NACUBO Advisory Guidance

Defining an Operating Measure for Independent Colleges and Universities

March 31, 2011 (originally issued January 5, 2007)

In January 2007, NACUBO's Accounting Principle Council (APC) published this position paper in an effort to provide recommendations to independent colleges and universities on items that should be classified as **nonoperating**. These items arise from other than the mission-related activities of the institution and, as a result, would best be reflected outside of the operating activity of the entity. In addition, the activity will likely be presented in either the investing or financing sections of the Statement of Cash Flows.

With the codification of accounting standards by the Financial Accounting Standards Board (FASB) and new issuances and updates to those standards, NACUBO has revised the recommendations as follows:

- "Gains and losses on sale of long-lived plant assets that are incidental or peripheral to central operations" has been removed. Because this type of transaction does not meet the criteria to be considered a discontinued operation it, therefore, should be included in income/loss from continuing operations.
- "Cumulative effect of a change in an accounting principle & prior period adjustments and corrections of errors of prior periods" has been removed as subsequent FASB pronouncements have changed the way in which these items are presented in the financial statements. See further discussion about this change on page 15, Accounting Changes and Error Corrections.
- References to specific FASB pronouncements have been updated to reflect the relevant sections in the Accounting Standards Codification (ASC).

A substantial percentage of independent colleges and universities voluntarily report an intermediate operating measure on their statement of activities, as permitted under generally accepted accounting principles (GAAP). However, there has been no standardized definition of operations for higher education. For independent institutions that provide an operating measure, the APC recommends that the following items be classified as **nonoperating**. In other words, these transactions or events should normally be separately reported within the changes in Unrestricted Net Assets.

1. Investment gains or income in excess of the institution's spending policy.

2. Net assets released from restrictions related to capital additions or acquisition of long-lived assets [contingent on Net Asset Release policy, see below].*

3. Gifts restricted by donors for capital purposes (acquisition of long-lived assets) if the institution’s policy is to record gifts as UNA when expended within same fiscal period.

4. Changes in value of split-interest agreements reported in UNA.

5. Change in value of derivatives that are not part of the investment portfolio e.g., interest rate hedges or swap contracts related to institutional debt.

6. Gains & losses associated with the issuance, restructuring, and extinguishment of debt.

7. Changes in net assets related to pension and other postretirement benefits other than net periodic costs (as reported under ASC 958-715)

8. Extraordinary gains and losses from unusual or infrequently occurring events.

9. Result of discontinued operations & impairment of long-lived assets that are part of a discontinued operation.

This is not intended to be an exhaustive list nor is complete consensus anticipated. For example, some institutions exclude unrestricted estate gifts from operating since their internal board policy would designate these for capital or future endeavors. The same rationale that is used to defer unrestricted undistributed investment income to nonoperating can be used to say these bequests are nonoperating. However, arguments for including these transactions are also prevalent, e.g., the gift was the result of operating activities, i.e., fundraising. Moody’s and S&P both classify unrestricted estate or bequests as operating since they consider it “available” for operating and is a result of management’s value adding activities. In either case, if these are reported as nonoperating then disclosure within the footnotes would be appropriate.

This report is organized as follows:
(1) Illustrative example of a statement of activities with an intermediate operating measure
(2) Tables for each transaction or event which include examples and an expanded discussion
(3) Background for the project
(4) Theoretical discussion of the basis for our conclusions

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[*] Institutions that adopt a policy implying time restrictions on long-lived assets acquired with gifts restricted for those acquisitions would treat the net asset release as **operating over time** as depreciation is recognized. Without adoption of this policy these would be treated as **nonoperating**. The choice of policy also affects the third item, gifts restricted by donors for capital purposes when the gift is recorded in UNA.

EDUCATIONAL INSTITUTION
Illustrative Statement of Activities
Measure of Operations – FASB Format A
Single Column Format

Changes in unrestricted net assets:	
Operating:	
Revenues and gains:	
Tuition and fees, net of scholarship allowances	$XXX
Contributions	XXX
Contracts and other exchange transactions	XXX
Investment return distributed	XXX
Auxiliary services	XXX
Total unrestricted revenues and gains	XXX
Net assets released from restrictions	XXX
Total unrestricted revenues, gains and other support	XXX
Expenses and losses:	
Educational and general	
Instruction	XXX
Research	XXX
Public services	XXX
Academic support	XXX
Student services	XXX
Institutional support	XXX
Total education and general expenses	XXX
Auxiliary enterprises	XXX
Total expenses	XXX
Increase (decrease) in unrestricted net assets from operating activities	XXX
Nonoperating:	
Investment return on endowment, undistributed	XXX
Fire loss	(XXX)
Change in value of split interest agreements	XXX
Net assets released from restrictions	XXX
Increase (decrease) in unrestricted net assets from nonoperating activities	XXX
Increase (decrease) in unrestricted net assets	XXX
Changes in temporarily restricted net assets:	
Contributions	XXX
Present value adjustment to annuity obligations	XXX
Investment return undistributed	XXX
Net assets released from restrictions	(XXX)
Increase (decrease) in temporarily restricted net assets	XXX
Changes in permanently restricted net assets:	
Contributions	XXX
Investment return undistributed	XXX
Change in value of split interest agreements	XXX
Change in value of perpetual trust held by others	(XXX)
Increase (decrease) in temporarily restricted net assets	XXX
Net assets at beginning of year	XXX
Net assets at end of year	$ XXX

EDUCATIONAL INSTITUTION
Illustrative Statement of Activities
Measure of Operations – FASB Format B
Multi-Column Format

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Operating:				
Revenues and gains:				
Tuition and fees, net of scholarship Allowances	$XXX	-	-	XXX
Contributions	XXX	XXX	-	XXX
Contracts and other exchange transactions	XXX	-	-	XXX
Investment return distributed	XXX	XXX	-	XXX
Auxiliary services	XXX	-	-	XXX
Total revenues and gains	XXX	XXX	-	XXX
Net assets released from restrictions	XXX	(XXX)	-	-
Total revenues, gains and other support	XXX	XXX	-	XXX
Expenses and losses:				
Educational and general				
Instruction	XXX	-	-	XXX
Research	XXX	-	-	XXX
Public services	XXX	-	-	XXX
Academic support	XXX	-	-	XXX
Student services	XXX	-	-	XXX
Institutional support	XXX	-	-	XXX
Total education and general expenses	XXX	-	-	XXX
Auxiliary enterprises	XXX	-	-	XXX
Total expenses	XXX	-	-	XXX
Increase (decrease) in net assets from operating activities	XXX	(XXX)	-	XXX
Nonoperating:				
Contributions	XXX	XXX	XXX	XXX
Investment return undistributed	XXX	XXX	XXX	XXX
Fire loss	(XXX)	-	-	(XXX)
Change in value of split interest agreements	XXX	XXX	-	XXX
Change in value of perpetual trust	-	-	XXX	XXX
held by others	-	-	XXX	XXX
Net assets released from restrictions	XXX	(XXX)	-	-
Increase (decrease) in net assets from nonoperating activities	XXX	XXX	XXX	XXX
Increase (decrease) in net assets	XXX	XXX	XXX	XXX
Net assets at beginning of year	XXX	XXX	XXX	XXX
Net assets at end of year	$ XXX	XXX	XXX	XXX

Table 1	Investment gains or income in excess of the institution's spending policy
Example	Most institutions have adopted the total return concept for endowment spending which allows institutions to determine the amount of income distribution by considering current yield as well as both realized and unrealized net gains. The amount of return not distributed but reinvested would be treated as nonoperating.
Survey Fischer, et al. (2004)	The majority of institutions that reported an operating measure displayed undistributed or reinvested investment income as nonoperating revenue while the income authorized by the endowment spending policy for programmatic activities was reported as operating revenue. Only a few (5/85) reported all investment income as operating revenue. Some portion of investment gains from current or prior years might be included in operating revenue if investment income fell below the spending formula. [1] Also mentioned in this report was KPMG's recommendation that investment gains or income in excess of the institution's spending policy should be excluded from operations.[2]
FASB / AICPA / FARM	Gains and losses which may be peripheral to one organization may be central to another and consequently meet the Concepts Statement 6 definition of "Revenues." Also, "Financial reporting should provide information about the relation between inflows and outflows of resources during a period...In this way, financial reporting may provide information that is useful in assessing whether the activities of a nonbusiness organization during a particular period have been drawn upon, or have contributed to, past or future periods. Thus it should **show the relation of resources used in operations of a period** [emphasis added] to resource inflows available to finance those operations. "[3] Undistributed investment gains or income not drawn upon for current period operations should be identified. It could be argued that a portion of current earnings relate future operating periods to ensure "generational equity." This principle, found within endowment management circles, is applied when determining appropriate spending levels. One could also make the argument that it is industry practice to report undistributed investment income as nonoperating revenue, per Fischer, Gordon et al. Survey.
Rating Agencies[4]	Moody's treats undistributed earnings as nonoperating and calculates the operating portion by allowing 5% of the 3-year-average of beginning Cash & Investments into operating revenue. They indicated that it would be very helpful if the institution explained its spending policy within the footnotes. Difficulties do occur when institutions add supplemental draws to their spending for various reasons and this is often not counted as "spending" by the institution. S & P also considers undistributed investment earnings to be nonoperating.

[1] Fischer, et al. (May 2004)

[2] KPMG LLP and Prager, McCarthy & Sealy, LLC (1999), *Ratio Analysis in Higher Education: Measuring Past Performance to Chart Future Direction, For Independent Institutions* (4th ed., KPMG LLP)

[3] Statement of Financial Accounting Concepts # 4 ¶ 49

[4] Comment was received for each of the "top 10" from Susan Fitzgerald, Moody's Investment Services and Susan Carlson, Standard & Poor's

Advised Treatment	Investment gains or income in excess of the spending policy should be nonoperating. Investment income and gains utilized by an institution to fund unrestricted operations would be classified as operating revenue. It is “matched” or related to operating expense. The excess gains or losses above the spending rate are presumed to relate to future reporting periods. Supplemental disclosure of the institution’s spending rate and supplemental withdrawal policies for the fiscal period would be useful.

Institutions that do not adopt a policy implying time restrictions on long-lived assets acquired with gifts restricted for those acquisitions would treat the following (Table 2) as **nonoperating**. Those adopting the implied time restriction policy would recognize donor-restricted long-lived assets as **operating** over the life of the asset (as depreciation occurs).

Table 2	**Net assets released from restrictions related to capital additions or acquisition of long-lived assets [contingent on Net Asset Release policy, see above]**
Example	The university received a $10 million gift for the construction of a building which was recorded as temporarily restricted. The building was completed in year two. The $10 million was released or reclassified to unrestricted. This release of temporarily restricted net assets would be classified as nonoperating. However, if the institution had adopted the policy to record the plant as temporarily restricted net assets and release the assets from restriction, generally in accord with the depreciation schedule, the release would be operating.
Survey Fischer, et al. (2004)	Disclosure regarding the lifting of temporarily restricted to unrestricted was less than adequate. Only 27 percent disclosed a detailed breakdown specific to program restrictions met (e.g., capital versus operating), and 56 percent disclosed only the total amount. Most institutions with an operating section (51 out of 70) included an amount for net assets released from restrictions within the changes in unrestricted net assets.
FASB / AICPA / FARM	Institutions may adopt a policy that will imply a time restriction on long-lived assets and the restrictions expire as the economic benefits of the acquired assets are used up.[5] If an organization adopts such a policy, the contributions received should be reported as restricted support that increases temporarily restricted net assets. Depreciation should be recorded over the asset's useful life, and net assets should be reclassified periodically from temporarily restricted to unrestricted as depreciation is recognized. When an organization adopts a policy under which no donor-imposed time restrictions are implied then all restrictions expire when the long-lived asset is placed in service by the organization. [6]
Rating Agencies	Moody's indicated this transaction would not be operating, however, if an institution adopted the policy to match the net asset release over the life of the long-lived asset then no reclassification to nonoperating is necessary. However, only a small percentage of institutions have adopted this latter policy. Moody's would find it useful if the disclosure requirement would always include "Net Assets released for acquisition/construction of long-lived assets" if such exists. S & P would consider this to be nonoperating.
Advised Treatment	This would be nonoperating. However, this would be considered operating revenue if an institution adopted the policy to release the restriction over the life of the long-lived asset.

[5] FASB ASC 958-605-45-6

[6] AICPA *Audit and Accounting Guide, Not- for-Profit Entities,* March 1,2010, ¶5.77

Institutions that do not adopt a policy implying time restrictions on long-lived assets acquired with gifts restricted for those acquisitions would treat the following (Table 3) as **nonoperating**.

Table 3	**Gifts restricted by donors for capital purposes (acquisition of long-lived assets) if the institution's policy is to record gifts as unrestricted net assets when expended within same fiscal period**
Example	Similar to the example in Table 2, above. The university received a $10 million gift for the construction of a building except that the gift and expenditure for the building occurred in the same fiscal year. The gift for the building was recorded as unrestricted since the purpose restriction was met in the same period. This unrestricted gift would be nonoperating.
Survey Fischer, et al. (2004)	Unrestricted contributions were split between operating and nonoperating by 44 of the 70 institutions that displayed contributions in both the operating and nonoperating sections. The reason for the distinction was rarely found.[7] KPMG's ratio analysis publication recommended that gifts to be used for capital purposes should be excluded from operating.[8]
FASB / AICPA / FARM	FASB ASC 230, Statement of Cash Flows, classifies receipts from contributions for the purposes of acquiring or building long-lived assets as a *financing* activity. Two observations can be made: 1) gifts for long-lived assets are nonoperating in the statement of cash flow, and 2) a mismatch in revenues (gifts) and expense (depreciation) does occur when 100 percent of capital gifts are displayed as unrestricted operating revenue while only a portion of the long-lived costs (depreciation) flow through the changes in unrestricted net assets.
Rating Agencies	Moody's and S & P would consider this to be nonoperating.
Advised Treatment	This should be nonoperating. The disclosure requirements of the adoption of this policy, mentioned previously, are strongly encouraged.

[7] Fischer, et al. (May 2004)

[8] KPMG et al. (1999)

Table 4	Changes in value of split-interest agreements
Example	The university has various charitable gift annuity contracts where the assets are general assets of the institution and the liability to the beneficiaries is a general liability of the institution. The agreements do not contain provisions restricting the use of the assets. During the term of the agreement, certain transactions and events are recognized as "changes in the value of split-interest agreements" in the Statement of Activities. These transactions and events include the amortization of discount associated with the contribution and the revaluation of expected future payments to beneficiaries (based on changes in life expectancy and other actuarial assumptions). The change in value of split interest agreements is nonoperating.
Survey Fischer, et al. (2004)	These were reported by 15.6 percent of the institutions reporting an operating measure. [The low percent may be due to the fact that most changes flow through Temporarily Restricted Net Assets rather than Unrestricted Net Assets]. Institutions were not consistent in reporting gains and losses associated with split-interest agreements and annuitants. Some reported these as operating, while others reflected them as nonoperating. Some institutions displayed the changes in the revenue section, some displayed in the expense section, and some did not specifically display the item – presumed buried in ‘other’ revenue.
FASB / AICPA / FARM	During the term of the agreement, certain transactions and events should be recognized as “changes in the value of split-interest agreements” in the Statement of Activities and classified consistent with the initial classification of the contribution. These transactions and events include the amortization of discount associated with the contribution and the revaluation of expected future payments to beneficiaries (based on changes in life expectancy and other actuarial assumptions). [9] Annuity payments reduce annuity liability. Adjustments to the annuity liability to reflect amortization of the discount and changes in the life expectancy of the donor or spouse should be recognized as changes in the value of split-interest agreements and recognized in the statement of activities.[10]
Rating Agencies	Moody’s and S & P would consider this to be nonoperating.
Advised Treatment	This is nonoperating. These transactions fit many of the characteristics of gains or losses that would be peripheral or incidental, i.e., that which stems from the environment and beyond the control of management.

[9] FARM ¶ 431.2

[10] AICPA *Audit and Accounting Guide Not-for-Profit Organizations*, March 1, 2010, ¶6.55

Table 5	**Change in value of derivatives that are not part of the investment portfolio e.g., interest rate hedges or swap contracts related to institutional debt**
Example	The university entered into an interest rate swap agreement with a lender to effectively convert a variable rate bond issue to a fixed interest rate. The underlying fair market value of the swap contract changes due to the fluctuation in market interest rates. The change in fair market value of the swap contract is nonoperating.
Survey Fischer, et al. (2004)	N/A
FASB / AICPA / FARM	FASB ASC 815, *Derivative and Hedging*. All derivatives should be recognized as either assets or liabilities and measured at fair value.
Rating Agencies	Moody's and S & P would consider this to be nonoperating.
Advised Treatment	This is nonoperating. These transactions fit many of the characteristics of gains or losses that would be peripheral or incidental, i.e., that which stems from the environment and beyond the control of management.

Table 6	**Gains & losses associated with the issuance, restructuring, and extinguishment of debt**
Example	The balance of a debt issue is $6,161,572, i.e., $6,000,000 plus unamortized premium of $161,572. The institution issues new debt with a lower interest rate and calls (retires) the old debt, as provided for in the legal documents associated with the old debt, for $6,250,000. This results in a loss of $88,428:
	Bonds Payable 6,000,000 Premium on Bonds 161,572 Loss on Redemption of Bonds 88,428 Cash paid to call the bonds 6,250,000 The loss would be nonoperating.
Survey Fischer, et al. (2004)	N/A
FASB / AICPA / FARM	The difference between the reacquisition price and net carrying amount of the extinguished debt must be recognized as a separate item in the Statement of Activities. The net carrying amount of debt is the amount due at maturity adjusted for any unamortized premium, discount, or bond issuance costs. FASB ASC 860, *Transfers and Servicing*
Rating Agencies	Moody's and S & P would consider this to be nonoperating.
Advised Treatment	This would be nonoperating. Several factors would impact this classification. These transactions fit many of the characteristics of gains or losses that would be peripheral or incidental, i.e., that which stems from the environment and beyond the control of management (e.g., prevailing interest rates and its impact). Additionally, these amounts are classified as financing activities in the statement of cash flows.

Table 7	Postretirement benefit plan changes not recognized in expense
Example	Actuarial gain or loss for the year is recognized in the process of recording the net obligation on the balance sheet. In addition, amortization of unrecognized actuarial gain/loss in excess of corridor and amortization of any prior service or transition amounts are included in net periodic postretirement benefit costs but must be reversed out of unrestricted net assets. These changes are reported as a separate line on the statement of activities. The FASB explicitly permits these items to be reported as nonoperating.
Survey Fischer, et al. (2004)	N/A
FASB / AICPA / FARM	According to FASB ASC 715-45-1 a NFP shall recognize as a separate line item or items within changes in unrestricted net assets, apart from expenses, the gains or losses and the prior service costs or credits amounts not included in net periodic benefit expense.
Rating Agencies	N/A
Advised Treatment	Include among nonoperating items if an intermediate operating measure is reported (see the example in FASB ASC 958-715-55-4). Otherwise, report as a separate line item not included in reported total expense (example in FASB ASC 958-715-55-8).

Transactions, which have been defined as nonoperating by FASB pronouncements, are included in Tables 8 and 9.

Table 8	**Extraordinary gains and losses from unusual and infrequently occurring events**
Survey Fischer, et al. (2004)	Four of 207 annual reports included an extraordinary item as a change in unrestricted net assets.
FASB / AICPA / FARM	FASB ASC 958-225-45-10 & 11 states that if an intermediate measure of operations (for example, excess or deficit of operating revenues over expenses) is reported, it shall be in a financial statement that, at a minimum, reports the change in unrestricted net assets for the period. Some limitations on an NFP's use of an intermediate measure of operations are imposed. For example, if a subtotal such as income from operations is presented, it shall include the amounts of both of the following losses or costs: 1. An impairment loss recognized for a long-lived asset (asset group) to be held and used, 2. Costs associated with an exit or disposal activity that does not involve a discontinued operation. 3. A gain or loss recognized on the sale of a long-lived asset (disposal group) that is not a component of an entity Gains or losses are distinguished by their unusual nature and the infrequency of their occurrence (Refer to FASB ASC 225-20-45 for criteria for presentation as extraordinary items.)
Rating Agencies	Moody's and S & P would consider this to be nonoperating.
Advised Treatment	This would be nonoperating per FASB ASC 958-225.

Table 9	**Result of discontinued operations & impairment of long-lived assets that are part of a discontinued operation**
Example	A business decision was made to sell a dorm building resulting in a loss or impairment. While this normally is a non-reoccurring transaction, the student housing activity of the institution was not discontinued; therefore, the loss had to be treated as operating. Only if the entire university student housing operations were discontinued could the impairment or loss be treated as nonoperating. Impairment would require recognition if the revenue-generating ability of the dormitory declined because students no longer wanted to share rooms with other students causing low occupancy rates.
Survey Fischer, et al. (2004)	Two annual reports included discontinued operations line items but only one was reported within the change in unrestricted net assets.
FASB / AICPA / FARM	FASB ASC 958-225-45-10 & 11 states that if an intermediate measure of operations (for example, excess or deficit of operating revenues over expenses) is reported, it shall be in a financial statement that, at a minimum, reports the change in unrestricted net assets for the period. Some limitations on an NFP's use of an intermediate measure of operations are imposed. For example, if a subtotal such as income from operations is presented, it shall include the amounts of both of the following losses or costs: 1. An impairment loss recognized for a long-lived asset (asset group) to be held and used, 2. Costs associated with an exit or disposal activity that does not involve a discontinued operation. 3. A gain or loss recognized on the sale of a long-lived asset (disposal group) that is not a component of an entity FASB ASC 360, *Property. Plant and Equipment*, specifies the criteria for determining when a long-lived asset should be classified as being held for sale (360-10-05-5), how the impairment loss is determined (360-10-35-23 through 35-28), and related matters. FASB ASC 205-20-50 provides information on disclosures required for discontinued operations. An operating unit level test for impairment when a long-lived asset does not have an independent cash flow will likely mean that this loss will be atypical, except in institutional 'distress' situations.[11]
Rating Agencies	Moody's and S & P would consider this to be nonoperating.
Advised Treatment	This is nonoperating per FASB ASC 958-225. An impairment of an asset that is not considered part of a discontinued operation would be included as an operating item. This type of loss would be similar to a correction in the estimate depreciation and the assets useful life. See FASC ASC 205-45-1 through 45-5.

[11] NACUBO Accounting Tutorial *Impairment or Disposal of Long-lived Assets*

Accounting Changes and Error Corrections

The issuance of FAS 154 in 2005 changed the way that changes in accounting principle and correction of prior period errors were reported. In general, both of these items require retrospective application with the effect of the change reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented with any offsetting adjustment made to the opening balance of net assets. As a result, no amounts related to the cumulative effect of the change would be presented in the statement of activities.

The exception is when codification guidance specifically addresses the transition requirements as was the case with FASB Staff Position 117-1issued in 2008. That guidance stated "…an organization shall report any resulting net asset reclassifications in a separate line item within the organization's statement of activities for that period, outside a performance indicator or other intermediate measure of operations, if one is presented."

For further information on this topic, refer to FASB ASC 250-10-45.

Background for Project

What Measure?

The Change in Unrestricted Net Assets (UNA) is the only measure of current operating performance specifically mentioned in SFAS No. 117[12]. Institutions may report an intermediate measure of operations however it was clear from the AICPA task force that as it “tried to find a universal definition of ‘operations’ in a not-for-profit environment, differences in the use of that term became more apparent. In fact, it became clear that distinctions based on operations tend to be arbitrary.”[13]

At its January 2004 planning meeting, The Accounting Principles Council (APC), outlined several key issues to be addressed:

- Develop a list of the significant transactions or events that are normally excluded from changes in Unrestricted Net Assets in defining an operating measure
- Evaluate how these relate to the research undertaken on operating measures[14]
- Identify what FASB or AICPA standards, or other selected GAAP principles might contribute to this issue
- Request comment from external users of financial statements, i.e., Moody’s Investors Service (Moody’s), Standard & Poor’s (S&P)

FASB pronouncements identify only a few transactions and events that must be reported as nonoperating. These include extraordinary gains and losses, cumulative effect of changes in accounting principles, prior period adjustments, and the result of discontinued operations and impairments of long-lived assets that are part of a discontinued operation.

That this is inadequate has been attested by many external financial statement users and discussed at length in other reports and forums[15]. In a survey by Fisher, Gordon, et al., it was determined that 59 percent of the survey respondents report an intermediate measure of operations within the changes in UNA.[16] However, SFAS No. 117’s flexibility in the definition of an intermediate measure has resulted in reporting comparability problems between

[12] FASB exceptions from Changes in Unrestricted Net Assets do require separate display of income from discontinued operations, extraordinary gains and losses, and the cumulative effect of a change in accounting principle.

[13] Financial Accounting Standards Board, FASB (1993), *Statement of Financial Accounting Standar*ds (SFAS) No. 117 – *Financial Statements of Not-for-Profit Organizations*, ¶ 66-69

[14] Mary Fischer, Teresa P. Gordon, Janet Greenlee and Elizabeth K. Keating, Measuring Operations: An Analysis of US Private Colleges and Universities’ Financial Statements, *Financial Accountability & Management*, 20(2) May 2004, pp. 125-151.

[15] Proceedings NPEC/NACUBO forum – Institutional Operating Measures, September 13-14, 2000

[16] Mary Fischer, Teresa P. Gordon, Elizabeth Keating and Janet Greenlee, “When Operating Measures Don’t Add Up,” *NACUBO Business Officer*, Vol. 37, No. 7, January 2004, pp. 33-36.

institutions.[17] These differences in definition between institutions often rest on the fact that their underlying reporting objectives for the operating measure differ and even agreement of what is meant by "operations" is fluid.

The operating measure definition proposed in this paper focuses on the Changes in the Unrestricted Net Asset category after non-operating adjustments rather than changes in the Temporarily Restricted Net Asset category[18].

Basis for Conclusions: Concepts and Theory:

Some institutions have reporting objectives intended to create a link between the financial statements to their pre-existing budget and planning practices,[19] and some institutions have as the objective the reporting of financial performance from operations, broadly defined. Some institutions will define the term "Operations" more narrowly, e.g., exclude auxiliary activities or certain plant expenses, i.e., depreciation or interest. Since these options and others are allowed within the FASB framework and are considered acceptable, the operating measure definition tends to vary to the degree that these reporting objectives differ.

If, however, [1] a specific definition of "operations" is clearly stated and [2] a common reporting objective is developed then the elements of the operating measure (what to include or exclude) become clearer, resulting in greater consensus and consistency.

[1] Definition of Operations

The very first question to be resolved is this: What is meant by the term '*operations*'? The answer isn't as straightforward as it first appears. The accounting literature often defines the term *operations* by default. SFAS No. 95, *Statement of Cash Flow*, first defines financing and investing activities and then states the rest is operating[20]. This is fine for the cash flows statement but it falls short when one tries to expand the principle to the statement of activities. A recent

[17] Larry Goldstein, *To Measure or Not To Measure – That's Still in Question*, Business Officer, August 2002

[18] The proposed operating measure is focused on changes within the Unrestricted Net Asset group rather than changes in Temporarily Restricted Net Assets. Only the UNA class matches expenditures, "central operating activities", with revenues available for the current reporting period. Some institutions report TRNA gifts and endowment distributions under the operating section since these funds were generated from operations and are intended to fund expenses in future reporting periods. These revenues eventually flowed into UNA operating revenues as restrictions are released and reporting them within TRNA operating may contribute to predicting future inflows into UNA.

[19] Financial Accounting and Reporting Manual for Higher Education, FARM Release 03-4, ¶205.44

[20] FAS Statement of Financial Accounting Standards No. 95, ¶ 21, indicates Operating activities include all transactions and other events that are not defined as investing or financing activities. However, the exclusion of all items defined as investing would not be acceptable by institutions that typically report a portion of realized gains on investments as operating. Credit rating agencies also allow a portion of gains as operating revenues in their definitions.

report on Financial Performance measures by the G4+1 follows similar lines of thinking,[21] however, the report did attempt to develop broad characteristics of transactions or events that are typical of operating and typical of nonoperating.[22]

The G4+1 Report states, ¶ 2.9 "One of the most controversial issues in reporting financial performance is the classification of items into operating activities and other gains and losses." ¶2.10 "More specifically, the effect of price changes on assets and liabilities is often remote from the day-to-day activities of the entity." And ¶2.12 "Those items that would be reported in operations share similar characteristics, as do those that would be reported as other gains and losses." The characteristics typical of each group may be arrayed as follows:

Characteristics more typical of operating activities:	**Characteristics more typical of other gains and losses (nonoperating activities):**
Recurring	Non-recurring
Non-holding items	Holding items
Internal events (e.g., value adding activities)	External events (e.g., price changes)

FASB 117's discussion on the intermediate operating measure acknowledges this definition problem. "Because terms such as *operating income*, *operating profit*, *operating surplus*, *operating deficit*, and *results of operations* are used with **different meanings** [emphasis added], if an intermediate measure of operations is reported, it shall be in a financial statement that, at a minimum, reports the change in UNA for the period."[23] SFAS No. 117 ¶165 specifies, "if an organization's use of the term operations is not apparent from the details provided on the face of the statement, a note to financial statements should describe the nature of the reported measure of operations or the items excluded from operations." However, the Fischer, Gordon, et al. Survey indicated that nearly half (49 percent) made no explanatory disclosure.

The basic problem remains: "*Where do you go when authoritative guidance is silent on a specific issue or problem?"* FASB has stated that one should look to the Concept Statements for general direction when faced with problems in the absence of applicable authoritative pronouncements.[24] Although the Concept Statements are not included within tier a-d of GAAP hierarchy they do provide a general framework of objectives and concepts from which an answer can be developed[25].

[21] Canadian Institute of Chartered Accountants *Reporting Financial Performance: Proposals for Change Recommendations of the G4+1*, Invitation to Comment, October 15, 1999

[22] Canadian Institute of Chartered Accountants, (1999), p. 10

[23] Financial Accounting Standards Board, FASB (1993), *Statement of Financial Accounting Standar*ds (SFAS) No. 117 – *Financial Statements of Not-for-Profit Organizations,* ¶ 23

[24] Statement of Financial Accounting Concepts # 1, page 6 "That knowledge [of the objectives and concepts used by FASB] if used with care, may also provide some guidance in resolving new and emerging problems of financial accounting and reporting in the absence of applicable authoritative pronouncements."

[25] Proposed Statement of Financial Accounting Standards, The Hierarchy of Generally Accepted Accounting Principles, ¶ 5 (April 28, 2005)

Operations Defined

Concepts Statement # 6 describes an organization's "Central Operations" broadly.[26] It would:

1. Include the ongoing major activities by which it attempts to fulfill its basic function of providing goods or services to its constituency:
   - Service-providing efforts
   - Most fund-raising activities
   - Most exchange activities with other entities
2. Include within operating revenue the gains and losses that may be substantially related to the central activities of the organization[27]
3. Exclude the gains and losses that are peripheral or incidental to central operations:
   - Results from interactions with environments, e.g., price changes, casualties
   - Results partly or wholly beyond the control of management

After adjustments for gains and losses that are peripheral or incidental rather than central to the institution, ***essentially all remaining expenses, which flow through unrestricted net assets, would be considered central or core operations.*** Accepting this broad definition for *operations* one would include all auxiliary activity expense, all fund raising costs, and all plant expenses (e.g., repair and maintenance, depreciation, and interest).[28]

Essential to the definition of ***operating revenue*** is:

1. The degree to which transactions are related to these operating expenses, i.e., matching principle. Since contributions are considered operating, then fundraising expenses normally would be also.[29]

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[26] Statement of Financial Accounting Concepts # 6 ¶113. "A not-for-profit organization's **service-providing efforts [emphasis added]**, most of **its fund-raising activities**, and **most of its exchange transactions** with other entities are generally **ongoing major activities that constitute the organization's central operations** by which it attempts to fulfill its basic function of providing goods or services to its constituency and thus are the sources of its revenues and expenses. Its gains and losses result from **activities that are peripheral or incidental** to its central operations and from **interactions with its environment**, which give rise to price changes, casualties, and other effects that may be partly or wholly **beyond the control of** individual organizations and **their managements**."

[27] Statement of Financial Accounting Concepts No. 6 ¶113. Items that are revenues (or expenses) for one kind of organization may be gains (or losses) for another. For example, donors' contributions are revenues to many not-for-profit organizations but are gains to others that do not actively seek them and receive them only occasionally.

[28] Statement of Financial Accounting Concepts No. 6 ¶ 162 …This Statement reaffirms the conclusion in the 1983 Exposure Draft that how an asset was acquired and whether and how it will be replaced are not germane to whether or not the entity's using it up results in an expense. Some respondents to the Exposure Draft had suggested that depreciation often should not be an expense (or cost) of a not-for-profit organization, in part because the related assets were, and their replacements are expected to be funded by contributions or special assessments.

[29] Marvin J. Gross, Jr., Richard F. Larkin, and John H. McCarthy, *Financial and Accounting Guide for Not-For-Profit Organizations*, Sixth Edition, (John Wiley & Sons, Inc. 2000) 332.

2. The degree to which revenues relate to the specific reporting period[30], and
3. The degree to which transactions or events are peripheral or incidental,[31] e.g., does the transaction relate to the core activities or is it under the control of management?

Some gains/losses will be operating. Operating revenues would initially include all unrestricted gifts, excepting gifts restricted by the donor for long-lived assets – which may not match depreciation equally. One would also include revenue from government grants and contracts since they are exchange transactions. For many institutions research grants are a major operational activity.

[2] A Common Reporting Objective

Three reporting objectives were suggested from the NPEC/NACUBO forum.[32] A Financial operating measure should provide useful information for:

1. Making resource allocation decisions;
2. Assessing services and the ability to provide services in the future (internal strength of the college or university); and
3. Assessing management stewardship and performance and providing information about
   economic resources

All of the above objectives are supported by the Concept Statements, however, objectives with constraining characteristics are needed to help guide in determining what transactions or events should be included or excluded from an operating measure.

The 'constraining' objectives that can be derived from the Concept Statements are as follows:

1. **The measure should reflect the activity of central operations, broadly defined**.[33]

The implication is that operations 'broadly' defined would include all expenses, after adjustments for gains or losses that are peripheral or incidental.

2. **The measure should reflect the activity that was substantially within the control of management.**
3. **The measure should <u>not</u> include activity that is only peripheral or incidental to operating activities, e.g., interactions with its environment, which give rise to**

[30] FASB Statement of Financial Accounting Concepts No. 6 ¶ 145 & 147. The exclusion from operating of gifts restricted by donors for long-lived assets, net assets released from restrictions for long-lived assets, and undistributed investment earnings are guided by this concept.

[31] Statement of Financial Accounting Concepts No. 4, ¶ 49; No. 6, ¶ 113

[32] Proceedings NPEC/NACUBO forum – Institutional Operating Measures, September 13-14, 2000, page 1-2

[33] FASB Statement of Financial Accounting Concepts No. 6 ¶ 113

price changes, and casualties.[34]

Management control will vary by degree. The term is more narrowly defined as management's determined value adding activities which are undertaken to fulfill the institution's mission. Consequently, gifts would be considered operating since the institution's fund raising activities or other programs were planned and executed with the expectation of favorably influencing donor support. Other items, e.g., uninsured fire loss, would be non-operating if it is peripheral and incidental to mission related activities.

4. **The measure should reflect related revenues to related expenses for central operations.**
5. **The measure should reflect financial performance for a specific period.**

Identification of resources drawn upon to support operations and that relate to the current reporting period are central to distinguishing between operating vs. nonoperating. FASB Concepts #4 ¶49 states that "...financial reporting *must distinguish between resource flows that are related to operations and those that are not*. In this way, financial reporting may provide information that is useful in assessing whether the activities of a nonbusiness organization during a particular period have drawn upon, or have contributed to, past or future periods. Thus, *it should show the relation of resources used in operations of a period to resource inflows available to finance those operations* [Italics added]." Displaying undistributed investment earnings as nonoperating draws its rationale from this objective.

6. **The measure should reflect financial performance that is predictive of future results**.

The measurement of transactions and events that are reoccurring, thus providing a predictive element, are essential for determining whether the institution's financial strength is increasing or decreasing. Information that helps in the assessment of performance and management's likelihood to repeat that performance is an essential characteristic of an operating measure. FASB Concept #4 (¶ 39 & 44) contains this thought: "nonbusiness organization cannot, in the long run, continue to achieve its operating objectives unless the resources made available to it at least equal the resources needed to provide services at levels satisfactory to resource providers and other constituents…Financial reporting should provide information…that helps resource providers and others **identify** the organization's **financial strengths and weaknesses**, evaluate information about the organization's **performance during a period**, and assess its ability to continue to render service. [Emphasis added]" The operating measure display should allow for sufficient disaggregation so users can weigh transactions and events that are recurring differently from those that are "one-off" type events.

These conceptual points can be seen in FASB's *Financial Performance Reporting Project*.[35] The project's specific objectives were "[1] to improve the quality of information displayed so that

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[34] FASB Statement of Financial Accounting Concepts No. 6 ¶ 113

[35] FASB website, "Financial Performance Reporting by Business Enterprises," Last updated January 8, 2004, http://www.fasb.org/project/fin_reporting.shtml

investors and creditors could better evaluate an enterprise's financial performance. [2] It also concluded that the project should ascertain that sufficient information is contained within the financial statements to permit calculation of key financial measures used by investors and creditors." Their tentative conclusion stated that the principal objective is to develop standards that enhance **the predictive and feedback value** [Emphasis added] of the information presented in the statement of income. The report also affirms the importance of seeking specific feedback from bond credit rating agencies regarding their views of an operating measure definition.