

# Lehigh University

## Financial Reference Tool Document

The attached document is intended to provide definitions and brief descriptions of some of the key financial terms that are frequently referred to in our discussions of Lehigh's financial picture. The document includes information on **tax exempt status** and **tax exempt debt**, a description of the **endowment** and the **endowment spending rule** calculation, terms related to **sponsored research** activity, and a brief description of the University's **financial reports**.

We hope you find it useful, and would be glad to answer any questions you have on these, or other, terms.

**LEHIGH UNIVERSITY BOARD OF TRUSTEES  
FINANCIAL REFERENCE TOOL**

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## **Tax Exempt Status**

### **What Does it Mean to Be a Nonprofit 501(c)(3) Organization?**

#### **What is a 501(c)(3) organization?**

A 501(c)(3) organization is an organization that has applied for, and IRS has granted, status as tax exempt charitable organization under Internal Revenue Code Section 501(c)(3).

Under 501(c)(3), organization must be organized and operated for charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and prevention of cruelty to children or animals.

Note: there are other types of tax exempt organizations under different sections of the Internal Revenue Code, for example - 501(c)(7) Social Clubs, 501(c)(14) Credit Unions. Each type of organization has its own regulatory requirements under the Internal Revenue Code.

#### **What does 501(c)(3) status mean for Lehigh's operations?**

Generally,

- 1) With some exceptions, we are exempt from federal income tax
- 2) We are eligible to receive tax deductible contributions
- 3) We may not operate to benefit any private shareholder or individual
- 4) There are lobbying restrictions – we may not attempt to influence legislation as a substantial part of our activities and may not participate at all in campaign activity for or against political candidates
- 5) We are subject to different tax reporting requirements than for-profit organizations (File Form 990 information return and Form 990T unrelated business income return)

#### **1) Exemption from Federal Income Tax**

Generally, the activities we conduct as part of our exempt purpose (education and research) are exempt from federal income tax. What is taxable is any income we receive as a result of an unrelated trade or business. Our taxable income is reported on IRS Form 990-T.

Unrelated trade or business income as defined by the IRS:

- Income from a trade or business
- Regularly carried on
- Not substantially related to the performance of our tax-exempt functions

If unrelated activity were to become a significant portion of our operations, we could jeopardize our tax exempt status.

Examples of what would be unrelated business income at Lehigh (**TAXABLE**):

- Advertising Revenue (but not corporate sponsorships)
- Stabler external events (ex. – car show, Disney on Ice, WWF)
- Commercial testing services
- Conference Services external rentals when services are provided
- Athletics external events (Eagles training camp, etc.)

Examples of what is not unrelated business income (**NOT TAXABLE**):

- Revenue resulting from activities with substantial causal relationship to our exempt purpose
- Convenience businesses (laundry, food service for students, etc)
- Research (but not commercial testing)
- Corporate Sponsorships (but not advertising)
- Passive Income (certain investment income, real estate rentals without services, etc)
- Royalties

## **2) Eligible to Receive Tax Deductible Contributions**

- Donor must have “detached and disinterested generosity”
- Cannot have a return benefit to the donor (but can specify what portion of a payment is a tax-deductible donation)
- Donor must relinquish control of the funds
- Gifts with substantial restrictions on use of donation may cause deduction to be disallowed (donor can support a specific area of the University, can’t donate to support a specific student).
- There are reporting and acknowledgement rules depending on the amount and nature of the gift

## **3) Prohibition against Private Benefit / Excess Benefit**

None of the income or assets of the University may be diverted from its exempt purpose in order to unduly benefit a person who has some close relationship to the organization.

Transactions with “insider” individuals must be reasonable, on an arms length basis.

Types of transactions to consider:

- Sale, exchange, leasing or property
- Lending of money
- Furnishing of goods, services or facilities
- Payment of compensation or reimbursement of expenses (Is it reasonable compared to market rates? Is it a disguised attempt to distribute profits?)
- Transfer of income or assets of the University

## **4) Lobbying Restrictions**

The University is limited in the nature and scope of lobbying activity we can conduct.

Definition of Lobbying: attempt to influence legislation (but not executive branch or administrative agency regulations). Lobbying can be “direct” or “grassroots”.

There is an absolute prohibition on participation on political campaigns. If we would do that we would risk revocation of our tax exemption.

## **5) Subject to different tax reporting requirements**

We are required to file IRS Information Return on Form 990 as a nonprofit and Form 990-T Tax Return for our unrelated business income. The information in the 990 is based on our fiscal year and includes financial statement information as well as certain other disclosures relating to highly compensated employees and independent contractors, relationships with other organizations, university governance and other compliance issues.

Forms 990 and 990-T are subject to public inspection. There are legal requirements concerning required response time upon receipt of an inspection request

## **Tax Exempt Debt**

**Tax Exempt Bonds:** Debt securities which are exempt from Federal (and at times state and local) taxes. These securities are issued in the capital markets by qualified nonprofit organizations at interest rates lower than taxable bonds. Bonds are issued to provide funding for future capital expenditures (pending projects or reimbursement of recent past projects).

**Fixed Rate Bonds:** Debt whose interest rate remains fixed throughout the life of the bond issue.

**Variable Rate Bonds:** Debt whose interest can fluctuate throughout the life of the bond issue.

**Private Use Limitations:** Private use may not exceed 5% of the net and not more than 2% of the face amount of the issue may be used to finance issuance costs. Issuance costs are considered private use for purposes of the 5% threshold.

**Private Use:** Use of the bond proceeds or the bond-financed property for the trade or business of any person other than a governmental unit during the life of the bond.

**Arbitrage Limits:** There are limits on the University's ability to invest bond proceeds to generate a materially higher rate on return on the funds and exceeding these limits will cause the bond to lose its tax exempt status. Specifically identified permissible arbitrage activities are allowable.

**Defeasance:** The escrow of funds with a cash flow adequate to pay debt service on a bond issue.

**Derivative Products:** Financing alternative often used in conjunction with tax exempt financings. Typical derivatives used in tax exempt financing include interest rate swaps which can provide interest expense savings to the institution if properly structured.

**Bond Rating:** Grade given by private independent rating services (Moody's, Standard & Poor's) to bond issuers that indicates the rating agency's evaluation of the issuer's credit quality based on its financial strength and ability to pay principal and interest in a timely fashion. In general, higher ratings enable the University to issue bonds at lower interest rates. As of January, 2008, the University's bond ratings were high quality:

Standard & Poors:	AA-
Moody's:	Aa2

## **Endowment Funds**

**Endowment Principal:** A pool of money invested to support the purpose for which is it designated or restricted. Types of endowment principal include:

**Permanent Endowment (also known as “True” Endowment)**

Principal remains intact in perpetuity, earnings are used to support purpose as designated by donor. Gifts are reported as Non-operating Permanently Restricted Gift Revenue in audited financial statements.

**Temporarily Restricted Endowment (also known as “Term Endowment”)**

Principal remains intact for a specific period of time or until a certain event occurs. Earnings (and after term expires, principal) are used to support purpose as designated by donor. Temporarily restricted endowment gifts are reported as Non-operating Temporarily Restricted Gift Revenue in audited financial statements.

**Unrestricted Endowment (also known as “Quasi” or “Board Designated” or “Funds Functioning as Endowment”)**

Spending of principal not restricted by donor or other means, but was designated by the board or management to be set aside and treated as endowment. Earnings are used to support the purpose designated by Board or management. Gift is reported as Operating Gift Revenue in audited financial statements.

**Endowment Income:** Earnings from endowment principal to be used for the purpose for which it was designated or restricted by donor, board or management. If not restricted as to purpose, earnings may be used at the discretion of the university in support of its exempt mission. It may also be referred to as “endowment spending”. Amount of endowment income is determined by University’s endowment spending policy. Earnings are distributed monthly on the basis of established earnings per endowment share of the endowment pool.

**Endowment Shares:** When endowment gifts are received, they are invested in the endowment by purchasing shares in the endowment pool. The number of shares purchased as a result of the new gift is determined at the time of gift based on the current market value per shares outstanding.

**Endowment Pool:** All University-controlled endowment funds are invested in an endowment pool through our custodial bank, State Street Bank with oversight of Lehigh’s Investment Office and the Investment Subcommittee of the Board. Investment decisions are consistent with the asset allocation guidelines contained within the University’s Endowment Fund Policy Statement.

**Endowment Spending Policy:** This is the University’s policy for the distribution of earnings from the endowment pool to individual endowment spending accounts. Funds distributed to endowment spending accounts are available for use in support of designated endowment purpose. Earnings are distributed on a “per share” basis.

Each individual endowment account is assigned shares in the pool as gifts are received (see illustration of endowment life cycle below). For each share, the endowment spending account receives a specified monthly earnings distribution amount.

The earnings distribution amount per share is established for the coming year following the quarter ended December 31<sup>st</sup>. The endowment spending rate amount is calculated as 5% of a three year moving average of quarter-ending market value per share. The increase in spending rate per share cannot exceed 10% and cannot drop below that of the prior year. This floor and ceiling feature serves to insulate investment policy from budgetary pressures and to insulate program spending from fluctuations in capital markets. See sample calculation of endowment spending below.

Income earned in excess of the spending policy is reinvested and funds may be withdrawn from the investment return earned in prior years if current year income is less than the spending policy.

**PA Act 141 and Realized Gains:** PA legislation which allows charitable trusts the option of adopting a spending policy based on total return, rather than solely on dividend and interest income. Under the provisions of the law, up to 7% of the market value of the endowment may be considered income for institutions that opt for a spending policy based on total return. Lehigh has opted for a total return based spending policy under these regulations. In accordance with Pennsylvania law, accumulated gains on permanent endowment funds are reported in the University's audited financial statements as temporarily restricted net assets.

**Charitable Remainder Trusts (Annuity and Life Income Funds):** Gifts received from donors who have retained a life interest in their gifts, either in the form of an annuity or a right to receive income for life. Upon termination of the underlying trust instrument, the remaining assets revert to the University, with income to be used for purposes specified by the donors. Funds received by the University in the form of charitable gift annuities are invested in the endowment pool due to the long term nature of the investment and to maximize investment returns.

**Sample Calculation of Endowment Spending  
Fiscal Year 2008-09**

<u>Quarter Ended</u>	<u>Market Value Per Share</u>
March 31, 2005	134.755
June 30, 2005	136.072
September 30, 2005	141.312
December 31, 2005	144.665
March 31, 2006	149.849
June 30, 2006	145.972
September 30, 2006	148.369
December 31, 2006	154.293
March 31, 2007	156.046
June 30, 2007	161.871
September 30, 2007	163.517
December 31, 2007	<u>161.328</u>
Total:	1,798.049
	<u>        /12</u>
Average Market Value Per Share	149.83742
	<u>        x 5%</u>
Spending Amount based on 5% of Ave. Market Value	<u>7.49187</u>
Prior Year's Spending Per Share (07-08)	7.019
0% Floor Increase	<u>0%</u>
Permitted Spending Floor in 08-09 Budget	<u>7.019</u>
Prior Year's Spending Per Share (07-08)	7.019
10% Ceiling Increase	<u>10%</u>
Permitted Spending Ceiling in 08-09 Budget	<u>7.721</u>
<b>PERMITTED SPENDING RATE IN 08-09 BUDGET</b>	<b><u>\$7.492</u></b>
Spending as a % of Average Market Value	5.00%
Spending as a % of most current Market Value	4.64%

## Illustration of Endowment Gift and Earnings Distribution Process

### Facts:

- On August 1<sup>st</sup>, the University receives a gift in the amount of \$100,000
- Donor specifies that it is to be permanent endowment with earnings available to support scholarships.
- On October 1<sup>st</sup> the donor sends another gift of \$500,000.
- August 1st market value per share of the endowment was \$150
- October 1st market value per share of the endowment was \$160
- The endowment spending rate per share that was established for the year is \$7.50.

### The Endowment process:

1) Endowment principal fund is established in name of donor and designated as permanent endowment

2) Endowment spending fund is established in name of donor and designated for scholarship purposes

3) In August, gift is wired to State Street Bank for investment in the endowment pool. Donor's endowment principal fund is assigned ownership of 666.67 shares in the pool. These funds must remain invested in perpetuity.

Calculation:  $\$100,000 \div \$150$  current market value per share

4) In September, endowment earnings are distributed to endowment spending account in the amount of \$417

Calculation:  $(666.67 \text{ shares}) \times (\$7.50 \text{ spending amt. per share}) \div 12$

5) In October, additional gift is wired to State Street Bank for investment in the endowment pool. Donor's endowment principal fund is assigned an additional 3,125 shares. These funds must remain invested in perpetuity.

Calculation:  $\$500,000 \div \$160$  current market value per share

6) November earnings are distributed to endowment spending account in the amount of \$2,369.79

Calculation:  $666.67 + 3,125 = 3,791.67$  total shares  
 $(3,791.67 \text{ shares}) \times (\$7.50 \text{ spending amt. per share}) \div 12$

**Sponsored Research**

**Indirect Cost Recovery (ICR):** Sometimes called “F&A” (Facilities and Administration costs), the term refers to sponsored project revenue for recovery of broad categories of common costs not identified with a specific project or activity. Indirect costs include costs of central administration, library and technical services, operation and maintenance of buildings and grounds, building and equipment depreciation and interest on debt. ICR is calculated by applying the approved indirect cost rate to Modified Total Direct Costs (MTDC) of individual sponsored projects. The indirect cost rate is calculated in accordance with federally mandated cost principals and is negotiated with the University’s cognizant federal agency (currently the Office of Naval Research) on a periodic basis (currently every three years).

The University’s on-campus organized research indirect cost rate through 2009 is 58.73%

**Modified Total Direct Costs (MTDC):** Total direct costs less purchases of equipment (with a unit cost of \$5,000 or more), tuition and fee remissions for Research Assistants, and payments to subcontractors in excess of \$25,000.

**OMB A-133 Audit:** The OMB A-133 audit (also known as the Single Audit), is a rigorous, organization-wide annual audit that is required of all entities that expend \$500,000 or more of federal awards. The purpose is to provide assurance to the federal government as to the management and use of such funds. This audit is performed by the University’s auditors and encompasses both financial and compliance components. The A-133 Audit is submitted to the Federal Audit Clearinghouse.

**Lehigh Sponsored Research Profile per Fiscal Year 2007 Audited Financial Statements:**

Federal Grant Revenue	\$29,652,000
State & Local Grant Revenue	14,789,000
Private Grant Revenue	7,886,000
Total Government Grant Revenue	\$52,327,000
Expense to Support Activities classified as “Research” (internally and externally funded, does not include all grant-funded activities)	\$42,379,000

Largest federal research funding source fiscal year 2007:  
National Science Foundation

Largest state research funding source fiscal year 2007:  
PA Dept of Community & Economic Development

## **Financial Reporting**

The University's financial statements are presented in the required format for not-for-profit organizations. Explanations are presented below for items appearing on the University's financial statements that are unique to not-for-profit organizations' external reporting.

The statements are prepared on a consolidated basis, including the University's subsidiary organizations' results.

**Fiscal Year:** July 1 – June 30

**Subsidiary Organizations:** Ben Franklin Technology Partners of Northeastern PA  
Manufacturers Resource Center  
Lehigh and Northampton Counties Revolving Loan Fund

### **Primary Components of the Audited Financial Statements:**

- Statement of Financial Position (balance sheet)
- Statement of Activities (income statement)
- Statement of Cash Flows
- Footnotes

### **Statement of Financial Position:**

**Net Assets:** University resources are classified into three separate classes of Net Assets (commonly referred to as FASB Designations):

**Permanently Restricted Net Assets:** Net assets resulting from contributions and other inflows of assets whose use by the University is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the University. Primarily permanent endowment funds.

**Temporarily Restricted Net Assets:** Net assets resulting from contributions and other inflows whose use by the University is limited by donor imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the University. Primarily term endowment funds and accumulated gains on permanent endowment funds.

**Unrestricted Net Assets:** Net assets that are neither permanently restricted nor temporarily restricted by donor imposed stipulations. Unrestricted net assets can be internally designated for specific purposes.

**Contributions Receivable:** Outstanding pledges from donors, discounted for present value and estimated collectibility, and donor gifts to the University in the form of charitable remainder trusts, where the University is not the trustee of the assets.

**Funds Held in Trust by Others:** Gifts which donors have deposited with trustees and the University has been named as a beneficiary of the income earned on the trust assets. Similar to permanent endowment funds, where donors restrict their gifts for investment in perpetuity and only the income is made available to the University.

**Deferred revenues:** Revenue received but not yet earned. Examples include: advance payments of tuition and unexpended advances of grant and contract revenues.

**Annuity payment liability:** The present value of amounts payable to donors, and/or beneficiaries, who have made deferred gifts to the University in which they retain a life interest in the form of a charitable remainder trust where the University is the trustee.

**Deposits held for others:** Amounts held by the University for others such as funds held for various student and University organizations.

**Refundable federal student loan funds:** Federal Perkins loan funds which are accounted for as a revolving loan fund for the benefit of students.

### **Statement of Activities:**

**Tuition and Fees:** Includes tuition received by the University for its educational programs. Tuition is reported net of certain tuition-specific financial aid. Tuition revenue results from undergraduate, graduate, or non-credit students for courses offered on campus, on-line or internationally, during the academic year or summer session.

**Financial Aid:** Aid to students that can be established in a variety of forms, including scholarships for tuition and fees, fellowships, aid for auxiliary services such as room and board, work study awards, graduate assistantships, and employee tuition remission. Scholarships for tuition and fees are netted against tuition and fee revenues. Employee tuition remission is reported as an employee benefit expense. Financial aid for auxiliary services is netted against auxiliary enterprises revenue. Other types of financial aid (such as fellowships and work study) are allocated proportionately among all expense categories.

**Auxiliary Enterprises:** University organizational units that exist to furnish goods or services to students, faculty, staff or other institutional departments and charge a fee directly related to the cost of the goods or services. Auxiliary enterprises are managed as self-supporting activities. Examples at Lehigh include: child care center, conference services, debit card, telecommunications, residential operations, food services, Stabler Arena, and the bookstore.

**Economic Development Activities:** Includes the revenue and expense associated with the University's subsidiary organizations.

**Instruction Expense:** Expense for all activities that are part of the University's instructional program, both credit and noncredit. Instruction expense includes academic departments and programs, but does not include academic deans (reported as academic support).

**Research Expense:** Expense for all activities specifically organized to produce research, whether sponsored by agencies external to the University (generally referred to as grants and contracts), or separately budgeted for by an organizational unit within the University, such as centers and institutes. This category does not include all expense relating to external grants, such expense may be reported in any expense category.

**Public Service Expense:** Expense for activities established primarily to provide services beneficial to individuals and groups external to the institution. Examples include the Small Business Development Center and certain College of Education community support services.

**Academic Support Expense:** Expense to provide support services to the University's primary mission of instruction, research and public service. It includes libraries, museums and galleries, academic computing support, Zoellner Arts Center, and academic administration.

**Student Services Expense:** Expense for the Admissions and Registrar's offices and activities with the primary purpose of contributing to students' emotional and physical well-being including student activities, athletics, health services, etc.

**Institutional Support Expense:** Expense for centralized activities concerned with management and long-range planning for the entire institution, such as executive management, financial operations, legal services, human resources, risk management, advancement, etc.

**Non-operating activities:** Transactions of a long-term investment or capital nature including gifts restricted for the future acquisition or renovation of facilities, permanent endowment gifts, gains and losses on the disposal of equipment, and gains and losses on investments in excess of the University's endowment spending policy. Such activity is generally not included in the University budget.

### **Financial Reporting Analytical Reports and Resources:**

The following reports are available from the Controller's Office in support of Financial Statement analysis and enhanced understanding:

Commentary on Audited Financial Statements: Prepared on an annual basis, this report explains the composition of each line of the audited financial statements and the reasons for any variance from the prior year.

Trustee Audit Committee Presentation: Designed to provide a historical and analytical perspective on the University's financial statements, this presentation analyzes historical trends and ratios for key financial statement balances and results.

Financial Ratio Analysis: This analysis provides a comparison between Lehigh and its aspirational peers on a number of financial performance ratios, looking at current results as well as progress over time.