Christian College Finance 101:

The Unique Aspects of College and University Financial Reporting

Introduction

Accurate, timely reporting that informs good financial management is vital in today's volatile economy. The dramatic economic booms and busts of the last 20 to 30 years underscore how important it is for board members of Christ-centered colleges and universities to be presented with high-quality financial reports in order to skillfully direct the course of their institutions.

Background Principles

Core principles of good financial reporting are presented here. Solid understanding of these key principles will help guide the college board member to the right information and illuminate answers to the most pressing questions faced at the institution.

Principles:

1. For a Christian college, true success is NOT found in the size of its net income, its student body, its physical plant, or its endowment. The true measure of success lies in the accomplishment of key tasks that further the mission of the institution. Maintaining financial health removes one barrier to the successful completion of mission.
2. Financial reporting processes MUST deliver enough information in a highly summarized form to enable the board member to answer key questions about the institution's financial health.
3. The financial statements and budget reports alone are not enough to communicate the whole story.
4. Care for the people, systems, and processes that produce the timely and accurate reporting needed is as important as the reports and results themselves.

What Makes the Accounting and Reporting for Colleges and Universities Unique?

Business success is found in the value of the company stock and the strength and direction of profit margins being generated (which tend to strongly influence the stock value). Success is thus a function of the bottom line. Nonprofit organizations generally, and colleges specifically, have much more complex measurements to consider when deciding on the level of success the institution is experiencing.

In their work on financial management for nonprofit organizations, John Zeitlow, Jo Ann Hankin, and Alan G. Seider say, "In nonprofits, financial results no longer have primacy, because shareholder wealth or profit maximizing no longer serve as the overarching objectives."[i] A large national survey of nonprofit officers and board chairs found the following in regard to an organizational effectiveness assessment:

1. The majority surveyed thought that the main characteristics of an effective nonprofit organization included:
   a. A clear sense of mission, accompanied by
   b. A specific strategy to carry out that mission
2. Improvement strategies were primarily oriented toward "making mission central."
3. The effectiveness of the CEO was judged significantly by the extent to which the institution had a "strong mission orientation."[ii]

While this is true, other nonprofit management authors have pointed out two rules for successful nonprofit organization management. Rule one is mission, mission, and more mission. But the second and equally important rule is "no money, no mission."[iii] Therefore, while financial reports do not answer all of the key questions important to a college or university trustee, accounting and reporting for such institutions is, indeed, unique. So how do board members sort out the important issues and get answers to key questions as they execute their duties?

Delving Into the Key Questions: What Questions Should I Be Asking?

In the Association of Governing Boards of Universities and Colleges' *Board Basics Booklet* on financial statements, authors John H. McCarthy and Robert Turner point out the key strategic issues and related questions for each of the primary financial statements. The information below is adapted from that booklet.[iv] There are three required basic financial statements: The Statement of Financial Position (Balance Sheet), the Statement of Activities (Income Statement), and the Statement of Cash Flows. Each statement has its own set of key strategic questions, which are included at the end of this article.

Statement of Financial Position (Balance Sheet)

This financial statement will provide information on the institution's total assets, total liabilities, and total net assets (net worth). The net asset section is divided into three categories according to the level of donor restriction (unrestricted, temporarily restricted, and permanently restricted). The three net asset classifications give the reader a sense of the financial strength of the organization and its growth or decline.

- **Unrestricted** – This category includes both liquid equity and amounts invested in illiquid assets (brick and mortar equity). It is important to understand the amount of the total unrestricted that represents liquid equity, so subtracting the "net investment in plant and equipment" from the total unrestricted would yield a liquid equity balance. It is very important to have a healthy liquidity position as represented by a healthy unrestricted net asset balance (net of the investment in plant and equipment). Schools with negative equity after subtracting plant and equipment equity from the total are likely showing signs (including this one) of financial stress.
- **Temporarily restricted –** These are funds that cannot be used for general operations, although many times they do fund scholarships and other more operational supports. A healthy balance of temporarily restricted resources backed by hard assets in the asset section of the balance sheet (usually cash and investments) is important. Schools with large balances of temporarily restricted net assets (equity) and few real hard assets (cash and investments like marketable securities) are financially weak.
- **Permanently Restricted –** Think of this net asset category as permanent capital. It should never be counted on for operational needs (although many have been tempted and indeed have spent the marketable security values on operational needs when the revenue and the expense budgets did not harmonize). Permanently restricted equity backed by hard investments is a major help to funding the operation of the school. Interest earned from large endowments can fund scholarship assistance that helps maintain enrollment, faculty expenses (endowed chairs), plant operational costs (facility endowments), etc. The one downside (if there is one) is that schools with large endowments can be surprised by an extended downturn in the investment markets because the revenue flows depend (usually) on a percentage of value of an average amount of investment balance.

The literature establishing accounting rules codified by the Financial Accounting Standards Board notes that a balance sheet should inform the reader about the ongoing ability to provide services and also about its liquidity, financial flexibility, and financial needs. Existing resources should be sufficient and flexible enough to enable the institution to fulfill its mission.

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Statement of Activities (Income Statement)

One way to understand resource allocation for a college is to look at the percentage of each functional expense line compared to total expense. Most colleges display their expenses using a functional classification on the face of the Statement of Activities. Those lines normally include the following:

- Educational and General
- Instruction
- Research
- Public Service
- Academic Support
- Student Services
- Institutional Support
- Scholarships and Fellowships
- Auxiliary Enterprises
- Independent Operations

The line that represents "overhead," including management and general costs plus fundraising costs, is the Institutional Support line.

This statement represents the change in net worth sorted by the net asset classifications (unrestricted, temporarily restricted, and permanently restricted). There are three basic requirements in accounting literature for this statement when prepared for a nonprofit college:

- The statement must report the total amount of the changes in each of the net asset groups (unrestricted, temporarily restricted, and permanently restricted net assets).

- The statement must show the amount of the net income for each net asset classification. Many schools today break the net income into component pieces — operational net income, other gains and losses, and other changes in net assets — not necessarily gains and losses.
- The statement must show all of the individual expenses from the unrestricted net assets.

Although the formatting requirements are very flexible and change from institution to institution, it is important for the statement of activities to report net results of four major areas:

1. **Overall results**

The overall results should be analyzed by looking at the change in net asset line on the income statement. If there is a subtotal for net income from operations, that number should be positive. Industry-wide guidelines say that a healthy increase in net assets for all funds should be 3% to 4% beyond the rate of inflation, so 6% to 7%, assuming inflation at 3%. The change from unrestricted net assets should be 2% to 4%.

2. **Operating results (excluding non-operating and non-recurring income and expenses, large one-time gains and losses, and non-operational investment and related income)**

As noted above, there should be a positive change in net assets in the unrestricted column. If the measure of operations is used, it should also be positive. For most institutions, failure to generate net income from operations and unrestricted net assets in general cannot be sustained beyond one to two years without major changes. Many colleges exist hand to mouth for much longer sometimes, but those that thrive and enjoy robust achievement of their long-term mission generate healthy net income year in and year out.

An important element of a healthy college is a diverse revenue stream. The more diverse the various streams of revenue, the less reliant the institution is on one source. In their work on financially stressed colleges, authors James Martin and James E. Samels include a list of "at risk indicators" for colleges. The second indicator on the list is "tuition dependency more than 85 percent."[v]

Another reason to highlight operational resources separately from investment and non-operating income, as mentioned earlier, is that lumping large investment gains together with operational gains or losses can mask the true picture of operational strength, or lack thereof.

Of these four items, measuring and achieving operating net income is probably the most important path to lasting financial health. Without an operating margin, a school is vulnerable to the ups and downs of investment markets and donor giving.

3. **Investment performance**

Strong endowment income plus good annual contributions is very positive for a school. This means that these normal sources of income are taking some of the pressure off tuition income dependency. One downside to endowment income is that when the investment market produces negative results, as has occurred in recent years, schools that are very dependent on endowment income may have to make major cost restructuring decisions. One way to reduce the impact of major sustained market corrections is to drop the endowment spending rate to a level that will leave spendable resources in the "lean years."

The information necessary to allow trustees to monitor rate of return should be in the financial statements as well as in the notes. That means adequate disclosure of interest and dividends, net realized and unrealized gains and losses, and management and custodial expenses. When taken as a percent of the average market value, a board member should be able to gain a rough idea of the rate of return. Of course, a detailed analysis of rate of return is not expected from an external financial statement. Detailed investment analysis is normally relied upon for a detailed review. This data is normally shared as a part of the investment committee work.

The current investment and related endowment footnotes should also contain information regarding the allocation of assets and investment performance, including information on endowment return, spending policies, etc.

4. **Fundraising results**

A clear presentation of total fundraising costs is usually found in the notes to the financial statements. A board member should find that number and compare it to the contributions revenue number in the financial statements. The level of success with a given level of fundraising effort (expense) is sometimes the function of what the money is being raised for. Sometimes large gifts can be raised within a capital or endowment campaign and the yield can look quite good compared to years when no construction or organized campaign is underway and only annual funds are being raised.

Another source of net revenues that can take the pressure off tuition revenue are those enterprises and operations like bookstores, food service, housing, radio stations, coffee shops, and other income-generating services. It is important to show the revenues and expenses on the face of the Statement of Activities in such a way that the net income from these sources is visible. This is normally done by showing the auxiliary income in a separate line in the revenue section, with the auxiliary expense as a separate line in expenses. It would be a mistake to net this activity into other lines or net one against the other to only show the net.

One issue that makes the interpretation of an interim (monthly or quarterly) Statement of Activities particularly difficult, especially for those who are mostly familiar with reading for-profit financial statements, is the fact that there is a limited matching concept embedded in a nonprofit college financial statement. Contributions are recognized as income when they are received or promised, even though they may benefit future periods. Tuition revenue is earned as the educational services are delivered, but in most interim reports (monthly or quarterly), tuition revenue is all recognized at one time, at the beginning of each semester adjusted for the add/drop period. This makes monthly statements difficult to understand in terms of the matching principle (matching revenues earned with expenses incurred).

The Statement of Cash Flows

This statement reflects the institution's cash receipts and payments over the course of the year. When reading the statement of cash flows, a board member will be able to spot which areas of the institution were generating positive cash flow. The ideal situation is for the cash flow from operations to produce consistently positive results. There can also be cash flow from the net purchase and sale of investments and other institutional assets. This net cash flow is found in the investing activities section. If the school is borrowing to finance operations, that will be evident when looking at the cash flow from financing activities and comparing that to the cash flows from operations. In this case, the subtotal titled "Cash Flow from Operating Activities" will be less than the cash flows from financing activity, which means that cash is being supplied more from borrowing than operational net income. Board members will normally want to see consistent cash flows from operations. This means that the core operation is not only producing accounting net income, but it is also producing real cash.

Delivering the Goods

It takes more than a balance sheet, a budget, and an income statement to really know what is going on. The key strategic questions below can help lead to good information about a college and its financial results, but that is not the end of the story for evaluating the health of an institution of higher education. More colleges today are using the concept of key performance indicators, including the Composite Financial Index and other analytic tools, to advise leaders about key areas of performance that drive the success of the institution.

The Composite Financial Index is a four-ratio net score that runs from minus 4 to 10, with 10 being the best score possible. The first ratio is known as the primary reserve, and measures financial flexibility and liquidity. The middle two ratios measure net income from operations and from total return on all assets. The last ratio measures the use of debt. A scoring, weighting, and totaling of the four scores yields a composite score that can be compared period to period and from school to school.

Finally, information about the institution's internal controls is critical to board members' understanding of the reliability of the numbers. Some information on weaknesses noted in the internal control system is normally delivered by the audit firm in the form of the auditor's comment letter. Other than this, however, there is no reporting mechanism in most schools to monitor the adherence to internal controls. This leaves top management and boards vulnerable. A better monitoring system would include internal audit procedures done by university personnel, or by separate outside auditors hired to monitor the internal control system.

Conclusion

Timely, accurate reporting of the financial affairs of a college or university is a critically important management tool in today's volatile economy. Understanding these reports and the other data that should be read in conjunction with the statements is one of the most important activities a board member will engage in during the year.

A board member who does not understand aspects of the reports should never be afraid to question them. Nor should a board member hesitate to push for more detailed or timely reporting. Without such information, it is nearly impossible for a board of trustees to make the best decisions for the institution that it leads.

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Key Strategic Questions

From the Statement of Financial Position (Balance Sheet)

Are your institution's existing resources sufficient and flexible enough to enable the institution to fulfill its mission?

From the Statement of Activities (Income Statement)

1. Overall, how did your institution perform financially for the year?
2. Is your institution living within its means?
3. How reliant is your institution on each of its key operating revenue streams?
4. Do operating expenses by category reflect your institution's priorities?
5. How dependent was your institution on investment or endowment income and annual giving to meet its operational needs?
6. Do your institution's auxiliary enterprises and independent operations support their own costs?
7. How well did your institution manage its investments?
8. How well did your institution manage its fundraising?

From the Statement of Cash Flows

What are your institution's sources of cash and how were they used in operations, investing, and financing?

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[i] John Zeitlow, Jo Ann Hankin, and Alan G. Seider, Financial Management for Nonprofit Organizations: Policies and Practices (John Wiley and Sons, 2007), pg.194.

[ii] E.B. Knauft, Renee A. Berger, and Sandra T. Gray, Profiles of Excellence: Achieving Success in the Nonprofit Sector, (Jossey Bass, 1991).

[iii] Peter C. Brinkerhoff, *Mission Based Management: Leading Your Not-for-Profit in the 21st Century*, Third Ed. (John Wiley and Sons, 2009), pg. 35.

[iv] John H. McCarthy and Robert M. Turner, with Sandra L. Johnson, Ed., *Understanding Financial Statements* (Association of Governing Boards of Universities and Colleges, 1998)

[v] James Martin and James E. Samels, *Turnaround: Leading Stressed Colleges and Universities to Excellence* (Johns Hopkins University Press, 2009), pg. 10.