DOCUMENT RESUME

ED 080 039 HE 004 339

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TITLE	Accounting Principles and Financial Statements.
INSTITUTION	National Association of Coll. and Univ. Business Officers, Washington, D.C.
PUB DATE	May 73
NOTE	6p.
JOURNAL CIT	Professional File; v4 n3 p1-6 May 1973
EDRS PRICE	MF-$0.65 HC-$3.29
DESCRIPTORS	Budgeting; Colleges; Costs; Educational Administration; *Educational Finance; *Expenditures; *Financial Needs; *Higher Education; *School Accounting; Universities

ABSTRACT

This document presents the background and analysis of the American Institute of Certified Public Accountants (AICPA) guide to auditing colleges and universities. Highlights include the approval of the market value option, the treatment of endowment gains, debt services as transfers, the decisions on pledges, the use of financial statements, the treatment of total return, categories of current funds revenues/expenditures, coupling financial and statistical information, and greater uniformity among nonprofits. (MJM)

VOLUME 4, Number 3 • MAY, 1973

NACUBO **PROFESSIONAL FILE**

The AICPA Audit Guide: Background and Analysis

ACCOUNTING PRINCIPLES AND FINANCIAL STATEMENTS

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The American Institute of Certified Public Accountants is preparing to publish its new guide, Audits of Colleges and Universities, *the first such guide in the field of higher education and a document certain to have great influence on institutional accounting and reporting practices.*

In publishing the accompanying paper NACUBO presents for the information of its members a comprehensive analysis of the guide—and particularly of its significance in relationship to CUBA *(1968)—by a man uniquely equipped to make such comment. Mr. Robinson not only is Chairman of the AICPA committee by which the guide was developed, but he also serves, as he has served since its inception, as an* ex officio *member of the NACUBO Accounting Principles Committee. His paper is considered by the Accounting Principles Committee a full and balanced coverage of a development in which NACUBO has a deep interest.*

The present text brings up to date materials presented by Mr. Robinson at the 1973 workshop of the Eastern Association. It highlights those points upon which the AICPA committee responded—favorably in almost all cases—to the NACUBO recommendations submitted to AICPA by the Board of Directors last December (NACUBO Special Report *72-13). In the new revision of* CUBA *now going forward NACUBO's Accounting Principles Committee will be reexamining principles in the light of the thinking that went into the development of the guide.*

Over three years ago the American Institute of Certified Public Accountants created a Committee on College and University Accounting and Auditing. Since that time, the committee has been developing an audit guide that would serve as an authoritative source of information to the independent auditor in performing his attest function for institutions of higher education.

From the inception of its work, this committee has received important support and cooperation from the college and university community. First of all, the committee was able to make extensive use of literature already in the field, most particularly the 1968 revision of *College and University Business Administration* published by the American Council on Education. Secondly, two representatives of the National Association of College and University Business Officers have served as NACUBO's liaison representatives to the Institute, participating in all meetings of the Institute committee almost from the beginning.* As Chairman of the Institute committee, I have acted as liaison with the NACUBO Accounting Principles Committee. In this fashion, a very close working relationship was maintained over the entire period of the development of the audit guide.

It is important to note that prior to this, the senior committees of the Institute had done little to provide specific guidance to independent auditors working with nonprofit organizations generally. Almost all

*NACUBO's representatives are Clarence Scheps, Executive Vice President, Tulane University, and Robert B. Gilmore, Vice President for Business and Finance, California Institute of Technology.

pronouncements of the Accounting Principles Board (APB) and the Committee on Auditing Procedures (CAP) were limited to business enterprises. In the late 1960s, however, the Institute became deeply involved in nonprofit accounting through the creation of a half dozen committees that were charged with the responsibility of producing audit guides for such diverse entities as hospitals colleges and universities, private foundations, voluntary health and welfare organizations, governmental organizations and the like. One of the concerns of the Institute, then and now, is the different ways in which diverse types of nonprofit organizations treat the same types of financial transaction. Of concern to some, too, are the differences between nonprofit and business enterprise accounting practices, particularly with regard to fund accounting, depreciation, and determination of net income. These multiple activities and concerns made more difficult the work of the College and University Committee and influenced, to some extent, some of the final decisions respecting specific accounting practices sanctioned or prohibited by the audit guide.

Exposing the Audit Guide Draft

By the summer of 1972, a draft of the guide was approved for exposure by the Institute's senior committees. Arrangements were made through NACUBO to provide copies to all member institutions and to other institutions and interested organizations. Regional meetings were held under the auspices of the four regional business officer associations. Individual college officials, independent C.P.A.s, state auditors, coordinating councils of higher education, and state C.P.A. society representatives wrote in their comments. All of these materials were made available to all committee members and the NACUBO liaison representatives. Finally NACUBO presented a summary position paper prepared by its Accounting Principles Committee and approved by its Board of Directors. Our committee met three times, during which all significant comments were reviewed, many issues were thoroughly reconsidered, some important changes were made, the guide was completely rewritten, and the revised draft was submitted for ballot, approved by the committee, and referred to the APB for final approval, which it has received.

For the most part, much of what is in the audit guide will be familiar to most college and university business officers, partly because it carries forward what has been recognized as generally accepted in the industry for many years, and partly because of the extensive publicity and discussion that has surrounded the development of the guide over the past three and one-half years. Certainly this particular publication should come as no surprise to anyone who has stayed up to date with the literature coming out of NACUBO and elsewhere.

At the same time, there are some differences between the audit guide and the 1968 version of the *CUBA* manual. It would be useful, I think, to highlight what these are. In addition, there are some thoughts about future developments which I would like to mention that might be useful in pointing out the differences between what could be achieved in an audit guide and what might be done when research of a different sort is possible.

The Differences in Basic Statements

The first type of difference between the guide and the manual is in the preferred forms of presentation of the basic financial statements. Essentially, the balance sheet is not radically different from that shown in the manual, although greater attention is shown to the need to distinguish between unrestricted and restricted funds in each of the fund groups. The statements of changes in fund balances, which are presented separately in the manual, are pulled together in a columnar statement and shown as Exhibit B in the guide. Much attention and thought were given to the columnar statement of changes in fund balances and some important rearrangement of information is set forth in the sample exhibit. For one thing, the current funds, particularly unrestricted current funds, are reported broad in this statement rather than net. The revenues and other additions are reported first, followed by expenditures and other deductions, transfers among funds, and finally a net change for the year for each of the fund groups. This is followed by the opening balance and then the closing balance. In this fashion, a better view of the total activity for the year can be presented to the reader and certain key relationships among the funds are highlighted.

One of the most important changes relates to the statement of current funds revenues, expenditures and transfers, which is referred to in the guide as the statement of current funds revenues, expenditures, and other changes. This is more than simply a change in terminology, but rather reflects the fact that this third statement is supportive of the statement of changes in fund balances rather than being something totally detached from it. The concept here is that the bottom line on the statement of current funds revenues, expenditures, and other changes must be absolutely the same, both for unrestricted and restricted current funds, as that shown in the statement of changes in fund balances. Furthermore, the so-called "gifts applied"

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method of reporting unrestricted gifts, as illustrated and described in the manual, is eliminated in the guide. In its place is the requirement to report all unrestricted gifts in the statement of current funds revenues, expenditures, and other changes in the year received. A separate column might be used in that statement for gifts, but a total column must then be used showing the total of all transactions related to unrestricted current funds.

A somewhat greater emphasis is also placed in the guide on the requirement to provide additional information concerning investment performance. With the advent of the total return concept and the greater awareness of the need to increase the productivity of endowment and similar funds, the readers of financial statements of colleges and universities are looking more closely at investment performance. To date, the disclosure requirements have been very slim and we feel that this ought to be improved.

Approval of the Market Value Option

A closely related issue, namely, the value at which investments are to be carried, became a last minute change in the guide and similarly a last minute difference between the guide and the manual. The manual has consistently taken the position that investments should be carried at cost or at fair value at date of contribution. Up until the final moments before the APB action, the audit guide took the same position. The committee, however, had agreed earlier that if current market values could be considered as an acceptable alternative to cost, the guide should take that position. Just before taking this action concerning the audit guide for colleges and universities, the APB had agreed to allow market as an alternative in another audit guide for another branch of the nonprofit sector that was being approved for exposure. Thus, when it came to the college and university audit guide, the APB approved the inclusion of current market or fair values as an acceptable alternative to cost, provided this basis was used for all investments of all funds excepting, of course, investment in physical plant. While current market or fair values are not required and educational institutions can continue to use cost as most have done, those wishing to apply the current market value basis to all investments will be able to do so.

An area of some difference, although not particularly significant in one sense, concerns the old argument about depreciation. The basic concept in fund accounting of maintaining the segregation between current funds and plant funds, and, therefore, a complete reduction of current funds for all capital outlay as financed from that source, is carried forward in the audit guide. In this respect, it is the same as the manual. On the other hand, the guide does provide for a method of recording depreciation in the investment in plant fund subgroup of the plant funds group, if the institution so desires. While this is not mandatory, it does provide an outlet for those institutions that feel it important to record depreciation in the manner of other types of enterprises. We believe that in the future this may become a requirement in certain federal reimbursement programs. Thus it seems better to provide for this method than to leave the subject unmentioned.

An area that was discussed at great length, and which represents somewhat of a return to an older concept, concerns funds held in trust by others. Basically the audit guide reopens the feasibility of including such funds in the basic financial statements under certain circumstances and in the presence of certain types of claims.

Institutions operated by religious groups are changing some of their methods, particularly with respect to the recording of contributed services, and therefore some changes from the manual are incorporated in the guide. Further requirements for disclosure concerning the availability of physical facilities not owned by the institution and any related debt are incorporated in the guide.

The endowment area received a great deal of attention for obvious reasons. One of the changes that represents a departure from the manual is the elimination of that form of endowment income stabilization reserve which has been created by holding back pooled endowment income from the annual distribution to the income accounts. This type of reserve tends to distort the reporting of current period earnings. It also results in the co-mingling of restricted and unrestricted funds in a manner that makes it impossible to distinguish between them. Reservations of unrestricted current funds to meet unexpected losses in endowment income in the future can still be established, but this would be done after all current period earnings had been recognized as revenues.

The Treatment of Endowment Gains

The more ticklish problem of dealing with endowment and similar funds investment gains received not only a great deal of discussion, but has the longest treatment in the guide of any specific technical problem. Actually, the guide winds up in exactly the same position as the manual by maintaining the traditional distinction between ordinary income going into the income accounts and gains and losses being accounted for in the principal accounts. In addition, as is stated in the manual, any net gains or original principal of endowment and similar funds appropriated for expenditure would be treated as a transfer from one fund group to another and not as revenue in the receiving fund. Therefore, the guide and manual are the same in their conclusions. The manual, however, did not give any extensive treatment to the most recent developments in the field concerning total return and, as a result, a number of institutions have begun to develop rather unique and imaginative styles of computation and reporting of income from endowments. It seemed to the AICPA committee that some method of controling the situation was required until something better could be developed. I shall return to this subject later.

Another issue resulting in a difference between the guide and manual was the treatment of expired term endowments which become unrestricted funds upon the expiration of the endowment restriction. This condition is treated in the manual as a transfer to unrestricted current funds. The guide requires treating this as new unrestricted funds and, therefore, unrestricted current funds revenue in that year. A distinction, however, should be made in the reports between such unexpired term endowments and other gifts of an unrestricted nature received during that period. In this fashion, duplication of the reporting of total gifts will be avoided.

Debt Services as Transfers

Debt service on educational plant is treated differently in the audit guide. The guide calls for a treatment of debt service financed from current funds on educational plant parallel to the treatment afforded to debt service on auxiliary enterprise plant. The final conclusion on this, following particularly the recommendation of NACUBO, is to treat both types of debt service as transfers. However, the guide goes further and distinguishes between transfers of this sort which are considered to be of a mandatory nature because of the bonded indebtedness and surrounding legal requirements and transfers which might be made at the discretion of the governing board one year and not the next A similar mandatory transfer is the matching funds required under National Defense Student Loan program when financed from current unrestricted funds. These mandatory transfers are distinguished from other transfers of a voluntary nature which are treated separately in the statements.

Another item of difference concerns provision for encumbrances. The audit guide provides that accounting for encumbrances should be in accordance with the accrual basis of accounting so that expenditures should include only amounts associated with goods and services received and that liabilities include only the unpaid amounts associated with such expenditures. Provision for encumbrances, therefore, would remain on the balance sheet only as a reservation of fund balances or reservation of appropriation balances. We received a number of comments from state institutions stating that they were required to treat these items otherwise. Yet in spite of repeated requests by us for written documentation concerning such requirements, nothing was presented to us in writing supporting such a contention. Even in those cases where such requirements might be legally enforced, it seems to us that the institution should report in accordance with the law, but if it results in a substantial variation from generally accepted accounting principles, then the auditor should take an exception in his report.

Annuity funds is another area which called for some changes from the manual. Annuity funds involve the obligation to make fixed payments. At any given date, the institution has a liability for the present value of all future payments estimated to be made over the lifetime of the annuitant. The actuarially computed liability should be reported and any excess of net assets over that liability would be reported as a fund balance.

Agency funds have continued to be confusing and that confusion seemed to us to be compounded by the manual's requirement to report the changes in fund balances of such funds. The guide makes the point that there are no fund balances really, but only liabilities for amounts due to others. Thus, the term "fund balance" should not be associated with agency funds, and no statement of changes in fund balances is required.

The Decision on Pledges

The subject of pledges produced a rather interesting situation. We were informed by the NACUBO Accounting Principles Committee that the recommendation in the exposure draft of the guide requiring the inclusion of pledges receivable in the financial statements produced a unanimous agreement among all institutions of higher education for the first time. The unanimous position, of course, was against such inclusion. After considering fully the arguments presented by NACUBO, we changed the guide so that it now provides that pledges of a substantial amount should be disclosed in notes to the financial statements rather than including them within the statements as such unless the net realizable amounts of such pledges could be determined. The assumption is, in accordance with the representations of NACUBO and member institutions, that in most cases such determination is not feasible.

Current funds revenues and expenditures categories were a subject on which the Institute committee looked to NACUBO for guidance entirely so that what came out could be most useful to the industry. The changes incorporated in the guide included such things as grouping revenues and expenditures under two major subdivisions—educational and general and auxiliary enterprises—with student aid being folded into educational and general. Furthermore, revenues are now more nearly described by source. Certain functional terms, such as sponsored research and other sponsored programs, have been eliminated as revenue categories. Within educational and general expenditures, staff benefits is no longer shown separately.

Finally, the audit guide includes certain disclosure requirements to meet new opinions of the Institute's Accounting Principles Board which were issued after the 1968 Revision of *CUBA* was published.

Now, some words about the future of financial reporting for colleges and universities. It seems to me that with this audit guide we now have, for the first time, a stronger tool to use in bringing about a higher degree of uniformity in financial reporting by institutions of higher education. The audit guide will act as authoritative literature which the independent C.P.A. must pay attention to when he renders an opinion on financial statements of such institutions. At the same time, because of the way we have worked so closely with NACUBO, it seems to me that there is a greater impetus to compliance with the audit guide, including the changes referred to earlier.

In many ways, though, the audit guide is a beginning and not an end of an evolutionary process that must continue. The guide is not an appropriate vehicle for breaking wholly new ground or for exploring new concepts radically different from current established practice. There are at least five major areas of inquiry that I see calling for much intensive study. Let me mention them only briefly.

The Use of Financial Statements

First, there is the whole question of the way in which financial statements of colleges and universities are used. Many times our committee members debated this issue among themselves and with others and had to make many assumptions about who the readers of the statements are and what their needs are. Like all other situations, one set of financial statements will not meet all needs of all readers. We were dealing with one very highly stylized type of financial report, namely, the published annual report. There are many other types of reporting vehicles and many other reporting requirements. A growing number of people are seriously questioning the fundamental assumptions inherent in the use of fund accounting as a basic posture from which to express and view financial activity of colleges. These people would prefer to see something much more like a business enterprise's financial statements, and one that combines many of the figures that are now shown separately. They feel that the reader is confused by the multiplicity of fund groups, by the columnar form of statement presentation, and by the failure to readily identify a single figure which will summarize everything that has happened for the year. These same people feel that they are getting such information from financial statements of business enterprises, and they want to see the same thing in nonprofit organizations. Certainly businessmen who are members of governing boards of these institutions feel uncomfortable and do not always have the patience or the time to learn what the traditional statements are trying to say. And after they learn, perhaps they are not really interested.

One of the interesting observations here is that while these persons would see colleges move more to what business enterprises have done in the past, business enterprises, in turn, are turning away from what they have been doing and, in some ways, have been moving toward what colleges have been doing for decades. The growing importance and preeminence of the statement of source and application of funds is one such indication. This kind of information is already provided very clearly by the statement of changes in fund balances of a college. It is only now beginning to be appreciated by business enterprises. Nevertheless, this is an area that needs a great deal more exploration, inquiry and debate.

The Treatment of Total Return

The second area that needs a great deal of reexamination is the concept of total return and the attendant problem of income definition. The audit guide contains an extraordinarily detailed treatment of the subject in the form of a summarization of what has happened in the past, and where we stand at the present time. It holds on to the traditional method of accounting only because the committee could not see a clear path to some wholly new concept of the definition of income which was objectively determinable. If the total return concept and other types of management strategies for controlling investments are to be successfully carried out, then some new method of determining what income really is must be developed. The guide does provide some excellent guides to the direction in which future inquiry must go. But such inquiry would, of necessity, be a long, involved, and careful effort before some wholly new concept could be developed. Until it is developed, however, I believe that there is going to be an awful lot of unhappiness among those who are attempting to institute some of the more esoteric approaches toward investment management.

Categories of Current Funds Revenues/Expenditures

The third area needing further study concerns the categories of current funds revenues and expenditures. As was stated earlier, the categories used in the guide came from NACUBO. These were really reworkings of the traditional sources and functions that have been used by higher education for decades. The work of WICHE and NCHEMS, the emerging importance of program budgeting with its attendant program classification structure, and the desire on the part of some institutions to be able to compare program costs on an inter-institutional basis, ultimately must force a reexamination of the way in which current funds expenditures, at least, are reported in college financial reports. Searching inquiry in this area is going to have to take place so that people can decide what it is that they can and should be reporting to the public and what it is that is useful for internal management.

Coupling Financial and Statistical Information

The fourth area of the reporting which is totally unexplored as far as I am concerned is that of coupling financial information with statistical information so as to relate students, faculty, staff, physical facilities, course offerings, and the like to the financial effects. The more I work with financial statements, the more I have come to believe that financial statements standing alone can provide only a minimum of information to a reader who is seeking a thorough understanding of what is happening in the educational institution. I suspect that the day is not too far away when no financial report worthy of the name will be issued in the absence of correlative statistical information that breathes life into the financial data and makes the entire institution more understandable to the reader.

Greater Uniformity Among Nonprofits

The fifth area of concern which has not yet been dealt with adequately is the question of whether there ought to be a greater degree of uniformity among all or many of the different types of nonprofit organizations, among them being colleges and universities. As time goes on, universities are going to have to pay more attention to what other types of nonprofit institutions are doing, and *vice versa*.

* * *

And so it seems to me that this audit guide marks, perhaps, the end of an era, seeking to stabilize what can be accommodated today so that we can move on with the question of what ought to be in the future. Fortunately, accounting and financial reporting is an art and not a science. Each day we learn something new, society's needs change, and we can change to meet these needs. Questioning the old, or what exists, is always necessary. But, like other institutions in society, we can only move forward from a strong base.

My hope is that this audit guide will provide that firm base upon which you and others to come can build and that the pattern of mutual effort and support that was established between your profession and ours in the cooperative efforts of our committees will provide a vehicle for even greater progress in the future for the advancement and improvement of financial reporting for higher education.