

**Nonrecourse Financing Accounting & Reporting:
An Occasional Paper on
Recent FASB & GASB Guidance**

by Larry Goldstein, CPA

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Dear Higher Education Professional:

George K. Baum & Company is pleased to publish the occasional paper entitled *Nonrecourse Financing Accounting & Reporting: An Occasional Paper on Recent FASB & GASB Guidance*, authored by Larry Goldstein, CPA. This occasional paper is an update to the previously published white paper entitled *Nonrecourse Student Housing Financing Accounting & Reporting: A White Paper on Recent FASB & GASB Guidance*, originally dated November 2002.

Nonrecourse student housing financings have increased considerably in the last few years. My firm maintains a database of these project-based financings (posted at www.gkbaum.com/education/StudentHousing-List.pdf). It lists 215 projects completed or pending in 29 states, totaling over \$5.2 billion.

There has been a continued interest in the appropriate accounting for debt of special purpose entities that serve colleges and universities. We felt it would be a useful service to the higher education community to engage Larry Goldstein to prepare an updated comprehensive analysis of the most recent accounting standards for nonrecourse student housing project debt. This is timely given the latest release of both GASB and FASB guidance on the topic.

Larry Goldstein is a recognized authority on higher education accounting. He is a former senior vice president of NACUBO and head of its Center for Accounting, Finance and Institutional Management. He is a CPA and previously served as chief financial officer for the University of Louisville and controller for the University of Virginia. He also serves on a GASB Advisory Board.

We are very grateful to the 2005 NACUBO Accounting Principles Council members, as well as representatives of Grant Thornton, KPMG, and PricewaterhouseCoopers. These individuals provided invaluable feedback and suggestions for enhancing this occasional paper. However, neither these professionals nor NACUBO are responsible for the contents and conclusions of this occasional paper. Furthermore, George K. Baum & Company exercised no editorial control over the content of this occasional paper.

Additional copies of this occasional paper can be obtained by contacting me at 800.722.1670 or by downloading a PDF version at www.gkbaum.com/education/research.

Sincerely,

GEORGE K. BAUM & COMPANY

Lee White
Executive Vice President
Manager, Education & Non-Profit Finance Group

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by Larry Goldstein, CPA

Background

Colleges and universities (hereinafter referred to collectively as colleges or institutions) have become increasingly dependent on unique financing and development arrangements for various capital projects. This is especially true for the financing, development, and construction of auxiliary enterprise facilities such as residence halls and/or apartment-style complexes. These unique arrangements are another example of the increasing trend toward outsourcing or privatization within higher education. At every level, and in almost every area, institutions are engaging outside resources to perform non-core activities. This allows college staff to focus on those unique efforts that define success for the college.

As used in this paper, the term *nonrecourse* refers to situations involving debt for which an institution has no obligation to pay. Another entity is obligated to repay the debt, and creditors have no ability to obtain payment from the institution. In these situations the institution, its students, or employees benefit from a project developed, constructed, and/or operated by one or more third parties (who are obligated to repay the debt). These third parties, referred to as nonrecourse financing entities, exist, or are created, to fulfill the institution's needs for new or upgraded facilities for various purposes.

Opportunities for nonrecourse financing abound, but one area in particular has generated the largest number of arrangements to date. Institutions are finding themselves with a shortage of adequate residential space for a variety of reasons, including increasing student enrollment, past neglect of facilities, and higher student expectations. These factors have created an immediate need for improved residential space. The increased expectations are part of an overall trend of students rejecting traditional residence hall accommodations in favor of increased privacy and state-of-the-art amenities. Although many campuses have

invested significantly in upgrading and/or renewing residence halls, others have been unable to keep pace with the demand and have elected to pursue nonrecourse financing to obtain the needed beds.

For public institutions, the reasons for choosing nonrecourse financing are fairly obvious. The time needed to work through state processes and obtain required approvals can be substantial and can lead to significant cost increases for capital projects. In addition to the extra administrative cost related to the various processes, construction costs escalate monthly. Many business officers estimate that it can take anywhere from 12 to 18 months longer to develop and complete a project working through state processes as compared with a private commercial environment. Even in the most favorable economic climate, this delay can increase the overall construction cost of a project anywhere from 5 to 10 percent or more.

As used in this paper, the term nonrecourse refers to situations involving debt for which an institution has no obligation to pay.

Private institutions have their own bureaucratic requirements, but these are rarely so significant that they alone would justify reliance on outsourced financing or development arrangements. For private institutions, the decision to pursue unique financing and/or development tends to be driven by two factors. First, private institutions seek to preserve their borrowing power and, to the extent possible, their credit worthiness as demonstrated through various financial ratios and bond covenants. The utilization of alternative project development and financing is one possible way in which to accomplish this.

Furthermore, private institutions typically do not have access to a state agency available to assist with the multitude of tasks required to develop and complete a construction project. This may not be a major problem for larger institutions, but it can be a significant issue at a smaller institution in which the college staff must bear the administrative burden. With

the increased volume of campus construction, it makes sense to utilize the college staff for more complex and unique projects such as athletic, research, or other academic facilities. While residence halls and related projects are important to an institution's overall success, they do not possess the same level of complexity as a research facility. As such, they are ideal candidates for an outsourced approach.

The same trends are occurring on community college campuses, but for different reasons. Many community colleges are creating on-campus residential facilities for the first time in their history. This introduces an entirely new set of responsibilities, and rather than addressing it with internal staff, they are frequently turning to outsourcing to accomplish their objectives.

This paper focuses on the various factors that influence the accounting treatment for these arrangements and their implications for financial reporting. While there is no single development model for achieving an institution's objectives, it is fairly common for a college or university to rely on a separate entity (e.g., a third-party corporation—usually a not-for-profit organization) to serve as owner of the project. This entity, which typically is independent of the college, can be established in various ways. Depending on the specific decisions made, the nonrecourse student housing project terms may result in differing accounting treatment. Possible treatments include consolidation (or blending) of the activity within the college's audited financial statements, separate display of the entity's financial information, note disclosure of the details of the arrangement, or the absence of any reference to the project in the college's financial statements or accompanying notes. The appropriate accounting treatment will depend upon the fact situation of each project's financing, ownership, management, and operating arrangements.

As a result of the different paths taken by the Financial Accounting Standards Board (FASB)

and the Governmental Accounting Standards Board (GASB), the financial reporting of nonrecourse student housing financings is not governed by a single set of standards. In addition, various committees of the American Institute of Certified Public Accountants (AICPA) have established accounting standards applicable to colleges and universities. For ease of presentation, the reporting by private institutions is discussed separately from that of public institutions.

Factors Affecting the Accounting Treatment

The following factors are some of the items that, when considered together, determine whether a financing entity is likely to be included in the financial statements of the college (either through consolidation, blending, or discrete display), disclosed in the notes to the college's financial statements, or omitted entirely from the financial reporting by the college. Except where indicated, no single factor is determinative of financial reporting treatment. Each project and its unique characteristics must be examined to determine how it should be treated for financial reporting purposes.

It is important to note that not all factors apply in every case. Some factors which have importance in situations involving public institutions have little or no relevance to situations involving private colleges, and vice versa. The specific factors of greatest significance for the respective sectors are discussed later in the paper.

Possible treatments include consolidation (or blending) of the activity within the college's audited financial statements, separate display of the entity's financial information, note disclosure of the details of the arrangement, or the absence of any reference to the project in the college's financial statements or accompanying notes.

- **Ownership of the entity** is a critical determinant of the reporting treatment. If a college establishes or utilizes a separate entity to carry out the development and construction of a project and retains ownership of the entity, then the entity will be included in the college's financial reporting. The method for accomplishing this might vary based on the college's classification as a public or private

institution. Nevertheless, in either case, the entity's financial activity will be included with that of the college for financial reporting purposes. [For purposes of this discussion, ownership refers to traditional structures (e.g., stock in a corporation or equivalent arrangements). Arrangements that may represent ownership in substance, but not actual form, are addressed below.]

- **Control of the entity** refers to the amount of authority and responsibility the college has for the entity created or utilized to carry out the development and construction of a project. A college may not own the foundation or other not-for-profit organization (NFP) utilized in the financing, but it may still control it. Control can derive from the power to appoint a majority of the board members or be established by contract. (For instance, an NFP and a college may enter into an agreement in which the NFP receives certain benefits in exchange for giving the college the right to approve the appointment of the NFP's officers.) In either case, the accounting treatment is likely to be the same as in situations when a college owns an entity. The entity's financial results will be included with those of the college for financial reporting purposes. If one of the goals of the transaction is to avoid consolidation, it is best that the entity be truly independent of the college and not under its control.
- **Economic interest in the entity**, coupled with control of the entity through a majority voting interest, also results in the entity's financial results being reported with those of the college. When an economic interest in the entity exists, but control is achieved by means other than a majority voting interest (e.g., through a contract), such consolidation is permitted, though not required. [Various aspects of economic interest are discussed in greater detail in the section entitled "Private Institutions (Those Subject to FASB Standards)."]
- **Ownership of the land** is a factor for some projects but not others. Projects developed on college-owned land are more likely to be included in a college's financial

statements or notes than projects developed on land owned by others. Yet, even when college-owned land is used for a project, the financial reporting treatment of the project will be influenced by other factors as well. For instance, if the college and project owner execute a fair value lease for the land and the lease term approximates the useful life of the project, ownership of the land becomes much less significant.

- **Debt guarantees apply** when the college formally promises to repay the debt if the entity is unable to meet its obligations. The presence of such a guarantee assures that the arrangement will be disclosed in the college's notes at a minimum and may lead to full reporting of the entity's financial information with the college's financial statements.
- **Master leases** are created when the college executes a lease with the property owner, giving the college control of the individual housing units. In these situations, individual students or employees execute rental agreements with the college rather than with the property owner. If the lease agreement qualifies as a capital lease, such an arrangement will result in the property being reported as if it were owned by the college. (See discussion at FASB 13 below.) This is contrasted with operating leases, which might be disclosed in notes but will not result in asset recognition of the leased property.
- **Financial interrelatedness** refers to the relationship between the entity and the college as defined by the contractual terms. The more intertwined the entity's activities are with those of the college, the more likely it is that the entity should be included in the college's financial reporting. The absence of such interrelatedness may establish a basis for exclusion of the entity from the college's financial report. There are many factors that establish financial interrelatedness, including termination provisions and contingencies, guarantees other than debt guarantees, management and operating activities, and the significance of the project to similar activities of the college.

- ✓ **Termination provisions and contingencies.** These are typically covered in contractual agreements and may influence determinations about financial interrelatedness. For instance, if the college is obligated to operate facilities in the case of default by the entity, this indicates interrelatedness.
 - ✓ **Occupancy guarantees.** Occupancy guarantees occur when the college commits to ensuring that the entity achieves a specified level of occupancy for a residential facility. In situations involving occupancy guarantees, a college typically commits to assigning the number of residents specified in the agreement. Occupancy guarantees must be distinguished from referral arrangements or marketing partnerships. The mere existence of the latter arrangements, without explicit financial guarantees, will not automatically establish financial interrelatedness.
 - ✓ **Rent guarantees.** Unlike occupancy guarantees, which do not necessarily have financial implications for the college, rent guarantees represent a potential direct financial obligation. A rent guarantee represents a promise by the college to cover any shortfall in agreed-upon minimum rent revenues. Such guarantees indicate financial interrelatedness.
 - ✓ **Residual revenues.** The above examples refer to situations in which the college is providing guarantees to the entity. The opposite can occur as well. For instance, the entity may commit to share net revenues beyond a certain threshold with the college. Depending on the circumstance, and the likelihood of actually realizing such net revenues, this arrangement indicates financial interrelatedness.
 - ✓ **Management and operating activities.** Management activities, or other services provided by the college to the entity, or vice versa, are factors affecting financial interrelatedness. In these situations, agreements are executed under which the college relies on the entity to conduct activities that normally would be conducted by the college. Alternatively, an agreement can specify that college employees will perform designated activities (e.g., maintenance, security, grounds keeping) for the entity. Unless these arrangements include reasonable compensation for the services being provided, they typically represent evidence of financial interrelatedness. One particularly sticky area is the collection of rents by the college for the entity. This is a strong indication of financial interrelatedness, although it represents just one factor.
 - ✓ **Significance of the project to similar activities of the college.** If a residential facility project will provide the majority of the college's available housing, it is likely to be considered integral to the college's operation. On the other hand, if the portion of available housing represented by a project is relatively small, it is not likely to be deemed integral to the college's operation and should not establish financial interrelatedness.
- Institutions should focus on these and other similar factors when determining how to recognize or disclose a nonrecourse financing arrangement. These are the same factors that auditors should consider when determining whether a project is being treated properly for financial reporting purposes. As mentioned above, some of the factors are more relevant to public institutions, while others are more significant to private institutions.

Particularly with respect to private institutions, the factors can be viewed as points on a continuum with some located closer to consolidation and others closer to disclosure in notes (or complete omission from financial reports). Where a particular project ends up on the continuum will be a function of the combination of the various factors and, ultimately, will require professional judgment by both the college and its auditor.

Although a continuum is not an appropriate construct for assessing projects involving public institutions, some factors take on greater significance when other factors are present. Those factors are highlighted below. Ultimately, the college's classification as a public or private institution plays an important part in the reporting treatment. Specific rules established by the FASB, GASB, and AICPA are addressed below.

Where a particular project ends up on the continuum will be a function of the combination of the various factors and, ultimately, will require professional judgment by both the college and its auditor.

Private Institutions (Those Subject to FASB Standards)

The primary reporting guidance for private institutions is found in the AICPA's Statement of Position No. 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (SOP 94-3). As discussed below, SOP 94-3 establishes the guidance used by NFPs in determining whether to consolidate another entity's financial activity with their own. Consolidation of a nonrecourse financing entity results in on-balance sheet treatment. Conversely, if the relationship to a nonrecourse financing entity is disclosed in notes, or not addressed at all in an NFP's financial statements, it is deemed to be off-balance sheet.

In addition to consolidating related entities, another form of on-balance sheet treatment occurs with some leases. As a result, FASB Statement No. 13, *Accounting for Leases* (FASB 13), must be examined. Additionally, because some transactions are treated as leases even when this was not the parties' intent, another accounting standard must be considered. As its title implies, FASB Emerging Issues Task Force Consensus 01-8, "Determining Whether

an Arrangement Contains a Lease" (EITF 01-8), is relevant to some nonrecourse financing situations.

Finally, FASB Staff Position FIN 45-3, "Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners" (FSP FIN 45-3), provides guidance on disclosures required if rent or debt guarantees are provided.

SOP 94-3

The Statement of Position (SOP) provided the first definitive guidance to NFPs on financial statement consolidation and other matters related to the financial reporting of their related entities. Although it was issued by the AICPA, it represents authoritative guidance and must be followed by entities subject to FASB standards.

The summary section of the SOP establishes that decisions about consolidated reporting and/or disclosures "...should be based on the nature of the relationship between the entities." The guidance focuses on two separate types of arrangements: (1) investments in for-profit entities by NFPs and (2) financially interrelated NPOs.

Investments in For-Profit Entities

The treatment of investments in for-profit entities is fairly straightforward and represents an area in which the AICPA has applied rules common to for-profit entities to NFPs operating in a similar manner. This is done by explicitly extending the applicability of the AICPA's Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to NFPs that possess a controlling financial interest (i.e., own a majority of the outstanding voting stock) in a for-profit entity through direct or indirect ownership. In these situations, the NFP would present the financial activity of the other entity with their own.

If an NFP does not possess a controlling financial interest, but merely has a significant investment in a for-profit entity (i.e., owns at least 20 percent of the outstanding voting

stock of the entity but less than a majority), Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, applies to the arrangement. This method of reporting, common in the for-profit world, results in the reporting of the NFP's interest in the equity of the entity. The carrying value of the NFP's investment in the entity is adjusted as earnings or losses of the entity are recognized in the NFP's activity statement. Cash dividends received are not treated as revenues but, instead, are used to reduce the carrying value of the investment.

Other than a single line in the NFP's activity statement, representing its interest in the net results of the entity's operations, no information about the entity's activities appears in the NFP's financial statements. The NFP likely will disclose details about the activities of the entity if they have operational implications for the NFP. If not, the arrangement is treated the same as if it were a significant investment in any other company.

Investments in Not-for-Profit Entities

SOP 94-3 also establishes standards applicable to reporting by financially interrelated NFPs. The SOP identifies three specific ways in which NFPs may be interrelated: ownership, control, and economic interest. It provides reporting guidance for various situations involving these interrelationships. The relevant reporting approaches are described below.

The SOP begins with situations involving a controlling financial interest in one NFP by another through direct or indirect ownership of a majority voting interest. (Because NFPs generally are not owned, this usually is interpreted as one NFP being the sole corporate member of another.) In these situations, the controlled entity's financial activity should be consolidated with that of the controlling NFP.

Additionally, consolidation is required when an NFP has both (1) control of the other entity via the power to appoint a majority of the governing board of another NFP and (2) an economic interest in that NFP. The SOP provides a definition of economic interest that has potential relevance to nonrecourse student housing financing projects. An economic

interest exists when (1) an entity either holds or utilizes resources to produce income for, or provides services to, an NFP, or (2) the NFP is responsible for the liabilities of the entity. Examples of economic interest cited in the SOP include the assignment of some functions by an NFP to another entity and the guarantee of debt by one NFP for another.

Control of the other NFP can occur by means other than ownership of a majority voting interest or the ability to appoint a majority of the members of the governing board. For example, control may be established by contract or affiliation. If an NFP has an economic interest in another NFP but has "the direct or indirect ability to determine the direction of management and policies" solely via these other means, the controlling entity has the option to consolidate the controlled entity's financial activity with its own. If a controlling NFP elects not to consolidate, there are prescribed disclosures required in the notes to its financial statements. These disclosures include the following elements:

- identification of the controlled entity and the nature of the relationship;
- summarized financial data of the controlled entity; and
- disclosures required by FASB Statement No. 57, *Related Party Disclosures* (FASB 57), including a description of transactions between the entities, the dollar amount of transactions between the entities, amounts due between the parties and, if not apparent, a description of the terms and manner of settlements.

The final situation addressed in the SOP applies when an NFP has either control or an economic interest but not both. In these situations, consolidation is precluded, but additional disclosures are required. Specifically, the disclosures required by FASB 57 must appear in the notes to the NFP's financial statements.

Applying the above rules to nonrecourse student housing financing involves the continuum discussed previously. At the consolidation end of the continuum are situations in which a private college establishes or utilizes another NFP for a project and establishes ownership of the entity through a majority voting interest.

Similarly, if the college enjoys an economic interest in the entity, and has established control through the power to appoint a majority of the board, the arrangement falls at the same end of the continuum.

Arrangements involving only an economic interest established through an arm's length arrangement will cluster at the opposite end of the continuum, resulting either in note disclosure or complete absence from the college's financial statements, depending on the specifics of the arrangement. If the college provides debt guarantees, this results in note disclosure. Absent such contractual elements, however, it is possible that the college will elect not to address the arrangement anywhere in its financial statements.

In one of the rarities within financial reporting, there are situations in which an arrangement can land directly in the middle of the continuum. These are the situations that arise when the college has an economic interest in the entity involved in the nonrecourse financing arrangement but does not control the entity. In these cases, the college has the option to consolidate the entity with the college or merely describe the arrangement in the footnotes.

FASB 13

FASB 13 establishes the primary accounting guidance for one of the most complex areas of accounting—leases. One of the reasons for the complexity is the fact that lease accounting is sometimes applied to transactions even when this was not the parties' intent. Another factor contributing to the complexity is the number of alternatives that are available for the structuring of lease transactions. From the perspective of the lessee, there are two basic types of leases. Operating leases

are more common and are accounted for in a straightforward manner. In an operating lease, the lessor (owner) provides property for use by another (lessee) in exchange for rents. Under current accounting rules, such arrangements result in the lessee recognizing an expense, while the lessor recognizes receipts as rent revenue.

The second type of lease, capital lease, is more complex and subject to much more analysis and interpretation. The essential characteristic of a capital lease is that it is accounted for as if

it represents a sale rather than a lease. In other words, the lessee reports the leased property as a capital asset and the cumulative value of the contractual lease payments as long-term debt. The value of the asset is recognized as expense through annual depreciation charges over its useful life, just as any owned capital asset would be. In addition, the portion of the periodic lease payments representing interest is recognized as an expense. The balance of the payment reduces the long-term liability.

FASB 13 identifies four criteria that require the use of capital lease accounting. Meeting any of the criteria results in capital lease recognition. In other words, if any of the criteria are met, the property will be recorded as an asset of the college,

and the total value of the lease obligation will be recorded as a long-term liability. Ignoring some particularly technical variations, the four criteria are listed below.

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option exercisable at the option of the lessee. (That is, the lease agreement establishes a price for the purchase of the leased property

- *Arrangements involving only an economic interest established through an arm's length arrangement will cluster at the opposite end of the continuum, resulting either in note disclosure or complete absence from the college's financial statements, depending on the specifics of the arrangement.*
- *...situations that arise when the college has an economic interest in the entity involved in the nonrecourse financing arrangement but does not control the entity. In these cases, the college has the option to consolidate the entity with the college or merely describe the arrangement in the footnotes.*
- *The essential characteristic of a capital lease is that it is accounted for as if it represents a sale rather than a lease. In other words, the lessee reports the leased property as a capital asset and the cumulative value of the contractual lease payments as long-term debt.*

at an amount that is considerably less than its expected market value.)

- The lease term is equal to 75 percent or more of the estimated economic life of the leased property.
- The present value of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased property.

Whether an agreement is called a lease or a sales agreement, if any of the above criteria are met, the transaction will result in on-balance sheet treatment.

EITF 01-8

EITF 01-8 establishes guidance for situations involving characteristics of a lease that are not structured as a lease. The guidance applies primarily to manufacturing and production arrangements in which an entity—the purchaser—has effective control over property, plant, or equipment. In these situations, the purchaser is deemed to be a lessee and, when the arrangement meets the criteria of a capital lease, the asset and corresponding liability are reported in the lessee’s financial statements. Though originally developed for situations involving energy trading contracts, the consensus eventually was expanded to cover all agreements.

EITF 01-8 identifies several conditions that result in a determination that the purchaser controls the use of the underlying property, plant, or equipment. If any of the following conditions are present, the arrangement will be deemed to be a lease:

- The purchaser controls more than a minor amount of the output or utility of the property and
 - ✓ has the ability, or right, to operate the facility or direct others to operate it in a manner determined by the purchaser, or
 - ✓ has the right to control physical access to the underlying property.

- It is unlikely that anyone other than the purchaser will take more than a minor portion of the output or utility of the property, and the price paid by the purchaser for output is neither

- ✓ contractually fixed per unit, nor
- ✓ equal to the current market price.

Obviously, there are circumstances when a residential facility developed for a college could fall within the above parameters. Nevertheless, relatively few residential projects will be subject to the provisions of EITF 01-8. In the absence of a master lease between the college and the entity, the college will not be deemed to be a purchaser as contemplated by EITF 01-8. Similarly, if the units are controlled by a separate entity established outside the control of the college, the college will not qualify as a purchaser under EITF 01-8. As long as the individual occupants execute separate leases with the entity operating the facility, EITF 01-8 will not apply.

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FSP FIN 45-3

FSP FIN 45-3 modifies FASB Interpretation No. 45, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, an interpretation of FASB Statements No. 5, 57, and 107 and a rescission of FASB Interpretation No. 34 (FIN 45). FIN 45 established the disclosure requirements applicable to guarantees and, in some cases, the recognition requirements related to those obligations. As originally issued, FIN 45 had only limited potential relevance to colleges involved in nonrecourse financing arrangements. With the issuance of FSP FIN 45-3, however, that situation has changed.

FSP FIN 45-3 amends FIN 45 to include guarantees by one entity to another that the latter’s revenue for a designated period of time will be at least a specified amount. This situation arises when a private college provides guarantees regarding minimum rents to be realized by the nonrecourse financing entity.

In these situations, the college is required to include a note in its financial statements providing the following information.

- The nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that would require the guarantor to perform under the guarantee.
- The maximum potential amount of future payments the guarantor could be required to make. If there is no cap under the guarantee arrangement, then that must be disclosed. If it is not possible to estimate the maximum amount payable under the guarantee, then that must be disclosed.
- If the guarantee requires the recognition of a liability under the provisions of FASB Statement No. 5, *Accounting for Contingencies* (FASB 5), the amount of the liability must be disclosed. (It is relatively unlikely that a college would be in the situation of recognizing a liability for rent guarantees, because FASB 5 requires that it be probable that a payment will be made and that the amount of the payment can be reasonably

estimated. If this situation arises, by the time the financial statements have been issued, it is likely that the payment will have occurred.)

The final comment relative to private institutions centers on the FASB's recent efforts involving special purpose entities (SPEs). There has been a great deal of attention to these entities in recent years, especially in light of problems related to Enron and other highly publicized situations involving related entities. Many individuals incorrectly assume that the new SPE rules apply to entities established to carry out the types of projects discussed in this paper. FASB Interpretation

Although FIN 46R and its resulting FSPs have significant implications for some entities, NFPs are not among them. The scope of the document specifically excludes not-for-profit organizations. It is possible that the FASB will focus attention on NFPs and entities similar to SPEs at some point in the future, but such a project does not appear on their agenda at the time of this writing.

46 (R), *Consolidation of Variable Interest Entities*, an interpretation of ARB No. 51 (FIN 46R), issued in December 2003, has spawned a number of FASB Staff Positions (FSP) expanding on its guidance. Although FIN 46R and its resulting FSPs have significant implications for some entities, NFPs are not

among them. The scope of the document specifically excludes not-for-profit organizations. It is possible that the FASB will focus attention on NFPs and entities similar to SPEs at some point in the future, but such a project does not appear on their agenda at the time of this writing.

Private Institutions Continuum



Public Institutions (Those Subject to GASB Standards)

The relevant reporting guidance for public institutions comes from two sources: GASB Statement No. 14, *The Financial Reporting Entity* (GASB 14), and Statement No. 39, *Determining Whether Certain Organizations are Component Units* (GASB 39).

GASB Statement No. 14

GASB 14 establishes standards for defining and reporting on the financial reporting entity. The standard establishes that the financial reporting entity includes the primary government, its component units, and other organizations for which the nature and significance of the relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete.

Primary governments are entities with separately elected governing bodies, legally separate status, and fiscal independence—things not always true for public colleges. Yet, by specific reference in paragraph 9, the standard applies to public colleges, in addition to other types of governments. Although colleges rarely have popularly elected governing boards, the GASB extends the requirements of the standard to separately issued financial statements of component units and stand-alone governments.

Component units are legally separate organizations for which the elected officials of the primary government are financially accountable (or are the types of entities whose exclusion would lead to misleading or incomplete financial reporting). Most public colleges also are a component unit of the state in which they are located but, even when not component units, colleges almost universally report as stand-alone governments. As a result, for all practical purposes, GASB 14 is applied fully to public colleges.

GASB 14 establishes criteria for a component unit and, if one exists, how it will be presented. As mentioned above, one criterion relates to financial accountability. Financial accountability is established if the college appoints a majority of the entity's board members and (1) it is able to impose its will on the entity or (2) the entity has the potential to provide specific financial benefits or impose financial burdens on the college. The imposition of will can take many forms including the ability to modify or approve the entity's budget; set or approve rates or fees; appoint, hire, reassign, or dismiss individuals responsible for the entity's day-to-day operations.

Part of the significance of the standard established in GASB 14 is the method for presenting the financial information of component units. If the college and the reportable component unit share the same board of directors, or the reportable component unit exists exclusively to serve or benefit the college

(as opposed to students or other stakeholders), the financial information for the component unit will be blended with that of the college. With blending, the financial activity of the component unit becomes

indistinguishable from the college's financial activity. In essence, each category of revenue for the component unit is added to the college's amount for that category, and only the combined total appears in the financial statement. This also holds true for each expense category, asset category, etc. As a result, it is impossible to determine how much of the activity is attributed to the college and how much is attributable to the component unit.

In all other cases involving reportable component units, the financial activity will be presented through discrete display. With discrete display, the financial information for the component unit is presented in a separate column next to the financial information for the college, or on a separate page. The latter presentation is allowable in situations involving component units that follow FASB standards.

Financial accountability is established if the college appoints a majority of the entity's board members and (1) it is able to impose its will on the entity or (2) the entity has the potential to provide specific financial benefits or impose financial burdens on the college.

GASB Statement No. 39

GASB 39 amends GASB 14 by establishing additional specific criteria for determining when the financial information of independent organizations—typically fundraising foundations and other NFPs supporting public colleges—should be reported by the college being supported. There are three criteria in the standard: (1) the organization holds economic resources for the benefit of the college; (2) the college is entitled to or can otherwise access the resources; and (3) the resources are significant to the college. The standard requires that all three criteria be met for GASB 39 to apply.

GASB 39 further amends GASB 14 to establish additional criteria to be considered in determining whether an entity should be reported as a component unit, even if the entity does not satisfy the three criteria mentioned above. If an entity is closely related to or financially integrated with the college, there is a requirement to apply professional judgment to determine whether to report the entity in the college's financial report. The totality of the situation should be considered to determine whether the nature and the significance of the entity's relationship with the college requires its inclusion in the college's financial report to avoid misleading financial statements.

The net effect of GASB 39 is to require all but a few public college fundraising foundations' financial information to be presented with that of the college they support. The accounting treatment of other support or related organizations is not clearly delineated and depends, to a large extent, on the specific facts of the relationship between the organization and the college.

If a public college has a component unit that it established, or owns or controls through a common governing board, the entity's financial activities will be blended with those of the

college. The entity usually will be described in the first note to the financial statements in which the reporting entity is defined. Other disclosures will be a matter of professional judgment and may address issues related to investments, long-term debt, etc.

One might conclude that a special financing entity would be blended even if ownership or control does not exist, because of the requirement to blend entities that exist exclusively to serve or benefit the college. Some might believe that an entity created to provide housing exists to serve or benefit the college. In fact, the GASB takes a different view of this situation. The GASB concludes that the service or benefits actually are for the residents, not the college. As such, the requirement to blend does not apply.

- *If an entity is closely related to or financially integrated with the college, there is a requirement to apply professional judgment to determine whether to report the entity in the college's financial report. The totality of the situation should be considered to determine whether the nature and the significance of the entity's relationship with the college requires its inclusion in the college's financial report to avoid misleading financial statements.*
- *The GASB concludes that the service or benefits actually are for the residents, not the college.*

Absent control, the other elements of GASB 14 and GASB 39 must be reviewed. The typical outsource arrangement will fail the first two criteria for component units established in GASB 39. It would be very unusual in these arrangements for the entity to hold economic resources for the college. Any resources held by the entity would be needed for their operating activities. As such, it is unlikely that the college would be entitled to access those resources. There are situations in

which an entity is obligated to transfer the project to the college at the end of a specified period of time. Because these usually are long-term arrangements with renewal options, it would fail the second criterion relating to access. Additionally, even if the terms require the transfer of the project at a future date, it likely would fail the third criterion. The present value of a project that will not transfer until far into the future is unlikely to be considered significant today.

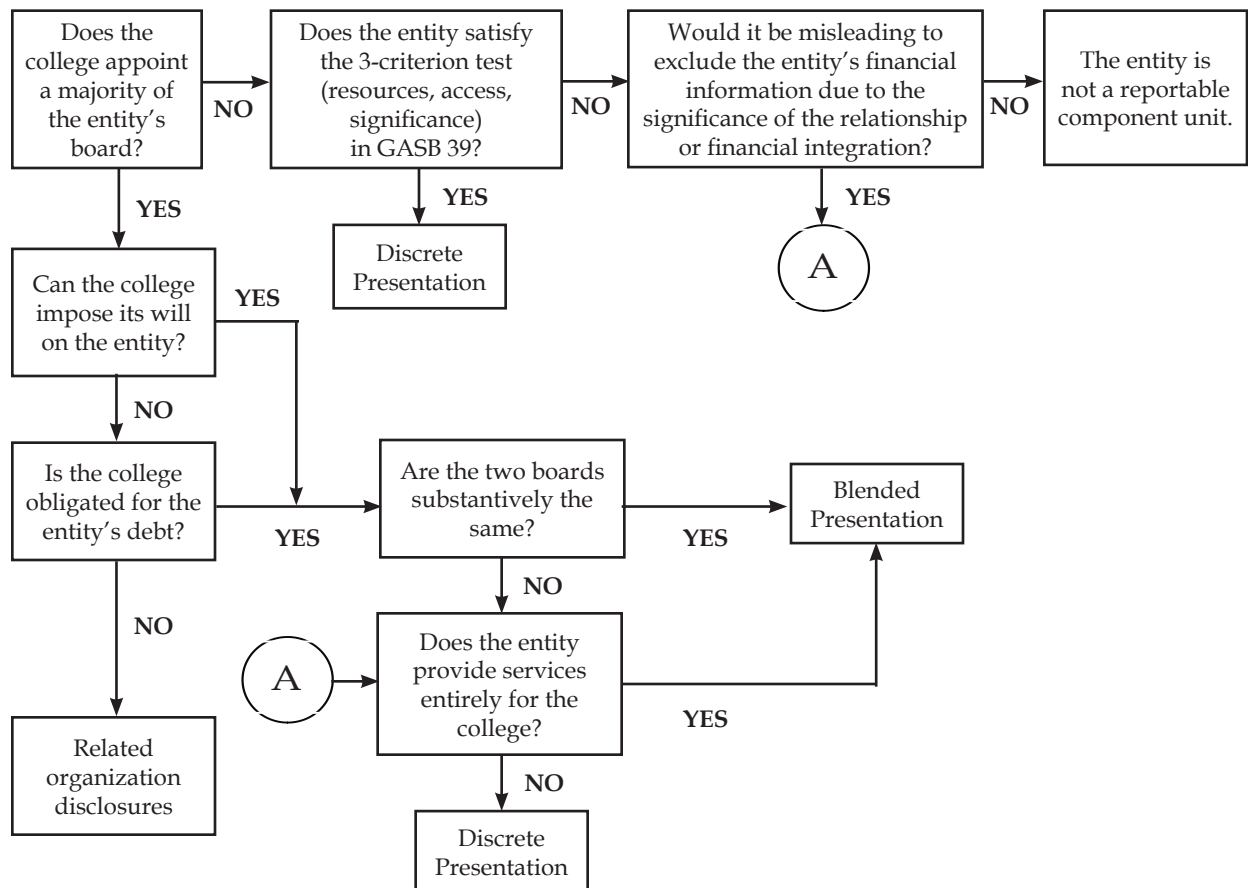
The only other factors for considering whether an entity is a reportable component unit are the significance of the relationship between

the college and the entity and financial integration. There is one situation which almost always leads to a conclusion that the entity is closely related to the college, thereby resulting in discrete display of the entity's financial information. This occurs when the entity provides a substantial percentage of the institution's total available housing. There is no specific percentage deemed to be substantial, but one can assume that it would have to be in the range of one-quarter to one-half or more of the available housing. Amounts less than this presumably would not create a sufficient relationship to conclude that the entity is a component unit of the college. Absent this determination, the college likely would disclose the reliance on the entity for a portion of its needed campus housing. But in situations when the amount of housing provided by the entity is relatively minor, and there are no other factors that would necessitate disclosure, the college may elect not to disclose the existence of the entity.

In GASB 39, several items are mentioned as potential examples of financial integration: (1) the entity's employees could participate in programs sponsored by the college; (2) the work performed by employees of the entity could qualify for coverage under the college's federal work-study program; or (3) allowing the entity to use the college's office space and administrative services or vice versa. These are just examples of factors to be considered, and by themselves do not automatically result in a determination that a component unit should be reported.

It should be noted that, when a college and an entity contract for services in an arm's length manner, and none of the other factors are present, it likely will not result in a determination that there is financial integration.

Public Institution Decision-Tree



Conclusion

The rules applicable to nonrecourse financing arrangements can be difficult to apply. They require careful analysis to assess the impact on individual projects. It is possible that the same situation occurring at a public institution would result in different treatment if it occurs at a private institution. Similarly, because of the variability of circumstances and the judgment required in assessing projects, it is possible that very similar transactions will be treated differently by different institutions. Despite this variability and the potential for differing treatment, it is expected that these projects will continue to proliferate throughout higher education. It is hoped that the information in this paper will guide financial officers, auditors, and others in their determinations about the accounting and reporting for the projects.

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