHARITABLE CONTRIBUTIONS

Charitable contributions continue to be an uncertain area, with questions about the tax exemption of organizations, the continued deductibility of donations, and the amount of charity to be expected by individual donors.

A recent article in *Free Inquiry*, a magazine published by the Council for Secular Humanism, discusses the argument that granting tax exemption to religious nonprofit organizations, including colleges, and allowing charitable deductions for contributions to such organizations is “unfair” because the taxes of all Americans have to make up for revenue “lost” from offering tax deductions and tax exemptions to religious organizations. The article further argues that the number of people living outside any religious tradition continues to grow… inferring the irrelevance of religious groups to the American public.[42]

In the article, lead author Ryan Cragun, Assistant Professor of Sociology at the University of Tampa, estimates that the U.S. government “gives up” approximately $71 billion a year in tax exemptions to religious nonprofit organizations. He argues for the demise of tax exemption for all religious nonprofits that do not provide a service the federal government would have to replace.[43]

The other side of this argument is evidenced by the recent passage of the plank in the Republican Party platform at their 2012 convention. One of the party’s “Fundamental Tax Principles” stated that “Because of the vital role of religious organizations, charities, and fraternal benevolent societies in fostering benevolence and patriotism, they should not be subject to taxation, and donations to them should continue to be tax deductible.”[44]

As for trends in charitable contributions, in an April 2012 survey by the Barna Group, 41% of the more than 1,000 U.S. adults surveyed had reduced donations to nonprofit organizations, up from 31% in November 2008. The April 2012 survey also found that 11% had stopped giving to churches altogether, compared to only 4% in November 2008.[45]

The 2012 survey group was not optimistic about the prospects for the economy, with 49% saying they believe it will take more than three years for the economy to recover or it will never recover. This is compared to only 37% who held that sentiment in November 2008.[46] Despite the angst felt by individual donors, however, the latest “State of the Plate” survey of church contributions found that 51% of churches saw giving increases last year, compared to 43% the year before.[47] In addition, the Council for Advancement and Support of Education (CASE) estimates the 2012 fiscal year brought a 4.9% increase in giving, and it expects a 5.1% increase for fiscal 2013.[48]

The key is to know that the results are mixed, and significant contribution increases should not be planned for in forward-looking budgets.

ACCOUNTING ISSUES

This year’s section on accounting and financial reporting focuses on the following:

- The “big three” convergence exposure drafts currently outstanding
- Accounting standard updates (ASUs) in both final and proposed forms
- Thoughts on the importance of clearly communicating the overall financial health of your institution and the trends in that financial health
- Background on the standard-setting process for smaller and mid-sized SEC-regulated corporations
- Other pronouncements

We’ll start with some background, as this is key to understanding the context of these accounting changes. First, the so-called “big three” convergence standards are components of the continuing work by the Financial Accounting Standards Board (FASB) to align U.S. generally accepted accounting principles (GAAP) standards and International Accounting Standards. If you read the FASB feedback comment letters, especially those from higher education and nonprofit groups, you will find that many feel these new standards impose heavy additional burdens and do not result in nonprofit financial statements that inform readers more effectively. They also point out that the Board seems to be creating standards that are ultimately directed at a narrow focus of industries, but all organizations are required to comply with the new standards, creating additional non-informative disclosures. In her April 1, 2012 response to the “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities – Impairment” document (the Supplementary Document), Susan M. Menditto, Director, Accounting Policy at NACUBO, writes: “Readers of financial statements are interested in information that is relevant to the preparer’s industry and, by requiring reams of disclosure that is irrelevant, it masks the truly important information in the statements.”[49]

In our work with college and university client boards this past fall, we noticed that many board members felt like they were drowning in pages of meaningless data as they tried to make sense of the disclosures. It’s understandable that many have a tendency to focus on the details and miss the big-picture message being communicated. We mention this because it’s essential that readers of higher education financial statements work diligently to see the big picture and uncover the story being told in the financial statements.

The newly formed Not-for-Profit Advisory Committee may provide some guidance and help on this as they deliberate over their recommendations on Management Discussion and Analysis.

THE BIG THREE: REVENUE RECOGNITION, LEASES, AND FINANCIAL INSTRUMENTS

REVENUE RECOGNITION

In mid-November 2011, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board issued for public comment a revision of the revenue recognition standard known as "Revenue from Contracts with Customers." The original 2010 proposal was significantly revised after almost 1,000 comment letters were received. Because many of the proposals were changed, the boards decided to re-expose the standard for additional public comment. That comment period ended on March 13, 2012.

Redeliberations started in July and one significant change was agreed upon. The boards decided to make the rules on revenue recognition "less onerous" by eliminating the onerous performance rules altogether in favor of existing rules on "loss contracts." This will mainly affect construction, aerospace, defense, and related entities.

More redeliberation will be needed to cover transition guidance and disclosures. Redeliberation will also occur on the distinction between contracts with customers and collaborative agreements. This topic received comment from the NACUBO Accounting Principles Committee (APC), which asked the FASB to address the definitions of both a customer and a collaborative agreement to "include contracts where no product or service is created for commercial marketing." The APC pointed out that a clear exclusion was important because terms used in the Standard Update to define certain research activities "do not adequately address the unique research mission of higher education institutions." The FASB was also asked to reconsider certain proposed reconciliation-type disclosure requirements, especially when contract revenue is not a significant source of revenue for the reporting entity.[50]

The remaining deliberations could last into 2013. A final standard is now expected in the first half of 2013.

While the main proposals are essentially the same, the application guidance has been modified significantly. The core principle and same five basic steps still apply, however:

Core Principle: To recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Five Basic Steps:

1. Identify the contract with the customer
2. Identify any separate performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the various performance obligations
5. Recognize revenue when a performance obligation is satisfied

Currently, the expected effective date for public entities is no earlier than 2015, perhaps even later. There may be deferral for nonpublic entities for one or two years beyond 2015.

Observation and Recommendation:

It appears that with the remaining deliberations, the impact of this standard on higher education may be minimal, especially if the disclosure requirements are dealt with

in a manner that allows certain entities without significant contract activity to downsize the disclosures required.

LEASES

The current accounting rules on leases are very old, dating back to SFAS 13, adopted in 1976. This standard was controversial at the time and went through nine amendments and additional modifications, from technical bulletins to rules proposed by the Emerging Issues Task Force.

Currently, leases are generally classified into two categories, operating leases and capital leases. This classification is based on four criteria:

1. Transfer of title to the asset
2. Presence of a bargain purchase option
3. Length of the lease term
4. Present value of future payments compared to the fair value of the asset

The problems noted with this current accounting methodology are:

1. Leases that fit the definition of an operating lease represent significant commitments of cash flows that remain "off balance sheet." This was noticed as early as 2005, when the SEC issued its report on the Sarbanes-Oxley Act of 2002. That report criticized off-balance sheet financing, which is what took Enron down.

2. With their bright-line tests, these rules resulted in "engineered transactions" to get the desired accounting treatment. This contributed to odd accounting results, such as commercial airline corporations that had large fleets of aircraft, but no asset or liability accounting for these fleets on their balance sheets. What's worse, the actual accounting resulted in some companies having part of the fleet capitalized and part under operating leases. Consider this excerpt from Delta Airline's 2011 annual report: "At December 31, 2011, we and our wholly-owned subsidiary Comair operated 111 aircraft under capital leases and 90 aircraft under operating

FIGURE 6

TOPIC	INITIAL ED	REVISED ED
Lessee expense recognition pattern	A lessee should recognize amortization of the right-of-use asset (straight-line [method]), and interest on the liability to make lease payments (effective interest rate [method]). The result is a front loading of expense in the income statement.	Some lessees will apply an expense recognition approach similar to that proposed in the initial ED [exposure draft]; some will use an approach that results in straight-line lease expense. Which recognition approach to apply will depend on the level of consumption of the underlying asset. A practical expedient will apply based on the nature of the underlying asset (property vs. non-property, such as equipment).
Lessor accounting	A lessor should apply the performance obligation approach if the lessor retains significant risks or benefits of the underlying asset during or after the expected lease term; if not, apply the derecognition approach. This was known as the "dual model."	A lessor distinguishes between leases to which the "receivable and residual" approach (similar to the derecognition approach) applies and leases to which an approach similar to operating lease accounting applies using the same principle of consumption and related practical expedients as for lessee accounting.
Lease term	A lessee or lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease.	The lease term is the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset. It also includes any options to extend the lease when there is a significant economic incentive to exercise that option (e.g. a bargain renewal) or a significant economic disincentive to not exercise the option (e.g. significant termination penalties).
Variable/uncertain cash flows	Contingent rentals and expected payments under term option penalties and residual value guarantees should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique.	The measurement of lease assets and liabilities includes lease payments that are: • In-substance fixed lease payments but structured as variable payments. • Dependent on an index or rate. • Expected to be payable under residual value guarantees. Variable payments based on usage or performance will not be included.
Definition of a lease	… defined as "a contract in which the right to use a specified asset is conveyed, for a period of time, in exchange for consideration."	… However the "specified asset" and "right to control" principles that an entity would apply to determine whether a contract contains a lease have been revised. This may change some existing conclusions about whether an agreement is or contains a lease.

leases. Our Contract Carriers under capacity purchase agreements (excluding Comair) operated 550 aircraft under operating leases." How is that for clear, consistent accounting treatment?

The current rules are obviously dated and far too complex to result in meaningful accounting. So what is the solution? The FASB and International Accounting Standards Board both believe simplification is needed. In August 2010 the Boards proposed a standard that called for all leases to be accounted for as capital leases. The only exception would be truly short-term leases with a maximum lease term (including extensions) of 12 months or less.

The result of that proposal was approximately 800 comment letters and at least two rounds of deliberation, the latest of which started in January 2011 and ended in July 2012.

To give you an update on the status of this important pronouncement, Figure 6 has a table excerpted from PwC Dataline publication No. 2012-11, dated September 17, 2012.[51]

Redeliberations are ongoing. The most recent estimated completion timeline is for a revised draft in the first quarter of 2013, probably with a 120-day comment period. That puts the end of the comment period in late 2013. If there are no further significant comments, a 2014 issuance is likely. When issued, the effective date will be two to three years out from the issuance for public companies, and maybe longer for nonpublic companies. So this could impact higher education organizations considered public entities (due to conduit debt) no sooner than fiscal 2016 or 2017. It might be a year or so later for nonpublic colleges.

FINANCIAL INSTRUMENTS

While this is one of the "big three" exposure drafts, the application to higher education is expected to be somewhat limited. In the September 24, 2012 issue of Deloitte's *Heads Up* newsletter, Magnus Orrell and Jason Nye commented that "many of the Board's decisions regarding the FASB's tentative model have been more in line with current GAAP and IFRS [International Financial Reporting Standards] than with the Board's May 2010 exposure draft (ED), which proposed a significant expansion of fair value accounting."[52]

Given that, we will provide only a quick summary of significant changes that would affect most colleges. There are other changes that might affect some institutions, however, so be careful to review the changes thoroughly. In summary:

1. Entities are permitted to measure non-marketable equity investments by using a new measurement approach under which the cost basis is adjusted for observable price changes. This may help some schools that receive these types of non-marketable equity investments in the form of stock certificates. Observable price changes might be found by interviewing the issuing company and inquiring about recent stock buybacks, if any.
2. The classification of debt-instrument financial assets such as loans, accounts receivable, and investments in debt securities is based on an entity's assessment of the assets' cash flow characteristics and its business model for managing the portfolio of assets. This will be helpful for colleges, especially in accounting for receivables and loans.
3. Non-public entities will not be required to disclose fair value measurements for financial instruments measured at amortized cost. This means that non-public entities with total assets equal to or greater than $100 million, or less than $100 million when derivatives are present, will no longer be required to disclose fair value measurements for financial instruments measured at amortized cost.

ACCOUNTING STANDARD UPDATES

This year's batch of Accounting Standard Updates (ASUs) includes only one ASU that might have some applicability to small private colleges. The list below contains the ASU pronouncements from the last publication through September 2012:

- Update No. 2012-04—Technical Corrections and Improvements
- Update No. 2012-03—Technical Amendments and Corrections to SEC Sections: Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 114, Technical Amendments Pursuant to SEC Release No. 33-9250, and Corrections Related to FASB Accounting Standards Update 2010-22 (SEC Update)
- Update No. 2012-02—Intangibles—Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment
- Update No. 2012-01—Health Care Entities (Topic 954): Continuing Care Retirement Communities—Refundable Advance Fees
- Update No. 2011-12—Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05
- Update No. 2011-11—Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities
- Update No. 2011-10—Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—a Scope Clarification (a consensus of the FASB Emerging Issues Task Force)

The only item that might have some applicability to colleges is the ASU on Intangible Impairments (ASU No. 2012-02). This standard will hopefully simplify the process for accounting for impaired intangibles.

COMMUNICATING FINANCIAL HEALTH AND TRENDS

As mentioned in previous *Higher Education Updates*, the Not-for-Profit Advisory Council (NAC) has several projects underway with regard to the clarity and transparency of financial health and financial reporting. (See pages 11 – 14 of the 2012 *Higher Education Update*.)

Part of the NAC agenda is an ongoing project to discuss financial reporting. The current plan for this work involves deliberations on standards projects. The current estimated completion date is the second half of 2014. Within this set of discussions are discussions on:

- Net asset classes – March 2012 discussion
- Liquidity and financial health disclosures – September 2012 discussion

There is also an ongoing research project to explore best practices in not-for-profit (NFP) financial reporting, including the idea of management discussion and analysis.

The NAC meeting in September 2012 included a review of FASB staff research findings and observations. The review noted that:

a. The staff's research findings about the general lack of liquidity and forward-looking information in other financial communications was surprising because creditors, donors, and other users often want information that helps their understanding of the short- and long-term viability of the NFP.

b. If other financial communications were required, the guidance should be flexible enough to enable the NFP to adequately tell its story.

c. The FASB projects on financial statement presentation and disclosure framework could yield significant influence on what should be in an MD&A-like commentary. Perhaps waiting for further progress on these other initiatives would be beneficial.

d. Different levels of detail in other financial communications may be appropriate, depending on an NFP's size or where it falls in a private/public continuum.[53]

The Board Education Session Handout presented at the May 16, 2012 FASB meeting contains further review and helpful background. The following NAC recommendations are excerpted from this handout:[54]

> **Updating the NFP Financial Reporting Model**
>
> As discussed with Board members at the September 8 and 9, 2011 NAC meeting, the NAC identified four areas for improvement. In brief, those four areas for improvement had the following objectives:
>
> (a) Improve the current net asset classification scheme, in conjunction with improving how liquidity is portrayed in an NFP's statement of financial position and related notes.
>
> (b) Improve the statements of activities and cash flows to more clearly communicate financial performance, by better disaggregation and classification of information within the statement of activities and better cohesiveness between the statements.
>
> (c) Review existing NFP-specific disclosure requirements to streamline if possible and otherwise improve their relevance and understandability.
>
> (d) Develop a framework for an NFP's directors and management to provide commentary and analysis about the organization's financial health, operations, and liquidity.

Recommendations (a), (b), and (c) formed the basis for the Not-for-Profit Financial Reporting: Financial Statements project. Recommendation (d) provided the basis for the Not-for-Profit: Other Financial Communications project. The following sections provide more detailed information about the NAC's specific recommendations.

Net Asset Classes

The NAC suggested possible improvements to the current net asset classifications. These included revising the net asset classification to have only two general net asset classes—donor-restricted and other net assets—and requiring or allowing for further breakdowns within those net asset classes. For example, further disaggregation of these net asset classes could include a breakdown of types of restrictions such as time-only, purpose, and perpetuity being presented on the statement of financial position, with additional detail in the notes. Similarly, a breakdown of other net assets might include net investment in plant, quasi-endowment, other key board designations, undesignated on the balance sheet, with any necessary detail in the notes.

NAC members also offered suggestions for net asset classifications with a focus on liquidity. This also would allow for further disaggregation in the statement of financial position and the notes, but the restricted classification need not be limited to net assets restricted by donors. Instead, the further disaggregation would be based on liquidity. All of the NAC's suggestions indicate that many believe that the temporarily-restricted net asset class not to be the most relevant to users and that additional disaggregation would be helpful.

NAC members think that donor restrictions generally are very important. However, the distinction between temporarily and permanently restricted net assets, at least as currently defined, seemingly has outlived its usefulness or that emphasis is insufficient for purposes of conveying information about liquidity or financial performance. They also prefer the term *other net assets* rather than *unrestricted net assets*. The latter term can confuse and perhaps mislead stakeholders to believe that those net assets are without any restrictions.

In reality, they too can be subject to limitations that result from laws, regulations, debt covenants, and other contractual restrictions. That is, *unrestricted* is somewhat less accurate than *not donor-restricted*.

More detailed disclosure of net asset classes in the notes could include sub-categories to give a better indication of the availability of net assets for specific purposes. Additionally, because many credit and other analysts, rightly or wrongly, often use the net asset class distinctions as part of their assessments of an NFP's liquidity, a project to potentially revise the net asset classes would best go hand-in-hand with a project to improve the reporting of liquidity.

Financial Statement Presentation

The NAC also developed several ways to potentially improve financial statement presentation for NFPs. NAC members support continuing to require a single presentation model for all NFPs and giving NFPs the ability to emphasize certain elements and deemphasize other elements, depending on the revenue mix and other fundamental sector characteristics.

NAC members also support requiring presentation of an operating measure in the statement of activities but want to retain some flexibility on how to define it. This could benefit from seeking closer synchronization between operating in the statement of activities and in the statement of cash flows. NFPs could further emphasize operations by presenting a two-statement approach to the statement of activities—one that focuses on current period operations and funding and a second that focuses on other changes in total net assets.

The NAC's suggestions also included a request to continue requiring functional expense reporting for all NFPs but to consider extending the requirement of a statement of functional expenses or a similar matrix in the notes for all NFPs except those with an insignificant percentage of revenue from contributions. The Board had considered extending this requirement in Statement 117 but decided that information about expenses by natural classification may not be essential in understanding the service efforts of all NFPs and their ability to continue to provide services. The Board noted in Statement 117's basis for conclusions that it would need to perform further research to determine whether a statement of functional expenses would be cost-beneficial for NFPs other than voluntary health and welfare organizations.

Notes to Financial Statements

Also related to the Not-for-Profit Financial Reporting: Financial Statements project, the NAC suggested some potential improvements to NFP-specific notes. NAC members observed that under current U.S. GAAP requirements for reporting for investment assets, the requirements for disclosure of fair value information (from FASB Statement No. 157, Fair Value Measurements) are separate and distinct from the requirements for disclosures about endowments. That separation also exists in the notes to NFPs' financial statements, yet the readers of those NFPs' financial statements need to understand how these two notes relate to one another to better understand an entity's liquidity position and the extent to which investments represent assets available to fund the operating budget. The NAC highlighted the need for cross-referencing the fair value disclosures with the endowment disclosures to provide clarity about the extent to which investments represent restricted net assets and restricted assets.

NAC members also suggested that NFPs could better depict financial risks through disclosure requirements. It was noted, however, that this could largely be accomplished by reinforcing existing U.S. GAAP disclosures for assets and liabilities rather than by creating new disclosure requirements or relying on net asset classifications.

Other Financial Communications [MD&A]

The Not-for-Profit Financial Reporting: Other Financial Communications project largely grew out of one of NAC's recommendation to potentially develop guidance for management commentary that would allow NFPs to better communicate their financial results to users. NAC members provided an example of how to structure such communication. They proposed that such management commentary should be supplemental information as part of a general purpose financial report and that it should be placed before the financial statements and notes. It would contain four sections:

(a) Introduction and Overview

(b) Financial Health

(c) Operations

(d) Liquidity.

This framework for management commentary reporting could be used as part of a process to solicit information and views about management commentary reporting as part of required supplemental information that would accompany audited financial statements. This effort also would involve surveying and cataloguing best practices and publishing the results of those efforts. At or near the conclusion of the research project, based on what is learned, the staff would then ask the Board whether a project should be undertaken to (a) amend the Board's conceptual framework, (b) set reporting standards for communications in addition to financial statements, or (c) both. If the research does not result in a standard-setting project, the Board could still pursue educational efforts like publishing the results of research on best practices.

The initial scope of the project, however, was broadly stated and neutral about whether any outcome of the research would lead to standards. Rather than focus specifically on the area of management commentary reporting, the research project is more expansive in scope and more open to consideration of various alternative ways of improving an NPF's communications. Those communication alternatives would be in addition to (and outside) basic financial statements.

NAC members provided an example of one type of discussion that could be useful in management commentary. They suggested a narrative discussion of the liquidity and reserves (the portion of unrestricted net assets available for use by an organization to sustain its operations during a period when the organization faces unbudgeted increases in operating expenses, unanticipated losses in operating revenue, and other stresses on its operating activities) of NFPs to clarify the differences between those terms and the roles they play in helping users evaluate the short- and long-term performance of NFPs.

Standard Setting

The January 2011 report issued by what was known as the Blue Ribbon Panel contained an important proposal recommending the development of a framework to identify exceptions and modifications to U.S. GAAP for private companies. The FASB subsequently performed a comprehensive assessment of private versus public company financial statement users and the cost-benefit of private and public company reporting. The assessment resulted in the identification of six factors that distinguish private company and public company reporting.

To further monitor developments from this assessment and to assist the FASB Board in developing its decision-making framework, the FASB formed a 10 member-panel known as the Private Company Resources Group. Then in October 2011, the Financial Accounting Foundation (the organizing group for the FASB Board) issued a request for comment on its proposal to create an organization that would work on improvements to the standard-setting process for private companies. This resulted in the creation of a Private Company Council in May 2012.

This new Council will identify, deliberate on, and vote on proposed modifications to existing GAAP (subject to FASB endorsement and public due process).

Donated Services

To reduce the diversity in practice regarding services donated from one organization to another related organization, the FASB Board issued an exposure draft proposing accounting standards for "Personnel Services Received from an Affiliate for Which the Affiliate Does Not Seek Compensation." This exposure draft was issued on July 23, 2012 with a comment deadline on September 20, 2012. It is expected that this change will be applied prospectively, with adjustments made to all prior periods presented in a financial statement, but with no adjustment to be made to the beginning balance of net assets. The effective date will be determined at a future date after considering stakeholder feedback.

This exposure draft suggests that services donated to an affiliate be recorded by the receiving organization at the cost recognized by the affiliate donating the services. If it provides a performance indicator (like income from operations), the not-for-profit entity receiving the donated services would report the increase in net assets associated with personnel services received from the affiliate as an equity transfer, regardless of whether those services are received from a not-for-profit affiliate entity or a for-profit affiliate entity. For other not-for-profit entities (those not presenting a performance indicator), the proposed update does not prescribe presentation guidance for the increase in net assets, other than prohibiting reporting as a contra-expense or a contra-asset.

Classification of the Sale of Donated Securities in the Statement of Cash Flows

Many colleges receive contributions in the form of donated securities. Many of them have policies that require the sale of the donated securities soon after receipt of the security. There is currently diversity in practice over where the proceeds from those sales are classified in the statement of cash flows. This consensus statement requires that the proceeds from the sale of donated securities be presented as an operating activity if (1) the assets were directed for sale upon receipt and (2) the college converts the assets into cash in the near immediate term.

Liquidity Risk Disclosure

This proposed Accounting Standard Update would require both quantitative and qualitative disclosures aimed at helping users of financial statements better assess an institution's ability to meet its financial obligations. This proposed standard would require a table showing its expected cash flow obligations segregated by expected maturities. The table would include both recorded liabilities and off-balance sheet obligations such as unfunded commitments. This also requires a separate table to disclose available liquid assets. The proposed standard defines available liquid assets as unencumbered cash, high quality liquid assets, and borrowing availability (such as lines of credit).

In addition to the tables, the institution would be required to provide a narrative about its exposure to liquidity risk.

The effective date of this proposal is yet to be determined. It was issued July 27, 2012 and comments were due September 25, 2012. In discussing this with knowledgeable participants in the standard-setting process, it appears that this may be folded into other projects, thus delaying implementation.

Not-for-Profit Audit Guide

The AICPA committee working on this important document is making an effort to update it for the first time since its first release in 1996. Over 100 issues are being considered. The committee is currently in the process of clearing individual chapters and additional issues.

CONCLUSION

The environment today is uncertain in so many ways. We are experiencing political uncertainty, general economic uncertainty, and business model uncertainty, all in an environment where accounting standards are changing rapidly and expectations for reporting and transparency are rising.

We hope the material contained in this update helps the administrators at your institution assess your plans for the future and successfully present your economic story.

NOTES

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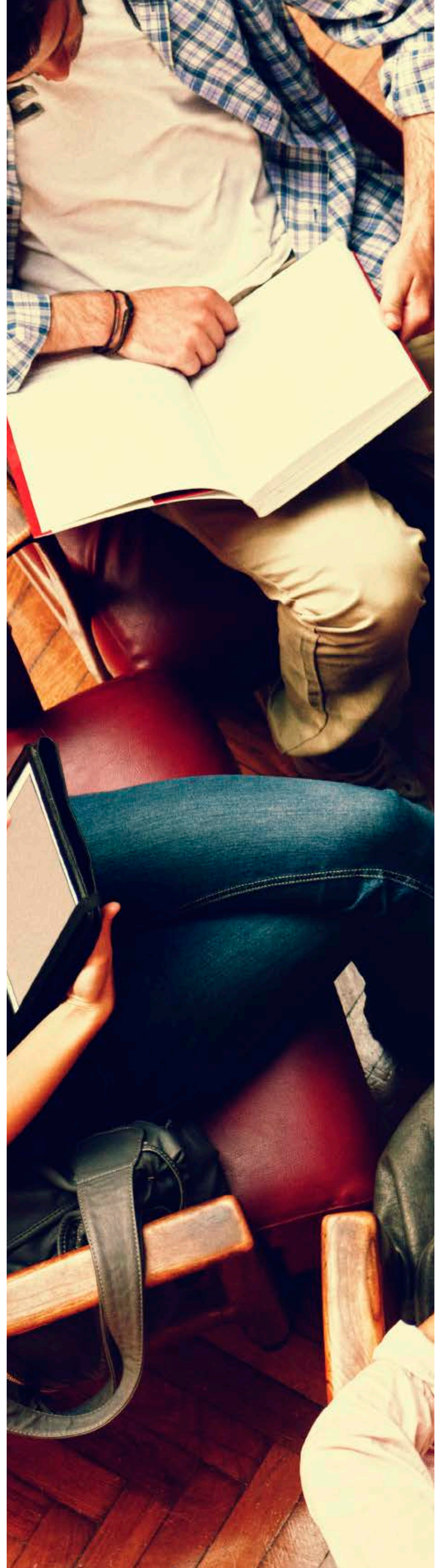

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