Summary of Emerging Issues* for Colleges and Universities in 2006
Executive Summary

PricewaterhouseCoopers is pleased to bring you this year’s edition of our Summary of Emerging Issues for Colleges and Universities ("Summary"). The accounting, financial reporting, tax, and regulatory compliance issues described in this Summary might affect institutions like yours in the near future.

First, we want to highlight the FASB’s FIN 47 and the AICPA’s SAS 60. FIN 47 is expected to be onerous for colleges and universities to implement. It requires recognition of a liability for the fair value of a conditional asset retirement obligation (CARO) if the liability can be reasonably estimated. For example, universities might have to recognize a liability for the cost of removing and disposing of asbestos in campus facilities. The FASB believes that many institutions will be able to reasonably estimate the removal and disposal cost. Estimating the liability will take time, so we encourage institutions to begin preparing immediately. FIN 47 is applicable to institutions for fiscal years ending in 2006. For more information, see page 5 in the FASB section of this document.

The AICPA is revising its Statement of Auditing Standards ("SAS") No. 60, Communication of Internal Control Related Matters Noted in an Audit. It will incorporate the definitions of the terms control deficiency and material weakness used in Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2 (AS2), and replace the term reportable condition with the term significant deficiency from AS2. The proposed SAS is expected to be effective for fiscal years ending after December 15, 2006. The impact of SAS 60 is expected to be significant because it will lower the bar on matters identified in the audit such that more matters will be significant. For more information, see page 15 in the AICPA section of this document.

The federal government also may adopt the terms control deficiency, significant deficiency and material weakness in its Government Auditing Standards, also known as the “Yellow Book.” The Government Accountability Office (GAO) is expected to issue a revised Yellow Book for comment during 2006. In addition, the OMB and federal agencies are expected to revise the Compliance Supplement and specific federal agency program audit guides to incorporate the same terms—control deficiency, significant deficiency and material weakness. For more information, see page 28 in the regulatory compliance section of this document.

The FASB is reconsidering the accounting for pensions and other postretirement benefits in a major project that would amend four FASB Statements. Phase I addresses balance sheet recognition of the difference between a plan’s funded status and the amount recognized in the balance sheet. The impact on balance sheets is expected to be significant. The exposure draft was released on March 31, 2006, and the final statement is expected in the fall. Phase II will begin shortly thereafter. Institutions are advised to begin planning now for the implementation of the first new FASB standard for pension and postretirement benefits. For more information, see page 10 in the FASB section of this document.

The AICPA issued two Interpretations of Statements on Auditing Standards in July 2005 pertaining to auditing fair values. The Interpretations raised specific questions in fiscal 2005 audits about assertions related to alternative investments. A special task force is considering additional guidance. For more information, see page 15 in the AICPA section of this document.

In early March, the Emerging Issues Task Force (EITF) issued No. 06-2, Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences. This issue addresses extended leave programs (such as sabbaticals) that are offered to employees that have worked for a specified period of time. Questions have arisen as to whether those benefits accumulate, and should be accrued over the extended service period or only recognized at the time an employee has completed the requisite service. The tentative conclusion is that the cost associated with unrestricted sabbaticals should be recognized over the service period during which the employee earns the benefit. For more information, see page 6 in the FASB section of this document.
We also want to highlight several GASB statements this year. GASB 43 establishes uniform financial reporting standards for other postemployment benefit (OPEB) plans and supersedes the interim guidance included in GASB 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*. Large institutions with annual revenues of $100 million or more are required to implement this Statement for periods beginning after December 15, 2005. For more information, see page 22 in the GASB section of this document.

GASB 45 establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures and, if applicable, required supplementary information (RSI) in the financial reports of state and local governmental employers, including public colleges, universities and other special purpose governments. As with GASB 43, GASB 45 will become effective in three phases. Institutions with annual revenues of $100 million or more would be required to implement this standard first—for the June 30, 2007 fiscal year. GASB 45 will most likely impact all of our public college and university clients, and the amounts of liabilities and their impact on net assets will most likely be material. For more information, see page 20 in the GASB section of this document.

The GASB issued its Statement No. 47, which establishes accounting standards for termination benefits, in 2005. This statement will significantly affect public colleges and universities that offer early retirement packages. Note that for termination benefits provided through an existing defined benefit plan, the provisions of this Statement should be implemented simultaneously with the requirements of GASB 45. For all other termination benefits, this Statement is effective for financial statements for periods beginning after June 15, 2005. For more information, see page 19 in the GASB section of this document.

Although slowed by Hurricane Katrina, there continues to be growing momentum for charity reform legislation at the federal level. Representatives from the U.S. Senate and House are in the process of reconciling tax reconciliation legislation that contains incentives to encourage charitable giving (e.g., allow tax-free distributions from IRAs for charitable purposes) as well as certain charitable reforms (e.g., require 990-T disclosure and certification relating to UBIT). One proposal would require public disclosure of Forms 990-T. For more information, see page 33 in the tax section of this document.

This year’s *Summary of Emerging Issues for Colleges and Universities* has been prepared under the leadership of John Mattie, PricewaterhouseCoopers’ National Education & Nonprofit Practice Leader. We had assistance from PwC partners Lee Ann Leahy and Nancy Shelmon as well as from Jocelyn Bishop, Barbara Cevallos, Ed Chait, Ralph DeAcetis, Kaye Ferriter, Don Fischer, Katharine Grover, Renee Lixfield, Mary Rodier, Shannon Smith and Gwen Spencer.

Because the issues in this *Summary* are emerging, their status is subject to frequent changes. The latest status of these issues can be found on the following web sites, among others.


Department of Education ([http://www.ed.gov](http://www.ed.gov))

FASB ([http://www.fasb.org/](http://www.fasb.org/))

Federal Audit Clearinghouse ([http://harvester.census.gov/sac/](http://harvester.census.gov/sac/))


IRS ([http://www.irs.gov](http://www.irs.gov)). In particular, see the section for “Charities & Non-Profits.”

NCAA ([http://www2.ncaa.org](http://www2.ncaa.org))

OMB ([http://www.whitehouse.gov/omb](http://www.whitehouse.gov/omb))

If you have questions about any of the issues in this *Summary*, contact your PricewaterhouseCoopers’ engagement team or contact our national office at education.nonprofit@us.pwc.com or call us at 1-888-272-3236.
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Summary of Emerging Issues for Colleges and Universities in 2006

I. FASB Pronouncements and Activities

The following FASB pronouncements and activities will affect colleges and universities this year or in the next few years. We begin with the most recently issued FASB Statements of Financial Accounting Standards (SFAS), and we look back at previously issued SFASs that will affect institutions for the first time this year. Then we discuss other recent FASB pronouncements, including FASB Interpretations and FASB Staff Positions as well as guidance from Emerging Issues Task Force (EITF). Finally, we highlight the projects that are on the FASB’s agenda in 2006 and beyond, including combinations of not-for-profit organizations.

**New Pronouncements**

**FASB Statement No. 154 (FAS 154), Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3**

FASB Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3, provides guidance on accounting for changes and error corrections. It is effective for accounting changes made in fiscal years beginning after December 15, 2005 and requires only prospective application. This Statement is designed to improve the comparability of financial information by requiring retrospective application of all comparative financial statements when reporting most accounting changes. When full retrospective application is not practical, this Statement requires that a new accounting principle be applied as of the earliest possible date. This Statement also requires that a change in depreciation method be accounted for as a change in accounting estimate, rather than as a change in accounting principle.

Much of the guidance in APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, was carried forward. Specifically, the following reporting guidance was carried forward:

- The correction of an error in previously issued financial statements
- A change in accounting estimate
- A change in the reporting entity
- Guidance in Opinion 20 on justification for a change in accounting principle

**Observation:** This Statement will apply to all colleges or universities if an error is discovered or in instances of accounting changes. All changes in accounting principles require retrospective treatment. This includes changes to accounting principles as a result of the issuance of new pronouncements.

**FASB Statement No. 149 (FAS 149), Amendment of Statement 133 on Derivative Instruments and Hedging Activities**

The FASB issued this Statement, the most recent of several on derivatives, in April 2003. FAS 149 amends FASB Statement No. 133 (FAS 133), Accounting for Derivative Instruments and Hedging Activities, for decisions made:

- As part of the Derivatives Implementation Group (DIG) process
- In connection with other FASB projects dealing with financial instruments
- In connection with implementation issues that have been raised to date

Derivatives are very complex, and numerous implementation issues have surfaced since FAS 133, the first of the FASB’s pronouncements on this topic, was issued in June 1998. The others include:

- Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities—an amendment of FASB Statement No. 133, which was issued in June 2000
• Statement No. 137, Accounting for Derivative Instruments and Hedging Activities—
  Deferral of the Effective Date of FASB Statement No. 133—an amendment of FASB
  Statement No. 133, which was issued in June 1999

The FASB discussed the application of FAS 133 to split-interest arrangements and decided not
to amend it to exclude from its scope the accounting by not-for-profit organizations for the
embedded derivatives in split-interest arrangements that would otherwise require bifurcation
and separate accounting as derivatives. Referred to as Issue B35, it addresses the conflict between:
1) the accounting that is applied to a not-for-profit entity’s liability for payments to a
donor in certain irrevocable split-interest agreements that are covered by the AICPA Audit and
Accounting Guide, Not-for-Profit Organizations (“AICPA Guide”), and 2) the accounting under
FAS 133 in cases involving a liability with an embedded derivative to which separate
accounting must be applied.

Observation: In light of their complexity, most institutions should seek assistance in order to
determine the correct accounting for individual transactions involving derivatives.

FASB Interpretations

FASB Interpretation No. 47 (FIN 47), Accounting for Conditional Asset Retirement
Obligations—an interpretation of FASB Statement No. 143

FIN 47 requires recognition of a liability for fair value of a conditional asset retirement obligation
(CARO) if the liability can be reasonably estimated. The liability should be recorded when the
institution has sufficient information to make a reasonable estimate by applying an expected
present value technique. A CARO is defined in FIN 47 as: "A legal obligation to perform an
asset retirement activity in which the timing and (or) method of settlement are conditional on a
future event that may or may not be within the control of the entity." The retirement of a
tangible long-lived asset could occur through sale, abandonment, recycling, or disposal in
some other manner.

The fair value of a liability for the CARO should be recognized when incurred. A CARO would
be reasonably estimated if it is evident that the fair value of the obligation is embodied in the
acquisition price of the asset, if an active market exists for the transfer of the obligation and if
sufficient information exists to apply an expected present value technique. Sufficient
information exists if either: (a) the settlement date and method have been specified by others
(e.g., in law, regulation or contract); or (b) Information is available to reasonably estimate the
settlement date or range of dates, method or potential method of settlement, and the
probabilities associated with dates and methods.

Sufficient information may not always be available to reasonably estimate the fair value of an
asset retirement obligation. This being the case, FAS 143 requires a liability to be recognized
in the period that sufficient information becomes available to estimate its fair value and if the
liability’s fair value cannot be reasonably estimated, that fact and the reasons shall be
disclosed.

FIN 47 is applicable to institutions for years ending in 2006 and the transition method follows
FAS 143.

Observation: Examples of a CARO that would be applicable to colleges and universities are
structures containing asbestos, lead-based paint, mercury-containing equipment and assets
subject to leases with end-of-term retirement obligations. Implementation issues associated
with FIN 47 include:

• Institutions may need to perform extensive research and analysis to inventory all
  potential conditional asset retirement obligations.
• Detailed record keeping is required, and complex assumptions, which may be based
  on speculation, need to be developed.
EITF Issues

The Emerging Issues Task Force (EITF) was formed in 1984 in response to the recommendations of the FASB’s task force on timely financial reporting guidance. The EITF continues to address a broad range of topics related to derivative financial instruments, convertible debt, equity instruments, and revenue recognition, among others. Highlights of pronouncements of possible interest to colleges and universities are summarized below.

EITF Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements

Issue No. 05-6 was intended to provide guidance on how an organization that has acquired another organization should account for any leasehold improvements that are assumed. FASB Interpretation No. 21, Accounting for Leases in a Business Combination, provides guidance specific to leases, but leasehold improvements are not discussed. In current practice, leasehold improvements acquired by an organization after their inception are amortized over the remaining lease term based on expectations at the time of acquisition.

The Task Force reached a consensus that leasehold improvements placed into service significantly after the beginning of the lease term should be amortized over either the useful life of the assets or the term of the remaining acquired payments and renewals that are reasonably assured (in accordance with the criteria defined in FASB No. 13) at the date of purchase, whichever period is shorter.

The Task Force is currently considering whether the amortization period for a leasehold improvement should be reevaluated after the initial determination of the amortization period. The EITF will submit a separate issue regarding this topic.

Observation: Business combinations are not frequent in higher education; however, we should have a general knowledge of this issue in case circumstances arise. We do not expect this to significantly affect many institutions.

EITF Issue No. 06-2, Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences

This Issue addresses extended leave programs (such as sabbaticals) that are offered to employees that have worked for a specified period of time. Questions have arisen as to whether those benefits accumulate, as that term is defined in FASB Statement No. 43, Accounting for Compensated Absences (FAS 43), and should be accrued over the extended service period or only recognized at the time an employee has completed the requisite service.

At the March 2006 meeting, the Task Force reached a tentative consensus that the cost associated with unrestricted sabbaticals or other similar benefit arrangements should be recognized over the service period during which the employee earns the benefit.

A draft abstract will be exposed for a 30-day comment period, after which time it will be considered for ratification by the EITF at its June 2006 meeting. If ratified, the consensus would be effective for the first annual reporting period beginning after the date of ratification by the FASB (which would be expected to occur in late June 2006). The provisions of the consensus would be applied through retrospective application in accordance with the guidance in FASB Statement No. 154, Accounting Changes and Error Corrections. During the comment process, the FASB staff will solicit views on the availability of information necessary to transition retrospectively, as well as the proposed timing of adoption.

Observation: The Task Force focused mainly on whether the cost of the benefit should be accrued over the service period prior to eligibility for the benefit. Thus, the interpretation of the term “accumulates” was not discussed in any detail by the Task Force. However, the consensus is consistent with our view that an employee benefit that accumulates is one which can be carried forward to one or more future periods, and should be accrued as an employee cost over the period during which the employee provides services to earn the benefit. Institutions that are using the "pay as you go" method should review the implications of the accrual basis of accounting for sabbatical leaves and consider the significance of the difference.
**FASB Staff Positions**

Beginning in 2003, the FASB staff introduced the FASB Staff Position (FSP) to provide application guidance on technical issues. A final FSP is announced in Action Alert and posted to the FASB web site at [http://www.fasb.org](http://www.fasb.org), where it remains until incorporated into printed FASB literature. FSPs are identified by the FASB standard they address and by either a number if the standard has been issued (e.g., FSP 106-2) or a letter (e.g., FSP 106-a) if the standard is still a draft. FSPs become effective with the beginning of the next fiscal quarter after they are issued. In this section, we discuss the FSPs of most relevance to colleges and universities.

**FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments**

A consensus was reached regarding disclosures about unrealized losses on available-for-sale debt and equity securities accounted for under FASB Statement No. 115 (FAS 115), *Accounting for Certain Investments in Debt and Equity Securities*, and FASB Statement No. 124 (FAS 124), *Accounting for Certain Investments Held by Not-for-Profit Organizations*. The new FSP also provides guidance for reporting equity securities whose fair value is not readily determinable (e.g., equity securities that are outside the scope of FAS 124) if those securities are reported at cost. The new FSP refers to those securities as cost method investments. The FSP describes the three steps an institution should take to assess whether a cost method investment is impaired and, if it is, whether a loss should be recognized. The three steps are as follows:

- Determine if the carrying amount of the investment exceeds its fair value.
- Consider the severity and duration of the impairment when determining whether there is sufficient evidence indicating a recovery of fair value up to (or beyond) the carrying amount of the investment.
- If the impairment is determined to be other than temporary, an impairment loss should be recognized equal to the difference between the investment’s carrying amount and its fair value at the balance sheet date of the reporting period for which the assessment is made. The fair value of the investment would then become the new cost basis of the investment.

This new FSP also requires disclosures for other-than-temporary impairments. The recognition and measurement requirements of FSP FAS 115-1 and FAS 124-1 are effective for reporting periods beginning after December 15, 2005.

**Observation:** FSP FAS 115-1 and FAS 124-1 may not have a significant impact on colleges and universities—unless institutions disclose an operating indicator that breaks out realized gains from unrealized gains.

**FASB Staff Position (FSP) FAS 13-1, Accounting for Rental Costs Incurred During a Construction Period**

FSP FAS 13-1 was issued to address whether a lessee can capitalize rental costs during a construction period. This FSP notes that rental costs are incurred for the right to use a leased asset during construction or once construction has been completed; there is no distinction between them. Therefore, rental costs associated with campus grounds or building operating leases that are incurred during a construction period should be recognized as rental expense. The rental costs should be included in income from continuing operations. A lessee should follow the guidance in Statement 13 and Technical Bulletin 85-3 to determine how to allocate rental costs over the lease term.

The guidance in this FSP should be applied to the first reporting period after December 15, 2005. Early adoption is permitted. A lessee should discontinue capitalizing rental costs as of the effective date of this FSP for operating lease arrangements entered into prior to the effective date of this FSP. Retrospective application in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*, is permitted but not required.
Observation: This FSP could affect institutions that were previously capitalizing rental costs during construction.

FASB Staff Position (FSP) FIN 45-3, Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners

This FSP amends FASB Interpretation No. 45 (FIN 45), Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. It was issued to amend FIN 45 to be applicable to situations where a guarantor has made a guarantee to a business or individuals that revenues will be maintained at a specified level for a certain period of time.

In November 2002, the FASB issued FIN 45 relating to the accounting for and disclosure of guarantees. It addresses: 1) a guarantor’s obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur, and 2) a contingent obligation to make future payments if those triggering events or conditions occur.

FSP FIN 45-3 elaborates on the disclosures to be made by a guarantor in its financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FSP FIN 45-3 does not prescribe a specific approach for subsequently measuring the guarantor’s recognized liability over the term of the related guarantee. FSP FIN 45-3 also incorporates, without change, the guidance in FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, which is being superseded.

This FSP amends FIN 45 to clarify that a guarantee granted to a business or individuals will remain at a specified amount for a clearly defined period of time. The FASB uses an example of a guarantee granted to a nonemployee physician by a not-for-profit health care facility. The facility has recruited a physician to move to the facility’s geographical area to establish a practice. The health care facility, as the guarantor, agrees to make payments to the physician at the end of a defined period, if the revenues of the new practice do not equal a previously specified amount. In this situation, the guarantor should apply the recognition, measurement, and disclosure provisions of Interpretation 45.

This FSP applies to minimum revenue guarantees granted to physicians regardless of whether the physician’s practice qualifies as a business under EITF Issue No. 97-2, Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements.

The FSP is effective for new minimum revenue guarantees issued or modified on or after the beginning of the first fiscal quarter following November 10, 2005. Earlier application of the provisions of this FSP is permitted. The guarantor’s previous accounting for minimum revenue guarantees issued prior to the date of this FSP’s initial application should not be revised or restated to reflect the effect of the recognition and measurement provisions of Interpretation 45.

Observation: This FSP would be relevant to those colleges or universities with an academic medical center or an affiliated hospital or physician practice.

FASB Staff Position (FSP) APB 18-1, Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18 upon a Loss of Significant Influence

FSP APB 18-1 was issued to provide guidance as to how an investor should account for its proportionate share of an investee’s equity adjustments for other comprehensive income (OCI) upon a loss of significant influence.
The FASB believes that an investor’s proportionate share of an investee’s equity adjustment for OCI should be offset against the carrying value of the investment at the time significant influence is lost. To the extent that the offset results in a carrying value of the investment that is less than zero, an investor should:

1. Reduce the carrying value of the investment to zero
2. Record the remaining balance in income

Upon adoption of this FSP, an OCI adjustment recorded in an entity's equity, relating to an investment for which the reporting entity no longer has an ability to exercise significant influence, should be offset against the carrying value of the investment. The amount that is offset should not include any items of accumulated OCI, relating to unrealized gains and losses recorded in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, that are recorded by an investor for an investment that is accounted for as an available-for-sale security in accordance with Statement 115 upon adoption of this FSP.

This FSP is effective for the first reporting period beginning after July 12, 2005 and should be applied retrospectively.

Observation: This FSP would be applicable to a not-for-profit organization that has an ownership interest in a for-profit organization and loses its significant influence. We do not expect that this will have a significant impact on most colleges and universities.

FASB Staff Position (FSP) SOP-78-9-1, Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5

FSP SOP 78-9-1 was issued because EITF Issue No. 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights, was recognized by the EITF to conflict with certain aspects of SOP 78-9, Accounting for Investments in Real Estate Ventures. This FSP helps to consistently assess whether a general partner or partners controls a limited partnership.

Typically, control in a limited partnership is defined by having more than a 50% share in the profits and losses of an entity. However, the majority interest owner may not control the entity if other partners with less than a 50% share participate in significant decisions. The determination of whether the partners have substantive participating rights should be made in accordance with the guidelines presented in EITF Issue No. 04-5. If the minority partners are determined to have substantive rights, then their rights overcome the presumption of control by the majority owner.

Three scenarios follow. First, if the presumption of control by the general partners is overcome by the rights of the limited partners, the general partners should apply the equity method of accounting to their interests. Second, if the presumption of control by the general partners is not overcome by the rights of the limited partners and if no single general partner controls the limited partnership, then the general partners should apply the equity method to their interests. If the presumption of control is not overcome by the rights of the limited partners but a single general partner controls the limited partnership, the general partner should consolidate the limited partnership and apply the principles of accounting applicable for investments in subsidiaries.

This FSP is effective for all new partnerships and modifications to existing partnership agreements after June 29, 2005. For general partners in all other partnerships, this FSP is effective for the first reporting period in fiscal years beginning after December 15, 2005; it allows for two different methods of transition.

Observation: This FSP makes the AICPA guidance consistent with that of the FASB. However, we do not expect this FSP to have a significant impact on most colleges and universities.
**FASB Exposure Drafts, Proposals, and Projects**

**FASB Exposure Draft, Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans**

The Board is reconsidering the accounting for pensions and other postretirement benefits in a major project that would amend FASB:

- Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits
- Statement No. 87, Employers’ Accounting for Pensions
- Statement No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions
- Statement No. 132 (revised 2003), Employers’ Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106

Phase I of this project addresses balance sheet recognition of the difference between a plan’s funded status and the amount recognized in the balance sheet. The fund status is to be measured as the difference between the fair value of plan assets and the benefit obligation. For a pension plan, the benefit obligation is the projected benefit obligation, while for other postretirement benefit plans the benefit obligation is the accumulated postretirement benefit obligation. The aggregate impact of Phase I tentative decisions on balance sheets is expected to reduce unrestricted net assets and be significant.

The FASB issued its Exposure Draft on March 31, 2006. A final standard also is expected this year. It would be effective for years ending after December 15, 2006, although a one-year delay is possible. Implementation will require retrospective application to prior-period balance sheets. Phase II will begin after the Phase I final standard is issued. Phase II is a comprehensive reconsideration of all elements of accounting for pensions and other postretirement benefits, which is expected to take several years to complete.

**Observation:** Institutions should consider taking the following steps:

- Identify and assess the impact of the potential balance sheet changes on covenants contained in loan and other financial agreements, and examine the need or ability to renegotiate those agreements with lenders.
- Consider managing the balance sheet liability through changes in benefit arrangements.
- Develop a communication strategy to meet the needs of financial statement users, such as credit agencies, and lending institutions.
- Begin to plan for implementation with auditors and actuaries
- Monitor the progress of FASB activities.

**FASB Exposure Draft (ED), Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140**

This FASB ED proposes an amendment to FAS 133, Accounting for Derivative Instruments and Hedging Activities, and FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. It also addresses issues regarding FAS No. 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets.

According to the FASB, this proposed Statement would:

- Permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation.
- Clarify which interest-only strips and principal-only strips are not subject to the requirements of FAS 133

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• Establish a requirement to evaluate beneficial interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation

• Eliminate restrictions on a qualifying special-purpose entity’s ability to hold passive derivative financial instruments that pertain to beneficial interests that are or contain a derivative financial instrument.

This proposed Statement would be effective for fiscal years beginning after December 15, 2005, or the fiscal year that begins during the fiscal quarter that the Statement is issued. It will be applicable to all instruments obtained or issued after this time.

Observation: In light of their complexity, most institutions should seek assistance in order to determine the correct accounting for individual transactions involving derivatives.

FASB Exposure Draft, Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries—a replacement of APB No. 51

This proposed FASB ED would replace Accounting Research Bulletin No. 51, Consolidated Financial Statements, as amended by FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries. It would establish standards for the accounting and reporting of noncontrolling interests (i.e., minority interests) in consolidated financial statements. The aspects of this proposal that would be applicable to not-for-profit organizations include the following:

1. The equity interests of minority interests would be accounted for and presented in net assets, separately from the parents’ net assets.

2. Net income or loss would be attributed to the respective controlling or minority interests based on the ownership interest, unless there is a contractual arrangement that states otherwise.

3. Losses attributable to the minority investors that exceed the carrying amount of their interest would be attributed to the minority interest versus the controlling interest.

The FASB believes that this ED would improve the consistency in financial reporting and the comparability between entities.

This proposed Statement would be effective for annual periods beginning on or after December 15, 2006, with earlier adoption encouraged, but not prior to the beginning of the annual period that this proposal is issued. This proposed statement would require retrospective application.

Observation: Not all paragraphs of this proposed FASB would be applicable to not-for-profit organizations. AICPA Statement of Position 94-3, Reporting Related to Entities by Not-for-Profit Organizations, and the AICPA Audit and Accounting Guide, Health Care Organizations, provide additional guidance on the application of consolidation policy by not-for-profit organizations.

FASB Exposure Draft, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115

On January 25, 2006, the FASB released its ED on fair values. The comment period ends on April 20, 2006. The FASB believes that fair values for financial assets and financial liabilities are more relevant and understandable than measures that rely on costs. If finalized, this ED would expand the use of fair value measurement for financial instruments. It also would achieve further convergence with international accounting standards and it would offset the accounting for changes in financial assets and liabilities without having to apply hedge accounting.

The FASB's fair value project has two phases. Phase 1 provides—by this proposed Statement—a fair value option for financial assets and financial liabilities. Also, securities reported at fair value in accordance with FAS 115 would be presented as required under this ED. Note that the FASB is using the term "option." At initial recognition of a financial asset or
liability an entity could elect to use fair value as the initial and subsequent measurement method. Its choice would be irrevocable.

Phase 2 of the FASB's project would permit a fair value option for certain nonfinancial assets and liabilities. It also might provide a fair value option for some of the financial assets and liabilities that were scoped out of this fair value ED.

The following financial assets and financial liabilities would be scoped out of Phase 1:

- An investment that would otherwise be consolidated (i.e., an investment in a subsidiary)
- Employers’ and plans’ financial obligations for pension benefits, other postretirement benefits, and certain other forms of deferred compensation arrangements
- Financial liabilities recognized under lease contracts as defined in FAS 13
- Written loan commitments that are not accounted for as derivatives under FAS 133
- Financial liabilities for demand deposit accounts

**Observation:** If adopted, this pronouncement would significantly impact assets and liabilities that are not reported at fair value. For example, stating promises to give at fair value is within the scope of this FASB project. The AICPA’s Not-for-Profit Expert Panel plans to submit to the FASB some examples from the nonprofit sector that might be included in the final Statement. Colleges and universities should monitor the progress of this Statement.

**Proposed FSP FAS 133-a, Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133**

This proposed FSP addresses accounting for unrealized gains (losses) relating to derivative instruments measured at fair value under FASB Statement No. 133 (FAS 133), Accounting for Derivative Instruments and Hedging Activities. This proposed statement would replace the guidance provided in footnote 3 to EITF Issue No. 02-3 and it also would amend FAS No. 133 Implementation Issue No. B6. The implementation of this proposed statement is contingent upon the release of the proposed FASB Statement that will result from the Fair Value Measurement Project (discussed below).

According to paragraph 2 of this statement, the proposed new definition of fair value is: "the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability."

When an entity acquires or assumes an asset or liability, the transaction price is assumed to be the fair value, unless proven otherwise. For a transaction involving a derivative instrument, however, the transaction price is determined in one of the following two ways:

1. Upon initial recognition of the derivative instrument, the transaction price is assumed to be the fair value if the transaction occurs in the reference market (e.g., New York Stock Exchange) for the derivative instrument.

2. If the derivative transaction occurs outside the reference market for the derivative instrument, the fair value of the derivative will be determined by the price in the market in which the transaction occurred.

In situation 2 above, an unrealized gain (loss) is measured as the difference between the transaction price and the estimated fair value of the derivative instrument. The gain (loss) would be recognized in income when a minimum liability threshold is met, that is, if the estimate falls within Levels 1 through 4 of the fair value hierarchy. (See the fair value hierarchy below in a description of the proposed FASB Statement, Fair Value Measurement.) In the event the minimum liability threshold is met at the initial recognition, an unrealized gain (loss) will be recorded. If the minimum liability threshold is not met, an unrealized gain (loss) will be recognized as a deferred credit or debit, separate from the derivative instrument and not amortized into income or recorded in equity. It should be recognized in income once the minimum liability threshold is met.
After the initial recognition period, the change in the fair value of the instrument in subsequent periods should be recognized in accordance with FAS 133. The minimum liability threshold is not applicable.

This proposed Statement would be effective for fiscal years beginning after December 15, 2006 and for interim periods within those fiscal years. When it is applied, it should be applied retrospectively as of the beginning of the fiscal year. Earlier adoption is encouraged, but not until FASB's *Fair Value Measurement* Statement has been applied.

**Observation:** In light of their complexity, most institutions should seek assistance in order to determine the correct accounting for individual transactions involving derivatives.

**FASB Project, Liabilities and Equity**

The objective of the FASB's liabilities and equity project has been to improve the transparency of the accounting for financial instruments that contain characteristics of liabilities, equity, or both. In 2003, the FASB issued its Statement No. 150 (FAS 150), *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. The FASB issued this Statement to provide guidance for certain troublesome financial instruments, even though it had not resolved separation and conceptual issues affecting other instruments. The issuance of FAS 150 concluded Phase 1 of the FASB’s project.

In Phase 2, the FASB plans to develop a Statement that addresses the remaining financial instruments. The Board will determine whether to classify those instruments entirely as equity, liabilities (or assets), or between equity and liabilities, or instead to analyze those instruments into components to be classified separately based on their characteristics. Tentatively, the plan is to supersede FAS 150 and replace it with a Statement that provides a single comprehensive set of standards for classifying all financial instruments.

The FASB expects to issue a preliminary view is 2007.

**Observation:** The FASB's financial instruments project, including liabilities and equity, is far-reaching in its scope. However, this project is directed primarily at for-profit enterprises. Phase I concluded with the issuance of FAS 150, which has little impact on not-for-profit organizations. It remains to be seen whether Phase 2 will affect not-for-profit organizations.

**FASB Project, Combinations of Not-for-Profit Organizations**

The FASB has been working on its project related to combinations of not-for-profit organizations for several years. According to the FASB’s recent agenda, it will issue an ED shortly, now that it has issued (in June 2005) a new Exposure Draft, *Business Combinations—a replacement of FASB Statement No. 141*.

Combinations involving not-for-profit organizations were excluded from the scope of FAS 141, *Business Combinations*, and they are excluded from the scope of the FASB’s June 2005 ED. The excluded transactions will continue to be governed by Accounting Principles Board Opinion No. 16, *Business Combinations*, until a final standard on nonprofit combinations is issued.

With regards to the soon-to-be issued nonprofit combinations ED, the scope is likely to include combinations between one or more not-for-profit organizations and the acquisition of a for-profit business by a not-for-profit organization. When the acquired entity is a not-for-profit organization, the FASB has tentatively concluded that it is important to determine if the combination is reciprocal (an exchange of commensurate value) or nonreciprocal (containing an inherent contribution). When it is an exchange of commensurate value, the combination would be reported similarly to the standards of FAS 141. If it is nonreciprocal—more like a contribution—then it would be reported in accordance with FAS 116.
The following summarizes the key tentative conclusions reached by the Board to date:

1. The purchase method will be used to account for any mergers or acquisitions by not-for-profit organizations. Assets that are identified or liabilities that are assumed will be recorded at their fair value on the date of acquisition. There are several exceptions, including the acquisition of collections, operating leases, employee benefits, or deferred taxes.

2. Reporting units primarily supported by contributions and returns on investments would test goodwill for impairment using a trigger-based approach that would write off goodwill in its entirety if certain events occur. At the date of acquisition, the acquiring organization would identify the reasons goodwill arose in the transaction and determine the triggering events that would indicate that goodwill is significantly impaired. Examples of triggering events would be provided in the FASB’s proposed Statement.

3. Accounting for partially owned subsidiaries would be guided by the FASB’s Business Combinations ED, but with several modifications. First, the partially owned subsidiary would be consolidated at the fair value of its net assets plus any goodwill. If the not-for-profit organization owned a noncontrolling equity interest in the consolidating entity prior to the business combination, the transaction would be valued at the fair value of their portion on the date of acquisition. A difference between this price and the fair value plus goodwill would be recognized as a gain or loss in the statement of activities. Second, any purchased goodwill would be allocated to the controlling interest, except in a combination that resulted in a net deficit situation (fair value of the assets acquired were less than the fair value of the liabilities). In this situation, the goodwill would be allocated to the controlling and noncontrolling interests based on their percent ownership.

4. The disclosures currently required by FAS 141 would generally be required for not-for-profit organizations. The proposed changes to FAS 141 as a result of the new proposed FASB on business combinations would also be applicable.

5. In addition to the disclosures required under FAS 141, not-for-profit organizations would be required to disclose the following:
   - The fair value of collection items acquired and not written off under the noncapitalization policy of FAS 116.
   - The reasons that goodwill arose and the triggering events that would require a write-off.

A date for the release of this pronouncement has not yet been determined, but it would be effective six months after the release and would be applied prospectively.

Observation: This pronouncement would have a significant effect on colleges and universities that are involved in business combinations. Currently, institutions that are involved in business combinations generally follow the pooling-of-interest method of accounting (i.e., a carryover basis is used). Under the proposed rules, the acquiree’s financial statements may need to be stated at fair value. Depending on the nature of the transaction, the transaction would be accounted for as a contribution under FAS 116, a business combination under FAS 141 and FAS 142, or a combination of FAS 116, FAS 141 and FAS 142.
II. AICPA Pronouncements and Activities

The AICPA has issued tools and guidance for colleges and universities, their auditors and their audit committees this year. We begin by highlighting recent guidance and then we highlight tools for auditors and audit committees.

Pronouncements

Auditing Interpretations Pertaining to Auditing Fair Values
The AICPA issued two Interpretations of Statements on Auditing Standards in July 2005 pertaining to auditing fair values. The first is AU Section 9332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities. The second is AU Section 9328, Auditing Fair Value Measurements and Disclosures. The Interpretations raised specific questions in fiscal 2005 audits relative to satisfaction of existence and valuation assertions as they relate to hedge funds and private equity partnerships.

Observation: A special AICPA task force expects to issue more guidance on accounting and auditing issues associated with alternative investments. The task force includes representatives from several AICPA Expert Panels--Not-for-Profits, Healthcare, Investments Companies, and Employee Benefits as well as two college and university business officers and a fund manager. The timing of their guidance is not certain.

Proposed SAS, Communication of Internal Control Related Matters Noted in an Audit
The AICPA’s ASB released an exposure draft dated September 1, 2005 of a proposed Statement of Auditing Standards ("SAS"), Communication of Internal Control Related Matters Noted in an Audit, which will supersede SAS No. 60. The goal is to significantly strengthen the quality of auditor communications in audits of nonpublic companies. The proposed SAS:

- Recognizes that the body to whom internal control matters are communicated may take different forms. For example, the communications may be directed to the board of directors, a committee of management, or an owner in an owner-managed entity.
- Uses the term those charged with governance to refer to the person(s) with responsibility for overseeing the strategic direction of the entity, and the entity’s financial reporting and disclosure process.
- Incorporates the definitions of the terms control deficiency and material weakness used in Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, and replaces the term reportable condition with the term significant deficiency and its related definition in PCAOB Auditing Standard No. 2.
- Requires the auditor to communicate, in writing, to management and those charged with governance significant deficiencies and material weaknesses in internal control. (These matters should be communicated even if they were previously communicated to these parties in connection with previous audits.)

In addition, the proposed SAS provides guidance to the auditor in evaluating: 1) deviations in the design or operation of controls and whether they constitute control deficiencies, and 2) the severity of control deficiencies, based on their nature, likelihood, and magnitude, including whether misstatements or potential misstatements are “more than inconsequential.” The proposed SAS also:

- Identifies specified control deficiencies that ordinarily would be considered at least significant deficiencies.
- Identifies specified circumstances that should be regarded as at least a significant deficiency and a strong indicator of a material weakness.
• Requires the auditor, after concluding whether a control deficiency is a significant
deficiency or a material weakness, to consider whether “people with general business
knowledge and experience” would agree with the auditor’s conclusion.

• Requires the auditor to communicate internal control matters to management and
those charged with governance no later than 60 days following the report release date
(the date on which the auditor grants permission for the client to use the auditor’s
report in connection with the financial statements).

The proposed SAS provides revised illustrative written communications for situations in which:

• The auditor has identified significant deficiencies or material weaknesses.

• The client requests a written communication from the auditor indicating that no
material weaknesses were identified in the audit of the financial statements.

• The client requests a written communication from the auditor indicating that one or
more significant deficiencies were identified in the audit of the financial statements,
but none is deemed to be a material weakness.

• Includes an appendix containing examples of circumstances that may be control
deficiencies, significant deficiencies, or material weaknesses.

The proposed SAS incorporates the definitions (with two minor exceptions - see below) of
control deficiency, significant deficiency, and material weakness used in PCAOB Auditing
Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in
Conjunction With an Audit of Financial Statements (AS 2) so that common definitions are
applicable to audits of both nonpublic and public companies.

The definitions in the proposed SAS are as follows:

• A control deficiency exists when the design or operation of a control does not allow
management or employees, in the normal course of performing their assigned
functions, to prevent or detect misstatements on a timely basis.

• A significant deficiency is a control deficiency, or combination of control deficiencies,
that adversely affects the entity’s ability to initiate, authorize, record, process, or report
financial data reliably in accordance with GAAP such that there is more than a remote
likelihood that a misstatement of the entity’s financial statements that is more than
inconsequential will not be prevented or detected.

• A material weakness is a significant deficiency, or combination of significant
deficiencies, that results in more than a remote likelihood that a material misstatement
of the financial statements will not be prevented or detected.

The definitions above are the same as the AS 2 definitions with the following two exceptions:

• The reference to "interim" financial statements in the AS 2 definitions of significant
deficiency and material weakness is not included above because interim financial
statements are not applicable to private companies.

• The reference to "external" financial data in the AS 2 definition of significant deficiency
is not included above because the COSO framework does not use that term in its
definition of internal control over financial reporting.

The comment period for this exposure draft ended on October 31, 2005. The proposed SAS is
expected to be effective for fiscal years ending after December 15, 2006.

Statement on Auditing Standards (SAS) No. 103, Audit Documentation
This SAS, which supersedes SAS No. 96, was issued in December 2005 by the AICPA’s
Auditing Standards Board (ASB), the senior technical committee that is designated to issue
auditing, attestation and quality control standards and guidance. It is effective for audits of
financial statements for periods ending on or after December 15, 2006, but earlier application is permitted.

The purpose of this SAS is to establish standards and provide guidance on audit documentation. Briefly stated, the auditor must provide sufficient documentation so that there is a clear understanding of the nature, timing, extent, and results of work performed as well as the conclusions the auditor reached.

Eight New Audit Standards Related to Audit Risk
The AICPA's Auditing Standards Board (ASB) issued eight SASs relating to the assessment of risk in an audit of financial statements. These SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement (whether caused by error or fraud) in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit.

The eight standards are:

• SAS No. 104, Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures ("Due Professional Care in the Performance of Work")
• SAS No. 105, Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards
• SAS No. 106, Audit Evidence
• SAS No. 107, Audit Risk and Materiality in Conducting an Audit
• SAS No. 108, Planning and Supervision
• SAS No. 109, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement
• SAS No. 110, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained
• SAS No. 111, Amendment to Statement on Auditing Standards No. 39, Audit Sampling

The ASB believes that the requirements and guidance provided in the new SASs will result in a substantial change in audit practice and in more effective audits. The primary objective of the SASs is to enhance auditors' application of the audit risk model in practice. The SASs will be effective for audits of financial statements for periods beginning on or after December 15, 2006. Early adoption is permitted.

Proposed Statement on Standards for Attestation Engagements (SSAE), Reporting on an Entity's Internal Control over Financial Reporting
In January 2006, the AICPA's ASB released for comment proposed SSAE, Reporting on an Entity's Internal Control over Financial Reporting. The proposed SSAE would revise the requirements and guidance for reporting on the internal control of an entity that is a nonissuer. As potential users of SSAE No. 10 (AT sec. 501) report, the nonprofit community should be alert for the issuance of a final standard later in 2006.
Tools

AICPA Audit and Accounting Guides
The AICPA is currently in the process of substantially revising its Audit and Accounting Guide, Not-for-Profit Organizations, to address numerous accounting, auditing, industry, and regulatory issues that have transpired since it was originally issued in 1996. Until the new Guide is issued, users should use the Guide that is dated May 1, 2005. PwC's Nancy Shelmon, a partner in our Los Angeles office, is a member of the committee that is updating the Guide.

The AICPA also is updating its State and Local Governments Guide as well as its Government Auditing Standards and Circular A-133 Audits Guide.

AICPA Audit Risk Alerts
Audit Risk Alerts are intended to provide auditors with an overview of recent economic, technical, industry, regulatory and professional developments that may affect the audits they perform. The AICPA publishes an Audit Risk Alert for: 1) Not-for-Profit Organizations, 2) State and Local Governments, and 3) Government Auditing Standards and Circular A-133 Audits. The most recent versions were published in September 2005. PwC's Nancy Shelmon contributes to the Alert for not-for-profit organizations while Ralph DeAcetis contributes to the Alert for government auditing standards and A-133 audits.

Audit Committee Toolkit
In 2005, the AICPA compiled toolkits to help audit committees fulfill their responsibilities as effectively and efficiently as possible. There is a toolkit for not-for-profit organizations as well as a separate one for government organizations. The toolkits can be downloaded at no charge at www.aicpa.org.
III. GASB Pronouncements and Activities

We first highlight new GASB pronouncements that may have an impact on public colleges and universities, including GASB 47 and 46. We then highlight two GASB pronouncements that we reported on last year, and they are still very significant this year. They are the Statements that deal with postemployment benefits other than pensions. Finally, we highlight GASB Exposure Drafts and GASB projects. Note that summaries of GASB statements and other pronouncements have been excerpted from the GASB’s web site at www.gasb.org.

New Pronouncements

GASB Statement No. 47 (GASB 47), Accounting for Termination Benefits

Issued in June 2005, GASB 47 establishes accounting standards for termination benefits. The standard requires that for an institution with financial statements prepared on the accrual basis of accounting, a liability and expense for voluntary termination benefits (e.g., early retirement programs) should be recognized when the offer is accepted and the amount can be estimated. If there are involuntary termination benefits (e.g., severance), a liability and expense should be recognized when a plan of termination has been approved by those with the authority to commit the organization to the plan, the plan has been communicated to the employees, and the amount can be estimated. If financial statements are prepared on the modified accrual basis of accounting, termination benefits (liabilities and expenditures) should be recognized to the extent the liabilities are normally expected to be liquidated with expendable available resources.

GASB 47 defines a plan of involuntary termination as a plan that at a minimum identifies the number of employees to be terminated, the job classifications or functions that will be affected and their locations, and when the terminations are expected to occur. In addition, a plan of involuntary termination establishes the terms of the termination benefits in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated. GASB 47 also outlines the accounting for a plan of involuntary termination that requires an employee to render future service in order to receive benefits.

If healthcare-related termination benefits are provided by a large-scale, age-related program (e.g., significant early retirement incentive program), liabilities and expenses should be measured at their discounted present values based on projected total claims costs for terminated employees.

There is an exception to the measurement requirements discussed above. The effects of a termination benefit on an employer's obligations for defined benefit pension or other postretirement benefits should be accounted for and reported under the requirements of GASB Statement No. 27, Accounting for Pensions by State and Local Government Employers, or GASB Statement No. 45, Accounting and Financial Reporting by Employers for Postretirement Benefits Other Than Pensions, as applicable.

For termination benefits provided through an existing defined benefit plan, the provisions of this Statement should be implemented simultaneously with the requirements of GASB 45. For all other termination benefits, this Statement is effective for financial statements for periods beginning after June 15, 2005. The cumulative effect of applying this Statement should be reported as a restatement to beginning net assets and the statements should disclose a description of the termination benefit arrangement, the cost of the termination benefits, and significant methods and assumptions used to determine termination benefit liabilities.

Observation: GASB 47 standardizes the way government organizations account for all voluntary termination benefits and establishes standards for involuntary terminations. This Statement may be very pertinent to our higher education clients that offer early retirement packages and have an aging workforce. The effects of this Statement also result in another reconciling item between the fund financial statements, which are presented on the modified
accrual basis and governmentwide financial statements which are presented on the full accrual basis.

**GASB Statement No. 46 (GASB 46), Net Assets Restricted by Enabling Legislation, an amendment of GASB Statement No. 34**

Issued in December 2004, GASB 46 helps governments determine when net assets have been restricted to a particular use by the passage of enabling legislation and specifies how those net assets should be reported in financial statements when there are changes in the circumstances surrounding such legislation.

A government’s net assets should be reported as restricted when the purpose for or manner in which they can be used is limited by an external party, a constitutional provision, or enabling legislation. Enabling legislation is a specific type of legislation that both authorizes the raising of new resources and imposes legally enforceable limits on how they may be used. Statement 46 is intended to alleviate difficulties in identifying enabling legislation restrictions by clarifying that “legally enforceable” means that an external party—such as citizens, public interest groups, or the judiciary—can compel a government to use resources only for the purposes stipulated by the enabling legislation.

The provisions of GASB 46 are effective for financial statement periods beginning after June 15, 2005.

**Observation:** GASB 46 confirms that the determination of legal enforceability is a matter of professional judgment, which may entail reviewing the legislation and determinations made for similar legislation, as well as obtaining the advice of legal counsel. Public institutions should review the legal enforceability of enabling legislation restrictions when new enabling legislation has been enacted to replace existing legislation and when resources are used for purposes not specified by the enabling legislation.

**GASB Statement No. 45 (GASB 45), Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions**

Issued in June 2004, GASB 45 establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information (RSI) in the financial reports of state and local governmental employers, including public colleges, universities and other special purpose governments.

The approach followed in GASB 45 generally is consistent with the approach adopted in Statement No. 27, Accounting for Pensions by State and Local Governmental Employers, with modifications to reflect differences between pension benefits and OPEB. GASB 43, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans, addresses financial statement and disclosure requirements for reporting by administrators or trustees of OPEB plan assets or by employers or sponsors that include OPEB plan assets as trust or agency funds in their financial reports.

Postemployment benefits (OPEB as well as pensions) are part of an exchange of salaries and benefits for employee services rendered. Of the total benefits offered by employers to attract and retain qualified employees, some benefits, including salaries and active-employee healthcare, are taken while the employees are in active service, whereas other benefits, including postemployment healthcare and other OPEB, are taken after the employees’ services have ended. Nevertheless, both types of benefits constitute compensation for employee services.

From an accrual accounting perspective, the cost of OPEB, like the cost of pension benefits, generally should be associated with the periods in which the exchange occurs, rather than with the periods (often many years later) when benefits are paid or provided. However, in current practice, most OPEB plans are financed on a pay-as-you-go basis, and financial statements generally do not report the financial effects of OPEB until the promised benefits are paid.
GASB 45 improves the relevance and usefulness of financial reporting by: a) requiring systematic, accrual-basis measurement and recognition of OPEB cost (expense) over a period that approximates employees’ years of service, and b) providing information about actuarial accrued liabilities associated with OPEB and whether and to what extent progress is being made in funding the plan.

GASB 45 requires employers that participate in single-employer or agent multiple-employer defined benefit OPEB plans (sole and agent employers) to measure and disclose an amount for annual OPEB cost on the accrual basis of accounting. Annual OPEB cost is equal to the employer’s annual required contribution (ARC) to the plan with certain adjustments if the employer has a net OPEB obligation for past under- or over-contributions.

The ARC is defined as the employer’s required contributions for the year, calculated in accordance with certain parameters, and including: a) the normal cost for the year, and b) a component for amortization of the total unfunded actuarial accrued liabilities (or funding excess) of the plan over a period not to exceed thirty years. The parameters include requirements for the frequency and timing of actuarial valuations as well as for the actuarial methods and assumptions that are acceptable for financial reporting. If the methods and assumptions used in determining a plan’s funding requirements meet the parameters, the same methods and assumptions are required for financial reporting by both a plan and its participating employer(s). However, if a plan’s method of financing does not meet the parameters (e.g., the plan is financed on a pay-as-you-go basis), the parameters nevertheless apply for financial reporting purposes.

For financial reporting purposes, an actuarial valuation is required at least biennially for OPEB plans with a total membership (including employees in active service, terminated employees who have accumulated benefits but are not yet receiving them, and retirees and beneficiaries currently receiving benefits) of 200 or more, or at least triennially for plans with a total membership of fewer than 200. The projection of benefits should include all benefits covered by the current substantive plan (the plan as understood by the employer and plan members) at the time of each valuation and should take into consideration the pattern of sharing of benefit costs between the employer and plan members to that point, as well as certain legal or contractual caps on benefits to be provided. The parameters require that the selection of actuarial assumptions, including the healthcare cost trend rate for postemployment healthcare plans, be guided by applicable actuarial standards.

A sole employer in a plan with fewer than one hundred total plan members (including employees in active service, terminated employees who have accumulated benefits but are not yet receiving them, and retirees and beneficiaries currently receiving benefits) has the option to apply a simplified alternative measurement method instead of obtaining actuarial valuations. The option also is available to an agent employer with fewer than one hundred plan members, in circumstances in which the employer’s use of the alternative measurement method would not conflict with a requirement that the agent multiple-employer plan obtain an actuarial valuation for plan reporting purposes. Those circumstances are discussed further in the Statement.

Employers participating in cost-sharing multiple-employer plans that are administered as trusts or equivalent arrangements are required to recognize OPEB expense/expenditures for their contractually required contributions to the plan on the accrual or modified accrual basis, as applicable. Required disclosures include identification of the way that the contractually required contribution rate is determined (e.g., by statute or contract or on an actuarially determined basis). Employers participating in a cost-sharing plan are required to present as RSI schedules of funding progress and employer contributions for the plan as a whole if a plan financial report, prepared in accordance with Statement 43, is not issued and made publicly available and the plan is not included in the financial report of a public employee retirement system or another entity.
Employers that participate in defined contribution OPEB plans are required to recognize OPEB expense/expenditures for their required contributions to the plan and a liability for unpaid required contributions on the accrual or modified accrual basis, as applicable. This Statement also includes guidance for employers that finance OPEB as insured benefits (as defined by this Statement) and for special funding situations.

The requirements of GASB 45 are effective in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999. Governments with annual revenues of $100 million or more (i.e., phase 1 governments) are required to implement this Statement for periods beginning after December 15, 2006. Implementation dates for phase 2 and 3 governments are discussed further in the Statement.

Earlier application of GASB 45 is encouraged. All component units should implement the requirements of this Statement no later than the same year as their primary government.

Observation: GASB 45 will most likely impact all of our public college and university clients, and the amounts of liabilities and their impact on net assets will most likely be material. It is important for our clients to understand the new reporting guidance, engage in active valuation of these liabilities and to engage technical experts to prepare the necessary actuarial valuations. For those institutions that participate in pooled arrangements (e.g., with a state system), it is important to understand the accounting and reporting requirements applicable to employers participating in cost-sharing multiple-employer plans. Also, see the Summary below for information about GASB 43.


Issued in December 2004, GTB 04-2 clarifies the application of requirements regarding accounting for employers’ contractually required contributions to cost-sharing pension and OPEB plans issued in GASB 27, Accounting for Pensions by State and Local Governmental Employers, and GASB 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions, respectively.

GTB 04-2 clarifies that with regards to expenditure/expense recognition, contractually required contributions are recognized in the period they are due “for” rather than the period they are due “on.” For example, pension or OPEB expenditures that are “for” (i.e., related to) December’s payroll should be recorded in December even if they are due “on” February 1. This point was not clear in GASB 27 and 45, and was causing confusion.

The provisions of GTB 04-2 are effective for financial statement periods ending after December 15, 2004, with respect to pension transactions, and should be applied simultaneously with the implementation of GASB 45 with respect to OPEB transactions.

GASB Statement No. 43 (GASB 43), Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans

Issued in April 2004, GASB 43 establishes uniform financial reporting standards for other postemployment benefit (OPEB) plans and supersedes the interim guidance included in GASB 26, Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans. The approach followed in this Statement generally is consistent with the approach adopted in GASB 25, Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans, with modifications to reflect differences between pension plans and OPEB plans.

The standards in GASB 43 apply for OPEB trust funds included in the financial reports of plan sponsors or employers, as well as for the stand-alone financial reports of OPEB plans or public employee retirement systems or other third parties, that administer them. GASB 43 also provides requirements for reporting of OPEB funds by administrators of multiple-employer OPEB plans, when the fund that is used to accumulate assets and pay benefits or premiums is not a trust fund. A related Statement, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (referred to as the related Statement),
addresses standards for the measurement, recognition, and display of employers' OPEB expense/expenditures and related liabilities (assets); note disclosures; and, if applicable, required supplementary information (RSI). The measurement and disclosure requirements of the two Statements are related, and disclosure requirements are coordinated to avoid duplication when an OPEB plan is included as a trust or agency fund in an employer's financial report. In addition, reduced disclosures are acceptable for OPEB trust or agency funds when a stand-alone plan financial report is publicly available and contains all required information.

The financial reporting framework for defined benefit OPEB plans that are administered as trusts or equivalent arrangements includes two financial statements and two multiyear schedules that are required to be presented as RSI immediately following the notes to the financial statements. The financial statements focus on reporting current financial information about plan net assets held in trust for OPEB and financial activities related to the administration of the trust. The statement of plan net assets provides information about the fair value and composition of plan assets, plan liabilities, and plan net assets held in trust for OPEB. The statement of changes in plan net assets provides information about the year-to-year changes in plan net assets, including additions from employer, member, and other contributions and net investment income and deductions for benefits and refunds paid, or due and payable, and plan administrative expenses.

Required notes to the financial statements include a brief plan description, a summary of significant accounting policies, and information about contributions and legally required reserves. In addition, OPEB plans are required to disclose information about the current funded status of the plan as of the most recent actuarial valuation date, and actuarial methods and assumptions used in the valuation.

The required schedules (RSI) provide actuarially determined historical trend information from a long-term perspective, for a minimum of three valuations, about: a) the funded status of the plan and the progress being made in accumulating sufficient assets to pay benefits when due, and b) employer contributions to the plan. The schedule of funding progress reports the actuarial value of assets, the actuarial accrued liability, and the relationship between the two over time. The schedule of employer contributions reports the annual required contributions (ARC) of the employer(s) and the percentage of ARC recognized by the plan as contributions. The required schedules are accompanied by notes regarding factors that significantly affect the identification of trends in the amounts reported.

Plans are required to measure all actuarially determined information included in their financial reports in accordance with certain parameters. The parameters include requirements for the frequency and timing of actuarial valuations as well as for the actuarial methods and assumptions that are acceptable for financial reporting. If the methods and assumptions used in determining a plan's funding requirements meet the parameters, the same methods and assumptions are required for financial reporting by both a plan and its participating employer(s). However, if a plan's method of financing does not meet the parameters (e.g., the plan is financed on a pay-as-you-go basis), the parameters apply, nevertheless, for financial reporting purposes.

For financial reporting purposes, an actuarial valuation is required at least biennially for OPEB plans with a total membership (including employees in active service, terminated employees who have accumulated benefits but are not yet receiving them, and retired employees and beneficiaries currently receiving benefits) of 200 or more, and at least triennially for plans with a total membership of fewer than 200. The projection of benefits should include all benefits covered by the current substantive plan (the plan as understood by the employer and plan members) at the time of each valuation and should take into consideration the pattern of sharing of benefit costs between the employer and plan members to that point, as well as certain legal or contractual caps on benefits to be provided. The parameters require that the selection of actuarial assumptions, including the healthcare cost trend rate for postemployment healthcare plans, be guided by applicable actuarial standards.
OPEB plans with a total membership of fewer than one hundred have the option to apply a simplified alternative measurement method instead of obtaining actuarial valuations. This alternative method includes the same broad measurement steps as an actuarial valuation (projecting future cash outlays for benefits, discounting projected benefits to present value, and allocating the present value of projected benefits to periods using an actuarial cost method). However, it permits simplification of certain assumptions to make the method potentially usable by nonspecialists.

Multiple-employer defined benefit OPEB plans that are not administered as trusts or equivalent arrangements should be reported as agency funds. Any assets accumulated in excess of liabilities to pay premiums or benefits, or for investment or administrative expenses, should be offset by liabilities to participating employers. Required notes to the financial statements include a brief plan description, a summary of significant accounting policies, and information about contributions.

Defined contribution plans that provide OPEB are required to follow the requirements for financial reporting by fiduciary funds generally, and by component units that are fiduciary in nature, set forth in Statement 34 and the disclosure requirements set forth in paragraph 41 of Statement 25.

The requirements of GASB 43 for OPEB plan reporting are effective one year prior to the effective date of the related Statement for the employer (single-employer plan) or for the largest participating employer in the plan (multiple-employer plan). The requirements of the related Statement are effective in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999. Plans in which the sole or largest employer is a phase 1 government—with annual revenues of $100 million or more—are required to implement this Statement in financial statements for periods beginning after December 15, 2005. Implementation dates for the other two groups are discussed in more detail in the Statement. Early implementation is encouraged.

**Observation:** GASB 43 was written from the perspective of the plan itself or its administrator, as opposed to from the view of the participating employer. It is important for public institutions to distinguish between the requirements of GASB 43 and GASB 45. GASB 43 provides guidance on reporting for OPEB plans; GASB 45 provides guidance on accounting and valuation for OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information (RSI).

**GASB Concept Statement No. 3, Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements**

In 2005, the GASB issued Concept Statement No. 3, which clarifies the relationship of basic financial statements, notes to basic financial statements, and supporting information reported with basic financial statements within the framework of general purpose external financial reporting. It provides a conceptual basis for selecting communication methods to present items of information within general purpose external financial reports that contain basic financial statements. These communication methods include recognition in basic financial statements, disclosure in notes to basic financial statements, presentation as required supplementary information, and presentation as supplementary information.

Each of these communication methods is defined, and criteria are developed to help the GASB or, in the absence of authoritative guidance, a preparer of a financial report determine the appropriate methods to use to communicate an item of information. Using a consistent approach in the selection of communication methods should benefit users in understanding the location and nature of information in financial reports.

This Concepts Statement also addresses the necessary elements for the effective communication of relevant and reliable messages within financial reports. This includes a clarification of the roles and responsibilities of the preparer, the user, and the GASB for the effective communication of information.
GASB Exposure Drafts

Proposed GASB Statement, Accounting and Financial Reporting for Pollution Remediation Obligations

The GASB issued this Exposure Draft in January 2006. It is intended to provide guidance and consistency with respect to the accounting and reporting of obligations and costs related to pollution remediation.

Specifically, the Proposed Statement identifies the following circumstances under which a government would be required to report a liability related to pollution remediation:

- Pollution poses an imminent danger to the public or environment and a government has little or no discretion to avoid fixing the problem;
- A government has violated a pollution prevention-related permit or license;
- A regulator has identified or evidence indicates a regulator will identify a government as responsible for cleaning up pollution, or for paying all or some of the cost of the clean-up;
- A government is named in a lawsuit to compel it to address the pollution; or
- A government begins to clean up pollution or conducts related remediation activities.

This proposed standard would require liabilities, expenses, and expenditures to be estimated using an “expected cash flows” measurement technique and would require disclosures about pollution clean up efforts in the notes to the financial statements.

The requirements of this proposed Statement would be effective for financial statements for periods beginning after June 15, 2007. The comment deadline on this Statement is May 1, 2006.

Observation: If adopted, this exposure draft may have a significant impact to public colleges and universities that are aware of pollution remediation on their campuses.

Proposed GASB Statement, Sales and Pledges of Receivables and Future Revenues

This proposed Statement is designed to clarify existing guidance on accounting for sales and pledges of receivables and future revenues. It will address whether certain transactions should be regarded as a sale or a collateralized borrowing. In addition to clarifying guidance on accounting for sales and pledges of receivables and future revenues, the proposal will:

- Require enhanced disclosures for future revenues that have been pledged or sold
- Provide guidance on sales of receivables and future revenues within the same financial reporting entity
- Provide guidance on recognizing other assets and liabilities arising from the sale of specific receivables or future revenues.

The requirements for this proposed Statement would be effective for financial statements for periods beginning after December 15, 2006. The comment deadline on this proposed Statement has already passed.

Observation: This proposed Statement is especially pertinent to public colleges and universities who sell student loans. If adopted, it may have an impact to the accounting for and disclosures of these loans on the college’s or university’s financial statements.

This Proposed Technical Bulletin (TB) clarifies the application of existing standards of accounting and financial reporting to payments that an employer or a defined benefit or other postemployment benefit (OPEB) plan receives from the federal government under Medicare Part D in relation to prescription drug benefits (pursuant to the provisions of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003). Using a series of questions and answers, the TB provides that Medicare Part D payment to an employer from the federal government is a voluntary nonexchange transaction, as discussed in paragraph 7 of GAS 33. Accordingly, the payment is a separate transaction from the exchange of services for salaries and benefits (including postemployment prescription drug benefits) between employer and employees, for which the accounting is addressed in Statement 45. Therefore, a sole or agent employer should apply the measurement requirements of Statement 45 to determine the actuarial accrued liabilities, the annual required contribution of the employer (ARC), and the annual OPEB cost without reduction for Medicare Part D payments.

Likewise, an OPEB plan should apply the requirements of GAS 43 and measure the actuarial accrued liabilities, the ARC, and the annual OPEB cost without reduction for the Medicare Part D payments. The TB states that a Medicare Part D payment from the federal government to the plan is an on-behalf payment for fringe benefits, and should be accounted for as discussed in paragraph 7 of GAS 24.

This Technical Bulletin would be effective for financial statements issued after June 30, 2006, except for portions of answers pertaining specifically to measurement, recognition, or required supplementary information requirements of Statements 43 and 45. Those provisions should be applied simultaneously with the implementation of Statements 43 and 45. The deadline for comment on this proposed TB is April 17, 2006.

Observation: The proposed TB is especially pertinent to public colleges and universities where prescription drug benefits are provided to retirees. If adopted, it may have an impact on the accounting for and disclosures of these Part D payments on the college's or university's financial statements.

GASB Projects

A. Current Agenda Projects

Intangible Assets

Primary Objective: The aim of this project is to provide users of financial statements with more complete and comparable information about intangible assets used in providing government services. The project will expand upon the reporting requirements for such assets in Statement No. 34, Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments.

Status: A survey of exiting practice on reporting intangible assets was conducted in the fall of 2004 through the GASB's web site. Staff are currently analyzing the survey responses. Board deliberations are scheduled to begin in the second quarter of 2006, and an Exposure Draft is planned for the third quarter of 2006.

Derivatives and Hedging

Primary Objective: The objective of this project is to consider whether derivatives should be displayed at fair value on the statement of net assets and whether current derivative note disclosures are appropriate. If derivatives are displayed in the financial statements, consideration of hedge accounting will be necessary. Disclosures, such as derivative objectives, terms, and risks, also will be included within the scope of deliberations.
Status: During the final four months of 2005, the Board continued to develop a method of reporting derivatives based on fair value, allowing for hedge accounting if specific criteria are met. A Preliminary Views document is scheduled for the second quarter of 2006.

**Fund Balance Reporting**

Primary Objective: This project will assess whether existing reporting requirements related to fund balance reporting adequately meet the needs of financial statement users and will consider potential changes to improve the usefulness of fund balance information. The project’s scope was expanded to include a review of current governmental fund definitions in order to determine if any clarifications are needed to enhance users’ understanding of the information presented in those funds.

Status: The Board assessed potential fund balance display alternatives and agreed that before developing specific alternatives for public input, the definitions of fund types would be reviewed. This review will be used in part to determine what, if any, impact potential clarifications to those definitions could have on the fund balance display alternatives. A due process document, either an Invitation to Comment or a Preliminary Views document, is expected to be released in the third quarter of 2006.

**Conceptual Framework—Recognition and Measurement Attributes**

Primary Objective: This project has two primary objectives. The first is to develop recognition criteria for what information should be reported in state and local government financial statements and when that information should be reported. The second objective is to consider the measurement attribute or measurement attributes (e.g., historical cost or fair value) that conceptually should be used in governmental financial statements. This project will lead to a Concepts Statement.

Status: Deliberations are tentative schedule to begin in October 2006.

**Conceptual Framework—Elements of Financial Statements**

Primary Objective: The objective of this project is to define key elements of financial statements as well as to describe or define related concepts that primarily will guide the Board in establishing future standards. The project scope includes transactions and other events, specific elements (for example, assets and liabilities), and the interrelationship of elements.

Status: During the final four months of 2005, the Board continued discussing the inherent characteristics of assets, liabilities, inflows and outflows of resources, and deferred inflows and outflows of resources and developed tentative definitions for those elements. An Exposure Draft of a proposed Concepts Statement is planned for the third quarter of 2006.

**Other Projects**

For more information on other GASB projects (e.g., research guides, government combinations, electronic financial reporting), visit the GASB’s web site at [www.gasb.org](http://www.gasb.org).
IV. Regulatory Issues

We first highlight a proposed revision to an auditing standard that might significantly affect federal audits. Then we highlight issues affecting the regulatory environment as well as changes to the professional literature and regulatory standards.

Proposed New Auditing Standard

As reported in a previous section of this publication, the AICPA is replacing its current Statement on Auditing Standards (SAS) 60 with a new SAS, Communication of Internal Control Related Matters Noted in an Audit. The new SAS will incorporate the Public Company Accounting Oversight Board's (PCAOB's) definition of significant deficiency and material weakness from the PCAOB's Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.

The new SAS will impact institutions' OMB Circular A-133 audits. It may also impact grant audits conducted under various state regulations, because some states follow the federal reporting guidelines. The Government Accountability Office ("GAO") is planning to issue a revised Yellow Book for comment during 2006 which will incorporate changes in the requirements for auditing and reporting on internal controls, and is expected to include the new definitions contained in the proposed AICPA SAS. In addition, the OMB and federal agencies will revise the Compliance Supplement and specific federal agency program audit guides to incorporate the revised AICPA and GAO internal control standards. These revised standards will likely result in more internal control-related findings being reported to management/audit committees or significant deficiencies or material weaknesses and potentially included in A-133, state, and program audit reports.

Current Regulatory Environment

Organizations with federally sponsored research programs should monitor the following three areas very closely: a) time and effort reporting, b) export laws, and c) federal award reporting.

Time and Effort Reporting

Time and effort reporting is a challenging area, particularly for organizations that receive funding from the Department of Health and Human Services (HHS), which administers more grant dollars than all other agencies combined. In most federal awards, personnel costs (including direct labor charges, fringe benefits and the related indirect costs) represent—by far—the largest charges to the government. The HHS Office of Inspector General (OIG) and the Department of Justice have become increasingly aggressive in bringing charges for noncompliance with labor cost requirements as well as for overcharging for labor costs on federal awards. These cases often involve millions of dollars in repayments and fines.

The 2005 and 2006 HHS OIG audit plans include focused audits covering:

- Direct versus indirect charges
- Overcommitment of researcher effort on National Institutes of Health (NIH) award applications
- Assessment of how auditors assess and document organizational compliance with effort reporting requirements contained in A-21

The draft 2006 OMB Circular A-133 Compliance Supplement includes additional specific audit emphasis and procedures in this area, to reflect the continued concerns of granting agencies.

Observation: Federal recipients should be reviewing their time and effort reporting systems—and strengthening them where needed. As noted in our 2005 Summary of Emerging Issues, specific areas to address include, among others:
Summary of Emerging Issues for Colleges and Universities in 2006

- Timeliness of certification
- Completeness of the knowledge of the person certifying the effort
- Accountability of time incurred at other related and unrelated entities
- Reconciliation of actual effort to the effort committed via award documents
- Review of K Awards
- Review of central administration policies
- Review of effort report formats for OMB A-122 compliance
- Review of faculty appointments that include Veteran Administration (VA) hospital appointments and Memorandums of Understanding (MOUs)
- Review of PHS 398 budget forms for research faculty

In addition, symptoms of potential deficiencies in time and effort reporting systems might include:

- Missing or incomplete effort reports
- A high volume of cost transfers
- Multiple documents recording faculty effort
- Career awards (K Awards) that require 75% or more in effort commitments awarded to clinical faculty
- Incentive pay agreements that include specific clinical productivity targets
- Appointment letters that express faculty effort commitments to clinical and research activities

In particular, research organizations with characteristics such as the following should be aware of the potential risks associated with their time and effort reporting systems in the current environment:

- Rapid growth in clinical research
- Recent system implementations
- Closely affiliated Faculty Practice Plans
- Pre- and post-award processes that are outdated and understaffed
- Closely affiliated hospitals

Export Regulations
The U.S. export laws continue to be a compliance concern for colleges and universities that are engaged in the transfers of export-controlled technical data, as well as access of export-controlled technical data from foreign nationals. At the 2005 Annual Department of Commerce's Bureau of Industry and Security Update Conference in Washington, D.C., the government indicated that it is continuing to work with universities to help them comply with the Deemed Export Rule. Since then, the government has taken a number of enforcement actions against universities to ensure compliance.

The Deemed Export Rule states that a transfer of certain controlled source code or technology to a foreign national located in the United States is deemed to be an export to the home country of that individual and is therefore subject to U.S. export controls. To determine if the deemed export rule applies, universities must determine the reasons for control (i.e., national security, nuclear proliferation, etc.) associated with the technologies/source code and identify if these controls apply to the home country of the foreign national. If the controls do apply to the foreign national's home country, colleges and universities in the U.S. may be required to
secure export licenses from the Commerce or State Department before they can transfer or give access of controlled technical data to the foreign national. Many countries commonly trigger licensing requirements, depending on the degree of control associated with the technical data and the particular country involved. These countries can include so-called “business friendly” countries throughout the world, as well as embargoed countries, such as Cuba and Iran, that are highly restricted.

Failure to obtain the required licenses can result in substantial civil and criminal penalties, including monetary fines, loss of export privileges, reputation damage, and imprisonment.

Observation: Certain types of university-based research that qualify for the fundamental research and public domain exclusions may be exempt from export controls, including the deemed export rule, assuming universities meet the exclusions’ requirements. However, exemption from export controls requires careful analysis of the project activities and close scrutiny of contract and project terms (e.g., publication restrictions) to avoid disqualifications from the usage of such exclusions, as well as diligent compliance with several regulatory requirements. Note: A recent proposed regulatory change by the Defense Department may subject universities to more rigorous document and technology control requirements should the university-based research fall outside the scope of the exclusions. This proposed regulation is currently pending and is anticipated to be clarified over the next several months.

Federal Award Reporting Requirements

OMB Circular A-110 Section 51 requires the submission of a “Financial Status Report (FSR).” Federal awarding agencies establish the frequency of submission, generally not more than quarterly and at least annually. For example, according to the NIH Grants Policy Statement, reports generally should be submitted within 90 days after the close of the annual budget except for awards under the NIH Streamlined Non-Competing Award Process (SNAP) program, which requires an FSR to be submitted within 90 days of the end of the award or competitive segment.

Federal agencies are becoming increasingly concerned with the higher delinquency rate associated with both financial and technical reports. This problem is pervasive throughout the research industry.

In 2004, HHS, NIH Office of Inspector General (OIG) and the National Science Foundation (NSF) OIG issued reports detailing the magnitude of late reporting, which is substantially in the double digits. The HHS and NSF OIG reports include similar recommendations to NIH and NSF program management officials:

- Develop automated reminder systems
- Improve ability for electronic submission of documents
- Focus more attention on late reporting
- Consider withholding future funding until the researcher and/or organization is caught up on late reports

Observation: This is a complex problem. Organizational resources are constrained, reporting deadlines may be too tight, especially for complex awards involving subrecipients, and federal agencies sometimes cannot respond in a timely manner to organizational requests for additional information, thereby slowing down the process. In addition, there is a view at some at the federal level that the speed of research is too slow and, therefore, a reluctance to slow it further by withholding future awards. Organizations must work with the federal agencies to strike a reasonable balance. This will require auditors to exercise careful judgment when developing findings for late reporting.
**Changes to the Professional Literature and Regulatory Standards**

**Yellow Book**

In April 2005, the Government Accountability Office (GAO) issued *Guidance on GAGAS Requirements for Continuing Professional Education*, a revision to its 1991 *Interpretation of Continuing Education and Training Requirements*. This revision substantially updates the topics that are eligible for continuing education credit. The basic 80-hour and 24-hour rules remain; however, the new guidance does create a partial exemption for auditors who are involved only in performing fieldwork but not involved in planning, directing, or reporting on the audit or attestation engagement, and who charge less than 20 percent of their time annually to audits and attestations conducted in accordance with Government Auditing Standards.

The *Guidance on GAGAS Requirements for Continuing Professional Education* is available electronically at: [http://www.gao.gov](http://www.gao.gov). (Scroll down and click on “Yellow Book.”)

**Observation:** Many individuals who in previous years did not need to meet the 24-hour rule will now be required to follow that rule. This will be particularly burdensome to auditors who incur relatively few audit hours on yellow book-covered engagements.

**OMB A-133 Compliance Supplement**

The 2005 Compliance Supplement was effective for fiscal years ending June 30, 2005. There were no significant changes in the 2005 document relative to the 14 compliance requirements. OMB published in 2005 only the sections of the Compliance Supplement that contained changes from 2004. As such, it is necessary for the auditor to reference both the 2005 and the 2004 Compliance Supplements for accurate guidance. The 2005 and 2004 Compliance Supplements are posted at: [http://www.whitehouse.gov/omb/circulars/index.html](http://www.whitehouse.gov/omb/circulars/index.html). (Scroll down until you find the Supplement under OMB Circular A-133.)

The 2006 Compliance Supplement is currently being drafted by OMB, and is expected to be issued in the Spring of 2006. Significant changes in this draft currently include required auditing procedures under the Research and Development Cluster concerning the Bayh-Doyle Invention Act reporting rules and bio-safety compliance systems. Additional changes include required procedures surrounding cost transfers, effort reporting, and promises made to federal agencies by grantee institutions such as promises concerning staffing and support. Under the Student Financial Aid Cluster, major changes include testing of written agreements with other institutions to provide educational programs, and testing to ensure that all relevant campuses are noted in the institution’s ECAR. Part 3 of the draft Supplement contains changes to procurement, suspension and debarment testing, and cautions auditors to be alert for improper payments.

**Other Issues**

**National Single Audit Sampling Project**

The Department of Education (ED) and several other federal agencies, including HHS, NSF, the Department of Defense (DOD) and the Department of Housing and Urban Development (HUD), have designed a statistically valid approach to performing quality control reviews of Single Audits. Congress has provided several million dollars to fund this effort now called the National Single Audit Sampling Project. A report summarizing the results of this initiative will be provided to Congress as well as top federal agency officials in early 2006.

**Observation:** Substantially all quality control reviews have taken place. The results are now being evaluated and a report to Congress is expected, perhaps in July 2006.
Intercollegiate Athletic Programs: NCAA Requirements

Fiscal 2005 was the first year that members of The National Collegiate Athletic Association (NCAA) were required to comply with the amended legislation requiring agreed-upon procedures to be performed annually for Division I institutions and every three years for Division II institutions. Division III institutions are exempt from the agreed-upon procedures requirement as long as athletics department revenues and expenses are included in the institution's regular financial statement audit.

The changes require all Division I, II and III institutions to electronically submit financial data to the NCAA and require the submission of the agreed-upon procedures report to the institution's CEO by January 5th of each year.

The agreed-upon procedures guidance, dated March 31, 2005, specifies the format of the statement of revenues and expenses and the classification of revenues and expenses within that statement. The agreed-upon procedures guidance also addresses specific required disclosures that must accompany the statement related to:

- Disclosure of the methods of allocation of indirect expenses to the major intercollegiate sports programs;
- Significant changes to athletic department endowment or restricted fund balances;
- Contributions received by the athletics department;
- Policies and procedures for acquiring, approving, depreciating and disposing of athletics-related assets along with a schedule of assets that agrees to the institution's general ledger; and
- Repayment schedules for all intercollegiate athletics debt.

In its first year, the new agreed-upon procedures and reporting requirements have generated many questions. The NCAA has posted frequently asked questions to a FAQ web site, which can be accessed at: http://www1.ncaa.org/membership/ed_outreach/eada/faq_help.

This web site also contains key contacts at the NCAA to whom institutions may address questions on specific topics.

Observation: We encourage our clients to continue to review the reporting and disclosure requirements of the new agreed-upon procedures guidelines. Particular emphasis should be placed upon the agreed-upon procedures and reporting requirements concerning coaching staff compensation and support received from affiliated and outside organizations such as booster groups and alumni groups.
V. Tax Issues

Current Issues

Charity Reform
Although slowed by Hurricane Katrina, there continues to be growing momentum for charity reform legislation at the federal level. Legislative initiatives are continuing to evolve, and so we have provided web site addresses below where you can check their latest status.

In November 2005, the Senate passed the Tax Relief Act of 2005 (S. 2020), which contained, in addition to Hurricane Katrina relief, incentives to encourage charitable giving (e.g., allow tax-free distributions from IRAs for charitable purposes) as well as certain charitable reforms (e.g., require 990-T disclosure and certification relating to UBIT). In December 2005, the House passed its version of the tax act (H.R. 4297). The process of reconciling the differences in the legislation has begun.

The concerns of the higher education community include:

- Section 301 of the Senate bill would modify current law to allow nonitemizers to deduct cash charitable contributions in excess of $210 for single taxpayers and in excess of $420 for taxpayers filing a joint return. It would restrict deductions by itemizers to contributions in excess of the amounts applicable to nonitemizers.

- The proposal to require public disclosure of Forms 990-T would impose an obligation on exempt organizations that is not imposed on other taxpayers. Also, it is unclear what is meant by "certification" of unrelated business income. Such a requirement would impose additional expense on exempt organizations that is not imposed on other taxpayers.

- Section 306(c) of the Senate bill would require that Section 501(c)(3) organizations with gross income and receipts or assets of over $10 million file their returns with a certification by an auditor or counsel.

- There are new and complex regulatory guidelines for donor-advised funds in the Senate bill. It contains a number of provisions that could adversely affect charitable giving in situations where there has been no history of abuse and there is no reason to expect abuse will develop.

In the meantime, in early March 2006, the Senate Finance Committee staff hosted a roundtable to explore issues of nonprofit governance and accountability. Per the National Council of Nonprofit Associations (NCNA), the agenda included exploring recommendations of the Panel on the Nonprofit Sector (issued in June 2005 and available at [www.nonprofitpanel.org](http://www.nonprofitpanel.org)).

Observation: We encourage you to monitor the progress of legislative and other initiatives at the following web sites:

- Panel on the Nonprofit Sector: [http://www.nonprofitpanel.org](http://www.nonprofitpanel.org)
- American Counsel on Education: [http://www.acenet.edu](http://www.acenet.edu)
- National Council of Nonprofit Associations: [http://www.ncna.org](http://www.ncna.org)
Tax-Exempt Bonds
In keeping with its focus on targeted, limited scope audits, the Internal Revenue Service's Workplan for fiscal year 2006 includes an initiative to audit tax-exempt bonds. Prior initiatives in this area have been hampered by the difficulty the IRS has had in coordinating efforts between the exempt organizations and financial services groups. The Workplan indicates that the targets for review are questionable bond transactions and post-issuance compliance. The IRS anticipates conducting more than 20 but less than 50 limited scope audits of bond issues. We would anticipate that the focus for institutions whose bonds are reviewed will be on post-issuance compliance.

Tax-exempt bonds will lose their tax-exempt status if both the private use and private payment limitations are exceeded. Private use occurs when bond-financed property is used in the trade or business of an entity that is not tax-exempt. Private payments are revenue generated from private use. For private institutions, the limitation on private use and private payment is 5 percent. For public institutions, the applicable limitation is 10 percent. The private use/private payment limitations are reduced to the extent that proceeds are used for issuance costs. Up to 2 percent of bond proceeds may be used to fund issuance costs.

At the time of issuance, bond counsel would have engaged in a detailed review of all of the anticipated uses of and contracts associated with the financed facilities. Institutions need to review any post-issuance changes in the use of financed facilities. In particular, if bookstores or cafeterias are outsourced to third parties, the agreements should be reviewed to determine whether there will be private use/private payments as a result of the new agreements.

"Qualified management contracts" will not result in private use (see Rev. Proc. 97-13). The IRS will work with institutions to resolve violations of these rules where appropriate.

Observations: Institutions should review any changes in the use of bond-financed facilities subsequent to the issuance of tax-exempt debt to determine if there is private use in excess of the allowable limits. Any proposed contracts that involve the use of bond-financed space should be reviewed for compliance.

International Activities
Colleges and universities are frequently entering into collaborations with their counterparts in foreign countries. These collaborations may include joint education and/or sponsored research programs as well as consulting arrangements. Although colleges and universities may be considered tax-exempt organizations for United States income tax purposes, they may be subject to taxes and a variety of reporting requirements in foreign jurisdictions.

Various issues may arise as a result of foreign activities. For example, intellectual property may be developed out of these collaborations, and it could result in foreign tax implications. Professors, students and/or staff may travel to work in the foreign jurisdiction for periods ranging from a couple of days to well over a year; such activity may have tax implications for them as individuals.

The institution will need to review the specific facts of the arrangement to determine whether its activity will create a permanent establishment resulting in income tax nexus in the foreign jurisdiction. In addition, tax treaties should be reviewed as they may be applicable. There may also be withholding and other taxes associated with the activities. If there are tax liabilities associated with the program, it may be possible to negotiate for the foreign collaborator to assume responsibility for any tax liability and for the institution to receive its payment net of tax.

Professors, students and staff may enjoy the benefits of tax treaties that exempt payments made to them from taxes in the foreign country. It will be important to determine what steps, if any, are necessary for these individuals to minimize any foreign tax obligations.

Observations: It is important for institutions to understand the tax and registration requirements related to proposed activities in advance of entering into agreements. It is also important for them to be informed about potential foreign activities and contracts in advance of their implementation. Upfront planning is essential to assure tax compliance in the foreign jurisdiction and to understand the financial implications of each arrangement.
Treatment of Royalty Payments to Faculty and Researchers

Institutions typically require that professors and researchers transfer to them all rights to inventions and technology that they develop during their employment. Institutions generally have an arrangement that provides for the sharing of proceeds generated by the licensing or assignment of patent rights or intellectual property among the various parties, including the institution, the individual, and the department in which the individual works.

The question has been whether the proceeds that a professor/researcher receives from such an arrangement are considered compensation for services or royalty income. However, this matter has been clarified in a Technical Advice Memorandum; the Internal Revenue Service determined that the payments were not compensation for services but rather were payments related to the transfer of property. The development of technology was not considered a "work for hire." Payments resulting from the development of such technology are therefore not wages. As a result, the recipient of royalty payments associated with the licensing or assignment of a patent may be entitled to report the payments as capital gain and the institution would report the income to the individual on Form 1099-Misc. and not on their Form W-2. (TAM 117258-02)

**Observation:** Institutions should review their intellectual property sharing agreements to assure compliance with the facts set forth in the Technical Advice Memorandum.

Nonresident Alien Withholding

The withholding rules for wages paid to nonresident alien employees have changed for payments made after January 1, 2006. Employers no longer will be required to withhold an additional $7.60 from nonresident alien employees on a weekly payroll. Instead, for purposes of calculating income tax withholding only, employers will be required to add an additional $51 to the weekly wages of such employees. This additional amount will not be included in the employees’ Forms W-2 at year-end. This change will require that all nonresident alien employees complete a new Form W-4 and indicate "NRA" on line 6 of the Form. The IRS' intent in making this change is to minimize the amount of overwithholding on amounts paid to nonresident aliens.

**Observation:** Institutions need to obtain new Forms W-4 for nonresident alien faculty, students and staff. They also need to review their payment systems for compliance with the new regulations.

Form 990

Form 990 is an information return that federally tax-exempt organizations (other than state institutions) must file with the IRS annually. It provides information on the organization's financial transactions and activities over the course of a year.

An IRS team issued a draft of the revised Form 990 in December 2004 for comment. In early 2006, the IRS released the new tax forms for the 2005 tax year.

The 2005 return includes new questions about the organization's relationships with related parties. A new Part V-B has been added to Form 990 to request information about compensation and other benefits that former officers, directors, trustees, and key employees received from the organization. The new Form also asks whether the organization has a written conflict-of-interest policy.

**Observation:** It is likely that the IRS will further revise Form 990 for the 2006 tax year and require even more disclosures.
Electronic Filing

The IRS recently released regulations requiring certain tax-exempt organizations to electronically file (“e-file”) their Forms 990 beginning in 2006. For taxable years ending on or after December 31, 2005, the regulations provide that tax-exempt organizations with total assets of at least $100 million that file at least 250 returns during a calendar year must file electronically. For example, if a tax-exempt organization has 245 employees, each Form W-2 and quarterly Form 941 is considered a separate return; therefore, the organization files at least 250 returns (245 W-2s; four 941s; and one 990).

For tax years ending on or after December 31, 2006, the electronic filing requirements expand to include tax-exempt organizations with $10 million or more in total assets that file at least 250 returns. Additionally, private foundations and charitable trusts that file Form 990-PF will be required to file electronically, regardless of asset size, if they file at least 250 returns.

If an organization subject to the regulations fails to file its Form 990 or Form 990-PF electronically, the organization will be deemed to have failed to file the return. For organizations with gross receipts exceeding $1 million, the penalty for nonfiling is $100 for each day the failure continues, up to a maximum of $50,000 per return. In addition, the person responsible for nonfiling will be charged a penalty of $10 a day up to a maximum of $5,000, unless he or she shows that not complying was due to reasonable cause.

Organizations will need to file their return using an IRS-approved e-file provider. A list of approved e-file providers can be found on the IRS web site at: http://www.irs.gov/efile/lists/0,,id=119598,00.html. In addition to the Forms 990 and 990-PF, organizations may also file the extension, Form 8868, for these forms electronically. Form 990-T is expected to be available for electronic filing in 2007. Organizations that are not required to e-file can continue to file a paper return or file electronically. Tax-exempt organizations should check with the appropriate state agency to determine e-file requirements for state returns.

Observation: Institutions that are subject to the new e-filing requirement should consider well in advance of their return’s initial filing deadline whether they will use a tax professional to prepare the electronic return or if they will prepare and file their own returns. An organization that plans to prepare its own return should discuss electronic filing options with its software vendor as soon as possible and take steps to register and apply for electronic filing. Since the e-filing specifications do not allow attachments other than those prepared with the e-filing software, it will be important for institutions to determine how they can transfer data onto the returns and prepare required schedules in the most effective manner.

Compensation-Related Issues

Executive Compensation and Excess Benefit Transactions

Executive compensation continues to gain the attention of the IRS, the media, donors and others. In August 2004, the IRS announced the Tax Exempt Compensation Enforcement Project. The goal of this initiative is to identify and halt abuses by tax-exempt organizations that pay excessive compensation and benefits to their officers and other insiders.

As part of its “soft contact” initiative focused on compensation, the IRS has announced that it will send approximately 2,000 letters to tax-exempt organizations. These letters request information regarding the process used to determine compensation and benefits. In some cases, the IRS has decided to continue the dialogue with institutions through additional requests for information.

One of the primary areas of focus for the IRS is whether the organization is attempting to establish a rebuttable presumption of reasonableness for the compensation paid to their officers, directors, and key employees. A rebuttable presumption of reasonableness is established if the institution meets the following three requirements: 1) the compensation and benefits (especially deferred compensation plans) must be approved by the organization’s governing board, which must be comprised of persons who do not have a conflict of interest; 2) the governing board must rely upon appropriate data (i.e., comparables) in deciding whether to approve the compensation and benefits; and 3) the governing body must document its actions
(usually in the board’s minutes). The establishment of a rebuttable presumption of reasonableness puts the onus on the IRS to prove that compensation is unreasonable. If a “soft contact” is initiated, questions will be directed toward establishing whether the institution’s procedures met these criteria.

Observation: Organizations should make sure that their policies and procedures are sufficient to establish a rebuttable presumption of reasonableness as described above. Organizations frequently lack an appropriate level of documentation. Because documentation is essential for establishing a rebuttable presumption of reasonableness and because it has been a primary focus of the IRS, documentation should be an area of focus for tax-exempt organizations. Organizations also should consider other leading practices for executive compensation, including:

- Establishing a compensation committee;
- Developing a formal process to determine executive compensation; and
- Reporting compensation completely and accurately.

Expense Reporting

Similar to compensation, the IRS and the media are focused on situations where employees are being reimbursed for personal expenditures and these amounts are not reported as compensation. Therefore, it is essential that organizations make certain that their expense reporting procedures are adequate and are followed by both employees and officers.

Expense reports should be submitted on a timely basis, and they should include adequate documentation in order to satisfy the accountable plan rules. To satisfy these rules, receipts must be provided together with the name of the individual(s) involved and the business purpose for the expenditures.

Organizations also should establish appropriate policies regarding the approval and sign-off of expense reports submitted by senior management. For example, the CFO might sign off as to the completeness of the President's expense report and that it is in compliance with institutional policies. Trustees should periodically review the overall level of expenses incurred by the senior management for reasonableness. Such actions protect both the organization and senior management.

Observation: Organizations must establish adequate policies and procedures for reimbursing and documenting business expenses. They also should be aware that some “expenses” may constitute additional compensation. Organizations must identify and appropriately report additional compensation received by key employees through the reimbursement of nonbusiness-related expenses. Additional compensation that is not considered when establishing a rebuttable presumption of reasonableness may result in an automatic excess benefit transaction under Intermediate Sanctions. Therefore, we recommend that the board consider all forms of compensation, including the reimbursement of personal expenses, when considering whether their key employees are receiving reasonable compensation.

Nonqualified Deferred Compensation Plans of Tax-Exempt Organizations

The American Jobs Creation Act of 2004 (the “Jobs Creation Act”) added IRC §409A to the Internal Revenue Code (the “Code”) of 1986. IRC §409A addresses nonqualified deferred compensation and it applies to employees of both tax-exempt and taxable organizations. It has added an additional level of complexity to nonqualified deferred compensation plans.

Nonqualified plans maintained by tax-exempt employers are typically governed by IRC §457(f) of the Code. In this type of plan, amounts owed to an employee are taxed when there is no longer a substantial risk of forfeiture. Under IRC §457(f), a substantial risk of forfeiture exists when an employee must perform substantial future services in order to collect the compensation.
The rules under IRC §409A are more restrictive than those of IRC §457(f). Under IRC §409A, agreements not to compete and/or a rolling risk of forfeiture may not qualify as a substantial risk of forfeiture. IRC §409A applies when the payment of compensation that is earned and vested in one tax year is delayed and paid in a later year. This may occur if organizations and employees agree to extend the vesting date beyond the original date. At this time, the concern is that because a “covenant not to compete” does not qualify as a substantial risk of forfeiture, IRC §457(f) plans with such a covenant as the only substantial risk of forfeiture may be immediately subject to the IRC §409A rules.

The consequences of an agreement not conforming to the rules under IRC §409A are severe. All compensation deferred under the plan will become subject to federal income tax immediately and a 20 percent penalty on the amount of includible compensation will be added if the failure is not corrected within the statutory and regulatory guidelines. Transition rules allow amendment of agreements until December 31, 2006 that do not meet the new IRC §409A requirements.

The only types of programs excluded from the new regime are qualified retirement plans [including IRC §403(b)s, IRC §457(b)s, SEPs and IRAs], vacation, sick leave, compensatory time, bonus (if the bonus is payable within 2 1/2 months of year-end) and disability and death benefit programs. Among others, severance programs are not excluded from the definition and accordingly are potentially subject to IRC §409A.

Finally, the Jobs Creation Act contains other operational and documentation requirements for nonqualified deferred compensation plans. Failures in this regard will not accelerate taxation for IRC §457(f) plans, because taxation is delayed until the substantial risk of forfeiture expires (when amounts would already be subject to tax). However, because a failure to satisfy these additional rules may result in the imposition of penalty taxes in the amount of 20 percent of the compensation includible, employers should review and amend their plans to assure compliance.

Observation: Employers should take the following actions:

1. Inventory affected plans.
   *Inventory plans, looking not only at programs denominated as retirement plans, but also at employment agreements, severance policies, and other cash-based benefit programs. The Jobs Creation Act’s definition of nonqualified deferred compensation plans is very broad, and is not limited to programs between employers and employees. Thus, programs for directors or trustees and independent contractors would also be covered.*

2. Promptly review affected plans.
   *Once all affected plans are identified, they should be reviewed and amended, if appropriate. Revisions can be made until the end of 2006. The consequence of failing to “catch” and amend an affected plan may be current taxation of all amounts deferred for all years (as well as a 20 percent penalty tax when the amounts are included as compensation to the individual).*

Related Party Transactions with Trustees and Employees

In light of the Sarbanes-Oxley Act, there is a renewed interest in appropriate disclosure of related party transactions. In addition, the 2005 Form 990 includes new questions around related party transactions for officers, directors, and key employees. Therefore, organizations are looking more closely at these questions and, in many cases, are enhancing their disclosures.

Questions regarding related party transactions appear on Form 990, Schedule A, Part III and Part V, and certain state forms. Disclosure is required of certain transactions between the organization and its board members, key employees and the family members of board members or key employees. Disclosure is also required regarding certain transactions with for-profit organizations with which board members and key employees are affiliated.
Organizations should have procedures in place by which transactions with related parties are approved, documented, and disclosed. In addition, the related party should not participate in the organization’s decision to enter into the transaction. The related party’s nonparticipation in the decision process should be documented in the meeting records. Also, organizations should circulate annually to all officers, directors, and key employees a conflict-of-interest statement and questionnaire. The questionnaire should be completed, signed and returned. Organizations should review the questionnaires to identify those conflicts that may require disclosure on tax filings. Finally, key employees should review the disclosures to confirm that they are complete.

Observation: Related party transactions are not necessarily detrimental to the institution. Transactions with such parties can result in favorable pricing and greater access to opportunities that would otherwise be unavailable. However, they must be considered very carefully because they may result in an excess benefit to an insider that could result in Intermediate Sanctions being imposed. It is very important for colleges and universities to fully disclose related party transactions in tax filings. Organizations should review their current related party disclosures to make sure they are adequate and complete. Organizations may also compare their conflict-of-interest policies to the model policy released by the IRS in 2004 (See Form 1023, Appendix A).

Investments in Partnerships
Colleges and universities continue to diversify their endowment holdings through the use of alternative investments, particularly limited partnership investments. When an organization invests in a partnership, the organization must “look through” the partnership to the underlying activities to determine if those activities, if conducted directly by the tax-exempt organization, would be subject to tax or reporting had they been engaged in directly. This “look through” concept applies to all of the tax and reporting obligations described below including:

- Unrelated business income (federal and state)
- Reportable transactions (federal and state)
- Reporting of certain holdings in, and transfers to, foreign organizations

While this discussion focuses on partnership investments, it is important to note that all of the tax and reporting obligations listed above and described in detail below can arise outside of the partnership structure as a result of activities engaged in directly by the organization.

Continuing Issues
Unrelated Business Income
An investment in a limited partnership by a tax-exempt organization may give rise to federal and state unrelated business income (UBI) tax, regardless of the tax status of the other partners. The test here, as in all other UBI determinations, goes to the nature of the activity pursued by the partnership. If the partnership is involved in an activity that would be an unrelated trade or business activity if it were directly carried on by the organization, the participation by the organization in such a partnership does nothing to change the character of the activity carried on by the partnership. Therefore, an organization’s allocable share of gross income from a partnership pursuing an unrelated activity constitutes UBI.

Although a partnership’s revenue may be from passive investments, a percentage of its income may be unrelated if there is debt financing. In addition, the partnership’s activities may create state tax nexus for its partners that may result in a state UBI tax liability. Over 35 states impose a tax on UBI.
Summarized Emerging Issues for Colleges and Universities in 2006

Reportable Transactions
The reportable transaction regulations promulgated by Treasury (Treas. Reg. §1.6011-4) require disclosure of reportable transactions entered into on or after February 28, 2003. These regulations are applicable to tax-exempt organizations. In 2005, a number of states also introduced requirements where organizations that are filing reportable transactions at the federal level may also have to file with certain states. At this time, at least five states (CT, CA, NY, IL, and MN) require a separate state filing for reportable transactions.

The American Jobs Creation Act of 2004 added substantial penalties (up to $200,000) that generally cannot be waived for failure to comply with the regulations. The penalty for failure to properly report a listed transaction (described below) is $200,000 and the penalty for failure to properly report any other reportable transaction is $50,000. The $200,000 penalty may not be waived. The $50,000 may be waived only if “rescinding the penalty would promote compliance with the requirements of this title and effective tax administration” (IRC §6707A (d)). Guidance issued in January 2005 states that noncompliance cannot be cured by refiling a tax return with the necessary disclosure attached.

The first category is listed transactions, which are transactions that the IRS has specifically identified along with substantially similar transactions. Because tax savings generally represent a significant part of the economic benefit, it is not likely that tax-exempt organizations would intentionally or directly engage in these transactions since they would not benefit from the tax savings. It is possible, however, that a tax-exempt organization might be involved in a listed transaction as an intermediary or through an investment in a limited partnership.

Organizations should be alert to potential issues if they are approached to act as an intermediary in a tax-motivated transaction. Also, exempt organizations may indirectly engage in listed transactions when they invest in a limited partnership, and they must disclose these transactions.

The second category is confidential transactions. These are transactions in which the taxpayer signs an agreement with a paid advisor not to disclose the income tax treatment or structure of the transaction. Again, since most tax-exempt organizations would not benefit substantially from income tax savings, we have not seen tax-exempt organizations involved in confidential transactions.

The third category is transactions with contractual protection where the taxpayer’s fees are contingent upon realizing the intended tax result. This category applies only to income taxes. Therefore, a contingent fee arrangement with respect to a claim regarding employment taxes is not covered by this category.

The fourth category is excessive loss transactions. Two types of transactions are included in this category. The first type is capital loss transactions where the deductible loss per transaction exceeds $10 million in a single year ($20 million in a combination of tax years) for a taxpayer that is a corporation. When the taxpayer is an individual or a trust, a deductible loss per transaction in excess of $2 million in a single year ($4 million in a combination of tax years) must be reported.

The second type is loss from currency transactions under IRC §988. When the taxpayer is a corporation, IRC §988 losses in excess of $10 million must be reported. When the taxpayer is an individual or a trust, IRC §988 losses in excess of $50,000 must be reported. Some tax-exempt entities that have invested in limited partnerships that are engaged in foreign currency hedging have received information from the partnerships regarding the potential need to disclose such transactions.

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1 The IRS has created a web site on which current reportable transactions and other tax shelter information is summarized: http://www.irs.gov/businesses/corporations/. Click on “Abusive Tax Shelters and Transactions.”
The fifth and final category is transactions where the taxpayer holds an asset for a brief period (45 days or less) and claims a tax credit of more than $250,000. Again, it is not likely that tax-exempt organizations will enter into such transactions. (Note that a sixth category, substantial book-tax differences was recently removed from the list of reportable transactions.)

**Enhanced Foreign Reporting Requirements**

Over the last few years, more reporting requirements have been established for organizations that engage in certain transactions with foreign partnerships and foreign corporations. Penalties are associated with the failure to satisfy the filing requirements.

1) Certain Holdings in, and Cash Transfers to, Foreign Corporations - Form 926 and Form 5471

Tax-exempt organizations that make certain transfers to a foreign corporation and/or hold certain interests in a foreign corporation are required to report these activities to the IRS on Form 926 and/or Form 5471. Transactions that require disclosure on Form 926 include transfers of more than $100,000 to a foreign corporation during any twelve-month period that ends within the organization’s fiscal year. In addition, certain direct or indirect holdings in a foreign corporation of ten percent or more may require reporting on Form 926 and/or Form 5471. These reporting requirements most commonly occur when an organization invests in a partnership that invests in a foreign corporation.

2) Investments in Foreign Partnerships - Form 8865

Tax-exempt organizations that make certain transfers to a foreign partnership and/or hold certain interests in a foreign partnership are required to report these activities to the IRS on Form 8865. Transactions and holdings that require disclosure include transfers of more than $100,000 to a foreign partnership during any twelve-month period that ends within the organization’s fiscal year, holdings of more than ten percent in a foreign partnership, and holdings in a foreign partnership that drop below ten percent.

**Observation:** It is important for colleges and universities to institute appropriate policies and procedures to assess and manage the federal and state tax obligations and the reporting obligations that arise from partnership investments. This includes having in place a process by which those who are responsible for tax planning are informed when the organization is considering entering into a partnership investment so that it can be reviewed for potential tax and reporting implications. The organization should maintain a master list of all partnership investments to ensure that it receives a Schedule K-1 for each investment on an annual basis. The Schedules K-1 should be reviewed when they are received to determine if any of the following arise.

- **UBI both Federal and State:** Estimated tax payments should be made if UBI is generated. Federal UBI should be annually reported on Form 990-T. Many states also impose a tax on UBI. Therefore, it is important for organizations to determine in which states they have state tax filing obligations.

- **Foreign Reporting Requirements:** These requirements are frequently overlooked by tax-exempt organizations. These reporting requirements are occurring more frequently since many investment vehicles have moved overseas to avoid generating UBI. Although tax-exempt organizations were not the primary target for the added reporting, tax-exempt organizations are not exempt from the requirements. Therefore, compliance is important since penalties for failure to comply are significant. Organizations should identify direct and indirect transfers to foreign partnerships and foreign corporations to determine if reporting is required.

- **Reportable Transactions:** It is important that organizations be aware of these rules as the penalties for failure to report are extremely severe and, in many cases, are nonwaivable. In addition, the failure to file cannot be cured by filing an amended return with the reporting attached. Therefore, it is critical that organizations are knowledgeable about the rules and are diligent about reviewing transactions and investments when there is any possibility that disclosure may be required.
Summary of Emerging Issues for Colleges and Universities in 2006

To date we have observed that colleges and universities are most likely to encounter reportable transactions in connection with partnership investments. Generally, the reportable transactions are in connection with currency hedging but we have also seen references to listed transactions.

Because of the severe penalty regime, we recommend that organizations circulate a letter to the partnerships in which they have invested, and ask them to confirm whether there are any reportable transactions resulting from the investment. It is also important that determinations made on this issue are appropriately documented for future reference.

Charitable Contributions of Patents and Similar Intellectual Property
The Jobs Creation Act has put more emphasis on matching the true economic value of donated patents to the amount of charitable deduction the donor is reporting on his or her tax return. As of June 3, 2004, a charitable contribution deduction for a patent or other intellectual property is limited to the lesser of the donor’s basis in the property or the fair market value of the property. The donor is also allowed additional charitable deductions in the year of contribution and future years for a percentage of income generated by the intellectual property, ranging from one hundred percent in year one to ten percent in year twelve.

The donor must notify the charity at the time of the contribution of the donor’s intent to treat the contribution as a qualified intellectual property contribution. “Qualified intellectual property” is generally defined as any patent, copyright, trademark, and so on with certain exceptions. The institution must report annually to the donor via Form 8899 the amount of income that was generated from the property during the year. The charity is also required to file a copy of Form 8899 with the IRS. Form 8899 should be filed by the charity each year the intellectual property generates net income, for up to ten years after the date of donation.

Observations: This new provision requires that an institution track the proceeds it receives from the transfer of intellectual property and report to the donors annually for a period of ten years. It will be important that institutions develop a process to implement these requirements.

Information Reporting Requirements – Procurement Cards
Colleges and universities continue to be challenged by information reporting requirements associated with procurement cards ("P Cards" as they are commonly known). As a result of regulations issued in July 2004, certain payments for services made through P Cards are subject to information reporting requirements on Form 1099-MISC as if the organization (i.e., the cardholder/payor) made the payment directly to the merchant/payee. Since payments made through P Cards are subject to reporting on Form 1099, they also are subject to back-up withholding if the cardholder/payor does not have the merchant/payee’s taxpayer identification number (TIN).

Effective for payments made after December 31, 2004, P Card payments are not subject to backup withholding if they are made through a “qualified payment card agent” (QPCA) to a “qualified payee.” A QPCA is a payment card organization that has a current QPCA determination from the IRS. In general, a payee is a “qualified payee” if, at the time of the payment, the QPCA has validated the payee’s TIN through the IRS’ TIN matching program. The QPCA must notify the cardholder/payor of any merchant/payees that are not qualified.

The IRS has also released two related Revenue Procedures. Rev. Proc. 2004-42 provides an application procedure for payment card organizations acting, or seeking to act, as a QPCA. Rev. Proc. 2004-43 provides an optional procedure that payors, or their agents, may use in determining whether payment card transactions are reportable payments. The Revenue Procedure classifies businesses by merchant category codes (MCCs) according to whether they are predominantly furnishing services (which are reportable) or goods (which are not reportable). A payment card organization can assign MCCs to merchant/payees that accept its payment cards and notify cardholder/payors of the industry code assigned to the merchant/payee. A cardholder/payor may rely on the MCC assigned to a merchant/payee in determining whether a payment card transaction is subject to reporting.
Observation: In many cases organizations have found that achieving compliance with these new regulations is difficult. Compliance is particularly challenging where an organization's credit card company is not a QPCA or where their credit card company became a QPCA mid-year and was not able to provide the needed information for all of 2005. Organizations should move toward compliance in this area. They should review their agreements with credit card issuers to determine whether they are QPCAs. Also, P Card issuers are continuing to improve their ability to provide information that enables organizations to comply with these new requirements and, therefore, it is likely that an organization's ability to comply will improve in 2006.
VI. For More Information

PricewaterhouseCoopers is a leading provider of professional services for colleges, universities, academic medical centers (AMCs), and other types of not-for-profit organizations. For more information about our education and nonprofit services, call us in the U.S. at 1-888-272-3236 or visit our web site at www.pwc.com/education.

About Our Firm

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VII. Recent Higher Education Publications

Our publications, which can be downloaded at no charge from our web site at www.pwc.com/education, include:

*Enhancing the Transparency of Financial Reporting*, which was published in 2006, is designed to frame the issues and guide the discussion of voluntary transparency as it might broadly apply to the financial reports of colleges and universities.

*Internal Controls: The Key to Accountability*, which was published in 2005, is designed to help trustees, business officers and other senior managers of public and private research universities as well as smaller private colleges understand the components of an effective system of internal controls as well as how internal controls can be enhanced.

*The Changing Role of the Audit Committee*, which was published in 2004, highlights leading audit committee practices and includes samples of such documents as an audit committee charter.

*A Foundation for Integrity*, which was published in 2004, provides board members and senior executives with an overview of the issues surrounding codes of conduct, conflicts of interest and executive compensation.

*Meeting the Challenges of Alternative Investments*, which was published in 2004, highlights four fundamental issues posed by alternative investments: selection, monitoring, valuation, and reporting.

*Understanding Underwater Endowment Funds*, which was published in 2003, addresses the financial accounting and reporting impact of underwater endowment funds and some of the business issues caused by the existence of such funds.

*Developing a Strategy To Manage Enterprisewide Risk in Higher Education*, which was published in 2001 by PricewaterhouseCoopers and NACUBO, this paper presents risk management theory, examples of approaches being taken by the for-profit corporate sector, and the discussions held with higher education leaders about managing risk effectively in today’s dynamic higher education environment.

**Points of View**

In 2005, we launched our “Point of View” series, which offer our perspective on emerging technical issues and higher education industry-related business developments. We have published the following points of view, which can be downloaded at no charge from our website at www.pwc.com/education:

- Enhancing Financial Reporting Controls Beginning with the Closing Process
- Managing Technology Risks
- The Intellectual Property Horizon
- The Importance of Training Programs