

**A State University System**  
**Issues in The Implementation of GASB 34 and 35**

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**I. Introduction**

On June 10, 1999 the Governmental Accounting Standards Board (GASB) voted unanimously to issue Governmental Accounting Standard #34 (SGAS), the most comprehensive governmental accounting rule ever developed. At that time, GASB specifically excluded public colleges and universities from the new reporting model (SGAS 34 footnote 3). Five months later GASB unanimously voted to bring these entities under the umbrella of the new reporting model with the issuance of SGAS #35 (par. 5).

The new GASB Statements #34 and #35 will significantly change the way state and local governments, including public colleges and universities, report their finances to the public. According to the *GASB Overview*, “The statements were developed to make annual reports easier to understand and more useful to the people who use governmental financial information to make decisions: legislators, their staff, members of oversight bodies, investors, creditors, resource providers to governments, citizens groups, and the public in general” (1999, 4).

Under GASB #35, public colleges and universities have three options of reporting in their separately issued financial statements. They may report as:

- (1) business-type activities (BTA) only;
- (2) governmental-type activities only; or
- (3) a combination of the two (par. 43).

For public colleges and universities choosing the BTA model, the requirement of the new statements relating to the presentation of revenues, expenses, and changes in net assets presents interesting potential political and state funding implications. The model blurs the distinction between educational programs and auxiliary enterprise. State colleges and universities currently using the American Institute of Certified Public Accountants (AICPA) reporting model currently use a fund structure in presenting their financial statements. Following GASB #34, there will be no fund presentation, but a single column. The institutions will combine the operating revenues and operating expenses of educational programs and auxiliary enterprises under a single heading of Primary Government (SGAS #35 Appendix D). In addition, the new model requires the clear segregation of gifts and appropriations from other sources of revenues under the category of nonoperating revenues (par. 52). These presentations may have an impact upon how users view institutional funding.

Another way in which GASB #34 changes governmental reporting is through its requirements to report all plant, property, and equipment, including infrastructure, along with related depreciation (par. 18-22). For most state and local governments, identifying, valuing, and depreciating its capital assets will entail significant effort. For state colleges and universities currently using the American Institute of Certified Public Accountants (AICPA) reporting model, this task is less onerous. Under the AICPA model, such institutions have reported plant, property, and equipment (Ruppel 2000, 466). However, public colleges and universities will still face some implementation issues in this area. Currently institutions do not depreciate assets (SGAS 35 par. 31). Developing appropriate methodology for depreciation is crucial for consistent institutional reporting.

In this paper, we will look at one state University System and the explore the two issues identified above: BTA presentations of revenues and expenses and the depreciation of plant, property, and equipment. We will view the implementation to conform to GASB 34 and 35 while at the same time being cognizant of the related budgetary and political ramifications.

The change to GASB Statements 34 and 35 will affect all 36 units of this University System, of which 34 are teaching institutions, one is a marine research facility, and the remainder is the University System Office. The University System will report as a “business-type” activity under the new reporting guidelines since it meets the principal criterion established in paragraph 67 of GASB Statement 34 for an entity to elect that reporting. The business-type activity is available for any service for which a fee is charged to external users for goods or services. Although the institutions in the University System are regularly subsidized by state funds, they do cover a portion of their costs through external user charges for their services. The “business-type” activity reporting method requires an entity-wide, or single column financial report, as opposed to reporting by fund. This method should enhance comparability with for-profit counterparts. However, in spite of the numerous advantages of the new reporting system, the system also provides the risk that legislators and potential donors will view the financial results of the campuses in ways that could be counter productive to future funding requests for increased dollars.

Because the University System is included in the state’s Consolidated Annual Financial Report (CAFR), the implementation date for GASB 34 and 35 is the fiscal year ending June 30,

2002 (SGAS 35 par. 6). Unlike a number of other state agencies, the University System has maintained reasonably complete records . The amounts reported in the state's FY 1999 Comprehensive Annual Financial Report clearly support this position. The CAFR reports \$9.5 billion for the entire state in the Fixed Assets account on the Combined Balance Sheet of All Fund Types, Account Groups and Component Units. The University System reported \$5 billion of that amount in its Consolidated Financial Report for the same fiscal year. The remaining balance of \$4.5 billion relates to all state buildings, highways, and infrastructure outside of the University System. In comparison to the rest of the state, the University System has substantially less work to do to conform to the GASB #34 requirements for plant, property, and equipment. However, it faces some significant issues.

When the University System began planning in October 2000 for the implementation of GASB and the selection of a methodology to accomplish this task, it was apparent that the approach must address the following three issues:

(1) Budgetary Reporting:

The implementation of GASB 34 and 35 will cause discrepancies between the financial information reported on the Annual Financial Reports under GASB standards and the financial information reported to the legislature for the State Budgetary Reporting. The Board of Regents of the University System needed to develop a method that would allow multiple and flexible reporting capability to meet the various reporting requirements and not leave the leave it open to unfavorable interpretation of our financial needs.

(2) Depreciation vs 5% Renewal and Replacement:

The state requires auxiliary enterprises to be self-supporting and does not allow the use of state dollars to repair or replace items used by the enterprises. Several years ago, a few University System institutions encountered monetary problems with maintaining, repairing, and replacing equipment and buildings for auxiliary enterprises. The institutions did not have a system of reserving revenues from operations in order to perform needed maintenance or replacements. At that time the Board of Regents of the University System developed an accounting mandate of 5% for Renewal and Replacement (Board of Regents I-24). The institutions are required to transfer 5% of the gross sales of an auxiliary enterprise into a reserve for “Renewals and Replacements” at the end of each fiscal year. If the institution out-sources the activity to a third party, the 5% is calculated on the revenue that is paid to the institution by the vendor instead of calculated on gross sales. The University System internal auditors and the State Department of Audits staff auditors audit the transfer of these monies each year.

(3) Library Books:

Eight percent of the FY 2000 reported fixed asset total of \$5,425,373,487 for the University System Institutions was library books. A methodology for managing capitalization and depreciation for library books needed to be developed that was reasonable, simple, and auditable.

## **II. Budgetary Reporting**

Under GASB 35 using the BTA model, the University System must condense its current nine-column Statement of Changes in Fund Balance to the one column required in the Statement of Revenues, Expenses and Changes in Net Assets. As it does this, it also makes the institutions vulnerable to misinterpretations of financial abilities.

The GASB 35 Statement of Revenues, Expenses, and Changes in Net Assets is analogous to the Income Statement used in private industry. For public institutions of higher education, using the BTA model, all grants and contracts, (governmental and private), sales and services of educational departments, and revenues for auxiliary enterprises are included as operating revenue. It will identify all state appropriations and gifts as nonoperating (par. 52 and appendix D). This presentation could create an interpretation problem on the part of users of the financial statements.

Table I below shows the presentation, in summarized form, at four different institutions in the University System under the current reporting model. Table II below shows the pro forma presentation, in summarized form and without reflection of additional depreciation, at four different institutions in the University System under the BTA model.

If you were a state legislator, what conclusions could you draw from these numbers?



In the past the financial statements of the University System have followed a standard format, which consists of a separate column for each fund group. In that format, a relationship between the amounts received for state appropriations is not easily compared to the amount received from Auxiliary Enterprises or government and private grants. Therefore, the actual amount of state appropriations needed to fund the basic operations of the institution was not easily discernable. Under the AICPA model, state appropriations are camouflaged by the presence of all other types of revenue educational revenues. As a result their direct impact on the Change in Fund Balance is also masked.

Under the new reporting model might you look at the results differently? Any shortfall from operating revenues clearly stands out. The impact of both appropriations and gifts is obvious. Would you think that the institutions were under or over funded? Does Institution A appear over-funded? Does Institution C appear under-funded? Do you wonder what Institutions A and B do with the 19 million and 2 million respectively? These are the questions from legislators, citizens, and potential bond issuers that Board of Regents may face to under GASB 34 and 35.

The amount of state appropriations that the institutions receive is based on a complex formula that includes student headcount and completed semester credit hours along with numerous other calculations. During times of economic downturn and state government budget reductions, the amount state appropriations exceeding the operating loss is vulnerable. If an institution has enough gifts to cover some expenses, the State Office of Budget and Planning may redirect perceived excess appropriations to the State Treasury to fund critical state

operations. This creates a difficult situation for institutions that have invested time and effort in developing a donor base. In addition, donors are less likely to contribute in the future when their donation could possibly prevent the institution from receiving its fair share of state dollars. This would motivate institutions to funnel more of their donations through their private foundations.

In the previous paragraphs we have discussed several ways that the new financial presentation could affect future appropriation amounts. Under the Original Appropriations Act of the state the Regents are required to submit a Statement of Funds Available and Expenditures Compared to Budget (Sec. 53 and 57). This presents comparisons of the legally adopted budget with actual data prepared on the budgetary basis of accounting utilized by the state. Because the financial statements issued under GASB 34 and 35 are so different from the budgetary reports that it is required to provide to the Office of Budget and Planning and the legislature, it is difficult to predict the full impact on funding. Perhaps the legislators are only interested in viewing the information from the perspective that has always been presented and will only review annual percentage increases and decreases that have been the benchmark in the past. But with so many legislators being business owners themselves, it is difficult to believe that they will not be interested in financial statements with terminology and presentation that they can read and understand.

The University System is also in a delicate situation where depreciation expense appropriately reported can help Education and General Funds by increasing the expense side. Since depreciation expense will be a book entry only for Education and General, the expense is not a real money loss for the institution. Therefore any appropriation to offset depreciation, frees

up cash for other expenditures. On the other hand, Auxiliary Enterprises can be hurt by depreciation expense because depreciation for Auxiliary Enterprises will be funded and involves an actual setting aside of the monies to maintain the operation. We will discuss this further in the next section.

What can the Board of Regent do to mitigate the potential effects of misinterpretation of the Statement of Revenues, Expenses, and Changes in Net Assets? Essentially its task is to educate users and to communicate fairly the economic needs of its institutions. It must use its political influence to safeguard from changes in funding that could jeopardize the missions of the various schools.

### ***III. Depreciation vs 5% Renewal and Replacement***

As discussed in the beginning of the paper, the Board of Regents of the University System established a 5% Renewal and Replacement Reserve in order to deal with situations where institutions encountered problems having the funds to maintain, repair, and replace auxiliary equipment. Each year the institutions are required to make an addition to the Renewals and Replacements by transferring from the unallocated fund balance an amount equal to 5% of gross revenues on all enterprises operated by the institution. Some exceptions are made to the 5% rule when the enterprise is under contract or the gross revenue of the enterprise is made up of commissions. In these situations, the 5% is based on the net income of the operation instead of gross revenue.

The accumulated reserves may then be transferred to Unexpended Plant Funds and used for capital expenditures. However, when the financial position of Auxiliary Enterprises is such

that a deficit exists, only that portion of the reserve in excess of the amount of the deficit may be transferred to the reserve and budgeted for expenditure. Nor may anticipated additional to the Reserve for Renewals and Replacements be budgeted for expenditure until such additions have been realized and transferred from an unallocated fund balance created by the profit from operations. The Reserve for Renewals and Replacements fund balance must be supported by liquid assets, i.e., assets convertible to cash. The unallocated fund balance of Auxiliary Enterprises is composed of the accumulated earnings of this fund, which have not otherwise been used or transferred into reserve accounts. The unallocated fund balance is available for capital expenditures representing original improvements or new equipment and is distinguished in its usage from the 5% Renewal and Replacement reserve, which provides funds for renovations and replacements. Any amounts remaining in the unallocated fund balance at the end of a fiscal year are available exclusively for use in the operation of Auxiliary Enterprises during future periods. Currently purchases of Equipment-Inventory and Equipment-Non Inventory for Auxiliary Enterprises are made through Unexpended Plant Funds and are not included as operating expenditures in Auxiliary Enterprises (Board of Regents, I-24).

GASB 34 and 35 replaces the 5% Reserve for Renewals and Replacements with funded depreciation. The current liquid reserve balance will become a "Depreciation Reserve" and will be used to offset funded depreciation for as long as there is a balance. Equipment items that are easily identifiable as being used exclusively by an Auxiliary Enterprise will be transferred, along with the related depreciation charges, to that enterprise. As an institution purchases new Auxiliary Enterprise equipment, it will be charged to the appropriate enterprise. This change

will ensure more accurate accounting in that Auxiliary Enterprises are self-supporting and not subsidized by state funds.

The change will have both positive and negative financial effects on institutions depending on the amount of their current reserves. For this reason the new procedure has already caused concern among the Auxiliary Services Directors in the system. An institution that has a small bookstore and cafeteria operation located inside an Academic/Administration Building will probably need less than the 5% that is currently required to meet the depreciation charges. On the other hand, campuses that have stand alone Auxiliary Enterprises will incur not only the depreciation costs on equipment, but also on the building. This could be a burden for some dormitory operations that are already in financial difficulty. Because auxiliary enterprises are to be self-supporting, an increase in operating expenses as a result of depreciation could increase housing fees for students. The increases in operating expenses caused by funding depreciation could be passed on to the student with housing, food service, and other associated fees increasing to cover the deficit if the financial impact warrants the increase. The following schedule compares the current 5% Reserve for Renewals and Replacements to straight-line depreciation for a new dormitory:

Construction Price of the dormitory	\$4,000,000
Useful Life	30 years
Annual Depreciation (Straight line)	\$ 133,333
Income Generated (150 rooms @ \$2,400 per year)	\$ 360,000
5% Reserve for Renewals & Replacements	\$ 18,000

If the useful life of the dormitory is 30 years, this auxiliary enterprise would need to make a transfer of \$133,333 to the Reserves for Funded Depreciation instead of making a

\$18,000 transfer to the Renewals and Replacements 5% Reserve fund as it would under the current system.

If the useful life of the dormitory is 40 years, as illustrated below, the transfer amount would be reduced from \$133,333 per year to \$100,000. That is still more than five times greater than the transfer amount of \$18,000 required under the current method.

Construction Price of the dormitory	\$4,000,000
Useful Life	40 years
Annual Depreciation (Straight line)	\$ 100,000
Income Generated (150 rooms @ \$2,400 per year)	\$ 360,000
5% Reserve for Renewals & Replacements	\$ 18,000

How does the campus housing enterprise cover an increase of \$82,000 in required transfers to reserves since auxiliary enterprises must be self-supporting and cannot be supplemented with state funds? The most obvious option is to increase the housing fee for students on that campus. Of course, this situation will cause disgruntled students and parents to contact college presidents and legislators. This opens that particular campus and the University System up to close scrutiny as to the increase in expenses. The pro side of the issue is that students attending campuses with new or relatively new auxiliary enterprises will be sharing more equally in the cost of those enterprises. The con side is that past and current efforts to provide consistently affordable student services across the University System and the state will be more difficult if not impossible.

One of the major reasons the Governmental Accounting Standard Board gave for the implementation of GASB 35 was to make it easier to compare the operating results of public

colleges and universities with those of private institutions. (Allen 1999). In the area of depreciation, the straight comparison is not necessarily possible. Various governments determine the level of capitalization for the reporting entities under their governance and promulgate their guidance through statutes, regulations, or policies. Given that governments (and even institutions) are free to establish a capitalization criterion independent of any established standard, capital records will vary from institution to institution. For example, some state governments and institutions have adopted the federal capitalization limit of \$5,000. Others, due to internal or external mandates, have capitalization limits significantly less than \$5,000. When an attempt is made to compare financial statements between institutions, the potential difference in capitalization policies will have to be considered. Comparisons are aided by the GASB requirement that institutions disclose their policy for capitalizing assets and for estimating the useful lives of those assets.

#### ***IV. Library Books***

“Next to physical plant, the most valuable asset of an established research university or four-year college may be its library books. They are normally considered to have a useful life of greater than one year, therefore are capital assets and are depreciable. A proper valuation of this major asset for capitalization on the balance sheet is essential to any institution’s financial reporting and to its efforts to achieve greater control and management of its resources.”  
(NACUBO 407.65.)

Beginning balances, additions, deletions, and ending balance of library books is currently recorded on Schedule 15, Schedule of Changes in Investment in Plant, (summary schedule), and Schedule 16, Schedule of Investment in Plant, (detail schedule), in the Annual Financial Report.

Library books that are purchased are recorded at cost, while donated books are recorded at Fair Market Value.

Library holdings that meet the criteria of “works of art” and “historical treasures” under paragraph 29 of GASB Statement 34 need not be depreciated. The paragraph states that capitalized collections or individual items that are exhaustible, such as exhibits whose lives are diminished by display or educational or research applications, should be depreciated over their estimated useful lives. Depreciation is not required for collections or individual items that are inexhaustible. The term inexhaustible was neither defined nor explained in GASB 34. The term can, however, be traced to the Financial Accounting Standards Board (FASB) Statement 93 (SFAS) pertaining to the recognition of depreciation by not-for-profit organizations. Paragraph 6 of SFAS 93 indicates that, consistent with the recognition practice for land used as part of a building site, works of art or historical treasures that are protected and preserved have economic benefit or service lives that are used so slowly so as to be considered inexhaustible. Given this consideration, FASB did not require capitalization.

Private institutions are currently required to provide a depreciation charge for library books and generally follow a “group” depreciation procedure where an average life for books is established. Of the six institutions of the University System that were analyzed, library books comprise between 6% to 14% of an institution’s total assets. The University System has made the decision to follow a number of other systems across the country and use a 10-year useful life for library books. It developed an Excel spreadsheet to perform the calculations with a minimum of data input needed on behalf of the schools. This will be an annual journal entry at the close of

the fiscal year. The following three institutions have an ending Net Book Value that equates to a 70% to 75% reduction in book value:

	<u>Beginning Balance FY 00</u>	<u>Net Book Value FY 00</u>	<u>% Reduction</u>
Institution A	\$64,029,499	\$19,074,331	70%
Institution B	53,235,335	14,905,893	72%
Institution C	22,358,298	16,768,723	75%

The Net Book Value that results from the depreciation will let college administrators know if they are maintaining and updating their library resources on a constant basis. However, this raises the issue of how the rapid advance of technology in learning is affecting the necessity of hard copy library books. With massive amounts of information available on-line, should the quantity of bound books be decreased as the 10 year aging cycle is completed or is a yearly increasing decline in library books in order? Is the general public ready to lessen the dependency on the hard copy book? This is another area where constituents might be inclined to contact their legislators or institution presidents if the institutions do not maintain a balance between adding technology and adding to the hard copy library book collection.

## **VI. Summary**

GASBs #34 and #35 will significantly change the way public colleges and universities present their results of operation. Currently, many institutions use the AICPA model requiring the use of fund presentation. Collapsing these statements into a single column for the business activities option of reporting may cause interpretation issues that will have negative funding impact on the schools. The segregated presentation of state appropriations and gifts as nonoperating revenues may convince users that some institutions do not need the current level of funding. Another issue relates to plant, property, and equipment. Since the AICPA model calls

for the presentation of plant, property and equipment, other than identifying and valuing infrastructure, the inclusion of fixed assets on the statement of net assets is not a problem. However, public colleges and universities using the AICPA model do not take depreciation.

To soften the impact of the interpretation of the operating statement, the governing boards of public institutions need to develop plans both to educate users about the new presentation and to communicate the needs of the schools for accomplishing their missions. To address the depreciation issues, the boards must develop depreciation methodologies and implementation plans for proper compliance with the standards.

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