Mercyhurst College

Accountants' Report and Financial Statements

June 30, 2006 and 2005

Mercyhurst College

June 30, 2006 and 2005

Contents

Independent Accountants' Report on Financial Statements and Supplementary Information **1**

Financial Statements

Statements of Financial Position 2

Statements of Activities 3

Statements of Cash Flows 5

Notes to Financial Statements 6

Supplementary Information

Schedule of Expenditures of Federal Awards 20

Independent Accountants' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Financial Statements Performed in Accordance with *Government Auditing Standards* **22**

Independent Accountants' Report on Compliance and Internal Control Over Compliance with Requirements Applicable to Major Federal Awards Programs **23**

Schedule of Findings and Questioned Costs **25**

Summary Schedule of Prior Audit Findings **29**

Independent Accountants' Report on Financial Statements and Supplementary Information

Board of Trustees
Mercyhurst College
Erie, Pennsylvania

We have audited the accompanying statements of financial position of Mercyhurst College as of June 30, 2006 and 2005, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the College's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Mercyhurst College as of June 30, 2006 and 2005, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 1, 2006, on our consideration of the College's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying schedule of expenditures of federal awards required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is presented for purposes of additional analysis and is not a required part of the general purpose financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

BKD, LLP

September 1, 2006

Mercyhurst College

Statements of Financial Position

June 30, 2006 and 2005

Assets

	2006	2005
Cash and cash equivalents	$ 9,753,848	$ 7,976,555
Accounts receivable, net of allowance; 2006 - $489,666, 2005 - $306,356	1,531,555	1,662,078
Contributions receivable, net	148,494	747,189
Receivable from charitable remainder trust	555,767	450,089
Loans receivable, net of allowance of $139,270	2,713,441	2,489,851
Inventories	402,979	366,648
Prepaid expenses and other assets	465,806	573,546
Bond discount and issuance costs, net	345,677	396,239
Deposits with trustees	2,204,041	2,360,470
Long-term investments	17,355,412	14,720,849
Land, buildings and equipment, net	69,808,909	68,020,542
Total assets	$ 105,285,929	$ 99,764,056

Liabilities and Net Assets

Liabilities		
Accounts payable	$ 1,646,915	$ 3,410,743
Accrued expenses and other liabilities	2,207,897	3,051,156
Accrued interest	347,911	324,788
Student deposits	1,447,967	1,259,813
Deferred revenue	1,192,433	1,076,645
Notes payable	1,516,588	2,131,066
Bonds payable	32,270,000	33,690,000
Advances from Federal government for student loans	2,258,281	2,272,584
Trusts payable	275,894	271,116
Total liabilities	43,163,886	47,487,911
Net Assets		
Unrestricted	47,724,430	37,945,710
Temporarily restricted	4,909,356	5,183,827
Permanently restricted	9,488,257	9,146,608
Total net assets	62,122,043	52,276,145
Total liabilities and net assets	$ 105,285,929	$ 99,764,056

Mercyhurst College

Statement of Activities

Year Ended June 30, 2006

	2006			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues, Gains and Other Support				
Tuition and fees	$ 64,451,299	$ —	$ —	$ 64,451,299
Less college funded financial aid and scholarships	23,551,003	—	—	23,551,003
Net tuition and fees	40,900,296	—	—	40,900,296
Government grants and other contracts	7,977,244	—	—	7,977,244
Private gifts	664,561	1,751,927	309,454	2,725,942
Investment income	606,272	169,410	—	775,682
Net realized and unrealized gains	474,634	933,597	—	1,408,231
Other revenues	1,213,732	—	—	1,213,732
Auxiliary enterprises	16,151,165	—	—	16,151,165
Change in value of split interest agreements	—	100,900	—	100,900
Net assets released from restrictions	3,198,110	(3,198,110)	—	—
Reclassification of net assets	—	(32,195)	32,195	—
Total revenues, gains and other support	71,186,014	(274,471)	341,649	71,253,192
Expenses and Other Deductions				
Instruction	23,738,404	—	—	23,738,404
Public service	272,389	—	—	272,389
Academic support	2,402,692	—	—	2,402,692
Student services	11,579,910	—	—	11,579,910
Institutional support	9,025,444	—	—	9,025,444
Auxiliary enterprises	13,038,074	—	—	13,038,074
Interest	1,350,381	—	—	1,350,381
Total expenses and other deductions	61,407,294	—	—	61,407,294
Change in Net Assets	9,778,720	(274,471)	341,649	9,845,898
Net Assets, Beginning of Year	37,945,710	5,183,827	9,146,608	52,276,145
Net Assets, End of Year	$ 47,724,430	$ 4,909,356	$ 9,488,257	$ 62,122,043

Mercyhurst College

Statement of Activities

Year Ended June 30, 2005

	2005			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues, Gains and Other Support				
Tuition and fees	$ 59,441,234	$ —	$ —	$ 59,441,234
Less college funded financial aid and scholarships	21,374,836	—	—	21,374,836
Net tuition and fees	38,066,398	—	—	38,066,398
Government grants and other contracts	6,418,967	—	—	6,418,967
Private gifts	305,332	610,299	429,665	1,345,296
Investment income	399,010	136,890	—	535,900
Net realized and unrealized gains	462,641	623,343	—	1,085,984
Other revenues	1,165,138	—	—	1,165,138
Auxiliary enterprises	15,038,319	—	—	15,038,319
Change in value of split interest agreements	—	(147,862)	—	(147,862)
Net assets released from restrictions	641,058	(641,058)	—	—
Reclassification of net assets	108,181	(132,021)	23,840	—
Total revenues, gains and other support	62,605,044	449,591	453,505	63,508,140
Expenses and Other Deductions				
Instruction	20,825,125	—	—	20,825,125
Public service	268,982	—	—	268,982
Academic support	2,153,278	—	—	2,153,278
Student services	10,673,893	—	—	10,673,893
Institutional support	11,259,126	—	—	11,259,126
Auxiliary enterprises	12,177,109	—	—	12,177,109
Interest	1,254,278	—	—	1,254,278
Total expenses and other deductions	58,611,791	—	—	58,611,791
Change in Net Assets	3,993,253	449,591	453,505	4,896,349
Net Assets, Beginning of Year	33,952,457	4,734,236	8,693,103	47,379,796
Net Assets, End of Year	$ 37,945,710	$ 5,183,827	$ 9,146,608	$ 52,276,145

Mercyhurst College

Statements of Cash Flows

Years Ended June 30, 2006 and 2005

	2006	2005
Operating Activities		
Change in net assets	$ 9,845,898	$ 4,896,349
Items not requiring (providing) operating activities cash flows		
Depreciation and amortization	3,357,413	3,352,671
Net realized and unrealized gains on investments	(1,408,231)	(1,085,984)
Loss on disposal of land, buildings and equipment	—	245,162
Change in value of split interest agreements	(100,900)	147,862
Contributions received restricted for long-term investment	(309,454)	(429,665)
Changes in		
Receivables	505,628	786,057
Inventories	(36,331)	(66,000)
Prepaid expenses and other assets	107,740	70,136
Accounts payable	(1,763,828)	1,004,695
Accrued expenses and other liabilities	(820,136)	658,409
Student deposits	188,154	219,355
Deferred revenue	115,788	473,969
Advances from Federal government for student loans	(14,303)	26,880
Net cash provided by operating activities	9,667,438	10,299,896
Investing Activities		
Purchase of land, buildings and equipment	(5,095,218)	(13,434,927)
Purchase of long-term investments	(10,349,084)	(17,525,531)
Proceeds from disposition of long-term investments	9,122,752	15,980,255
Change in deposits with trustees	156,429	4,531,302
Net cash used in investing activities	(6,165,121)	(10,448,901)
Financing Activities		
Principal borrowings on bonds	—	18,365,000
Principal payments on bonds	(1,420,000)	(19,145,000)
Principal borrowings on notes payable	1,242,334	1,907,666
Principal payments on notes payable	(1,856,812)	(1,153,348)
Payments for bond issuance costs	—	(241,418)
Proceeds from contributions restricted for long-term investment	309,454	429,665
Net cash (used in) provided by financing activities	(1,725,024)	162,565
Increase in Cash and Cash Equivalents	1,777,293	13,560
Cash and Cash Equivalents, Beginning of Year	7,976,555	7,962,995
Cash and Cash Equivalents, End of Year	$ 9,753,848	$ 7,976,555
Supplemental Cash Flows Information		
Interest paid	$ 1,327,258	$ 1,365,940

Mercyhurst College
Notes to Financial Statements
June 30, 2006 and 2005

Note 1: Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

Mercyhurst College (the College) operates as a private, not-for-profit institution in northwestern Pennsylvania. A majority of its students are from Pennsylvania and surrounding states. The majority of the College's revenues are derived from tuition and fees charged to students.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues, expenses gains, losses and other changes in net assets during the reporting period. Actual results could differ from those estimates.

Cash Equivalents

With the exception of certain investments held in the endowment fund, the College considers all liquid investments with original maturities of three months or less to be cash equivalents. At June 30, 2006 and 2005, cash equivalents consisted primarily of money market funds. At June 30, 2006, the College's cash accounts exceeded federally insured limits by approximately $10,390,000.

Fair Value of Financial Instruments

The College's financial instruments which include cash, cash equivalents, receivables, investments, accounts payable, accrued expenses, other liabilities and debt are carried at amounts which approximate fair value.

Investments and Investment Return

Investments in equity securities having a readily determinable fair value and all debt securities are carried at fair value. Other investments are valued at the lower of cost or fair value. Investment return includes investment income, which includes interest and dividends; realized and unrealized gains and losses on investments carried at fair value; and realized gains and losses on other investments.

The College maintains pooled investment accounts for its endowments. Investment income and realized and unrealized gains and losses from securities in the pooled investment accounts are allocated quarterly to the individual endowments based on the relationship of the fair value of the interest of each endowment to the total fair value of the pooled investments accounts, as adjusted for additions to or deductions from those accounts.

Accounts Receivable

Accounts receivable are stated at the amount of tuition, room and board and fees billed to students adjusted for the allowance for uncollectible accounts. Student receivables are normally due four weeks prior to the first day of the fall term, and one to two weeks prior to the first day of the winter and spring terms. The College also offers payment plans which allow students to make three payments throughout the term, or nine payments throughout the year. Accounts that are unpaid after the due date may be subject to a late fee. A financial hold is placed on delinquent accounts, which bars a student from registering for any new classes until they make payment arrangements and bars a student from receiving transcripts or a diploma. The College provides an allowance for doubtful accounts, which is based upon a review of the outstanding student receivables along with current and historical collection information.

Loans Receivable

Student loans receivable under the Federal Perkins Loan Program are reported at the outstanding principal balances, net of allowance for collectibility. The repayment period begins after an initial grace period of nine months after the student ceases to be at least a half-time student. Interest income is recorded as monthly payments are received.

Land, Buildings, and Equipment

Land, buildings, and equipment are recorded at cost and depreciated on a straight-line basis over the estimated useful life of each asset. Repairs, maintenance and minor replacements of existing facilities are charged to expense as incurred.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the College has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the College in perpetuity. Generally, the donors of these assets permit the College to use all or part of the income earned on related investments for general or specific purposes.

Contributions

Gifts of cash and other assets received without donor stipulations are reported as unrestricted revenue and net assets. Gifts received with a donor stipulation that limits their use are reported as temporarily or permanently restricted revenue and net assets. When a donor stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restrictions. Gifts and investment income that are originally restricted by the donor and for which the restriction is met in the same time period are recorded as temporarily restricted and then released from restriction. Contributions other than cash are recorded at their estimated fair value.

Unconditional gifts expected to be collected within one year are reported at their net realizable value. Unconditional gifts expected to be collected in future years are reported at the present value of estimated future cash flows. The resulting discount is amortized and reported as contribution revenue using the level-yield method.

Conditional gifts depend on the occurrence of a specified future and uncertain event to bind the potential donor and are recognized as assets and revenue when the conditions are substantially met and the gift becomes unconditional.

An allowance for uncollectible contributions, which is based on management's judgment of the risks, is provided as a reduction of the amount of contributions received.

Collections

Collections of works of art, historical treasures and similar assets are not capitalized in as much as the items are preserved and cared for continuously. Contributions of collection items are not reported in the financial statements. The College's collections consist primarily of paintings, sculptures, and other works of art, books, and antique furniture.

Inventory Pricing

Inventories consist primarily of books, clothing, and other merchandise at the College's bookstores, and certain maintenance supplies, and are stated at the lower of cost or market using the first-in, first-out (FIFO) method.

Advances from Federal Government for Student Loans

The College administers Federally funded loan programs for the benefit of its students. This liability represents the amount that must be returned to the federal government upon termination of the program.

Government Grants

Support funded by grants is recognized as the College performs the contracted services or expends funds eligible for reimbursement under the grant agreements. Grant activities and outlays are subject to audit and acceptance by the granting agency and, as a result of such audit, adjustments could be required.

Auxiliary Enterprises

Revenues and expenditures from auxiliary enterprises include the student dormitories, food service, bookstore, special events, and outside sales. Certain indirect expenditures, such as depreciation and interest on indebtedness, are not charged to the auxiliary enterprises.

Income Taxes

The College is exempt from income taxes under Section 501(a) of the Internal Revenue Code (the Code) as an organization described under Section 501(c) of the Code, as well as a similar provision of state law. However, the College is subject to federal income tax on any unrelated business taxable income.

Reclassifications

Certain reclassifications have been made to the 2005 financial statements to conform with the 2006 financial statement presentation. The College also identified certain net asset fund balances that had been misclassified between unrestricted, temporarily restricted and permanently restricted during 2006 and 2005. The following net assets were reclassified in the 2006 and 2005 financial statements to appropriately recognize the restricted nature of certain net asset fund balances:

	2006	2005
Unrestricted	$ —	$ 108,181
Temporarily restricted	(32,195)	(132,021)
Permanently restricted	32,195	23,840

The reclassifications had no effect on changes in net assets for 2006 and 2005.

Note 2: Investments

Investments, including deposits with trustees, at June 30 consisted of the following:

	2006	2005
Cash equivalents	$ 401,915	$ 472,743
U.S. Treasury securities	2,021,179	2,025,287
Collective fixed income funds	3,744,813	3,219,304
Collective equity funds	7,615,801	6,928,584
Equity securities	4,649,498	3,353,730
Hedge fund-of-funds	702,245	657,669
Real estate	424,002	424,002
	$ 19,559,453	$ 17,081,319

Mercyhurst College
Notes to Financial Statements
June 30, 2006 and 2005

Note 3: Contributions Receivable and Conditional Gifts

Contributions receivable consisted of the following:

	June 30, 2006			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Due within one year	$ 12,447	$ 137,116	$ 37,705	$ 187,268
Due in one to five years	—	38,851	4,942	43,793
	12,447	175,967	42,647	231,061
Less				
Allowance for uncollectible contributions	(12,447)	(44,050)	(10,676)	(67,173)
Unamortized discount	—	(12,701)	(2,693)	(15,394)
	$ —	$ 119,216	$ 29,278	$ 148,494

	June 30, 2005			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Due within one year	$ —	$ 620,918	$ 252,705	$ 873,623
Due in one to five years	—	141,160	40,942	182,102
Due in more than five years	200,000	—	—	200,000
	200,000	762,078	293,647	1,255,725
Less				
Allowance for uncollectible contributions	(200,000)	(100,050)	(38,552)	(338,602)
Unamortized discount	—	(150,778)	(19,156)	(169,934)
	$ —	$ 511,250	$ 235,939	$ 747,189

The discount rate used was 6.0% for 2006 and 2005.

As a result of the capital campaign, at June 30, 2006, the College has been named in will commitments totaling $2,775,000 which are not reflected in the financial statements, as they are considered conditional promises to give.

Note 4: Receivable from Charitable Remainder Trust

The College is the beneficiary under a charitable remainder trust for which it is not the trustee. The College's beneficial interest in this trust is recorded at fair value, measured by the present value of the estimated expected future benefits to be received when the trust assets are distributed. At June 30, 2006 and 2005, the College's beneficial interest in remainder trusts administered by outside parties is $555,767 and $450,089, respectively.

Note 5: Land, Buildings, and Equipment

Land, buildings, and equipment at June 30, consist of:

	2006	2005
Land	$ 3,375,134	$ 3,333,484
Land improvements	8,132,876	7,800,522
Buildings	70,929,548	62,322,892
Furnishings and equipment	17,580,512	16,569,051
Library books	3,971,291	3,738,454
Construction-in-progress	550,507	5,692,706
	104,539,868	99,457,109
Less accumulated depreciation	(34,730,959)	(31,436,567)
	$ 69,808,909	$ 68,020,542

Note 6: Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities at June 30, consist of:

	2006	2005
Accrued payroll and deferred compensation	$ 1,490,540	$ 2,381,926
Accrued payroll taxes and withholdings	139,043	58,352
Accrued vacation	414,693	429,566
Other accrued expenses	163,621	181,312
	$ 2,207,897	$ 3,051,156

Note 7: Trusts Payable

The College administers two charitable remainder trusts. A charitable remainder trust provides for the payment of distributions to the grantor or other designated beneficiaries over the trust's term (usually the designated beneficiary's lifetime). At the end of the trust's term, the remaining assets are available for the College's use. The portion of the trust attributable to the future interest of the College is recorded in the statements of activities as temporarily restricted contributions in the period the trust is established. Assets held in the charitable remainder trusts are recorded at fair market value in the College's statements of financial position. On an annual basis, the College revalues the liability to make distributions to the designated beneficiaries based on actuarial assumptions. The present value of the estimated future payments is calculated using discount rates available at the date of the trusts' inception which were 7.0% and 7.6% and applicable mortality tables.

Note 8: Long-term Debt

Long-term debt at June 30 consists of the following:

	2006	2005
Notes payable		
Line of Credit	$ 1,449,921	$ 1,999,921
Note payable - GMACRAT	—	67,231
Other	66,667	63,914
Total notes payable	1,516,588	2,131,066
Bonds payable		
College Revenue Bonds of 1997, with interest rates ranging from 5.40% to 5.85%	2,235,000	2,380,000
Pennsylvania Higher Education Facilities Authority Revenue Bonds Series 1999 E1, with interest at 2.00% at June 30, 2006 and until November 1, 2006 and at variable rates thereafter that are based upon the Bond Market Association (BMA) index.	2,900,000	3,000,000
Pennsylvania Higher Education Facilities Authority Revenue Bonds Series 2001 I2, with interest at 3.30% at June 30, 2006 and until November 1, 2006 and at variable rates thereafter that are based upon the BMA index.	5,300,000	5,500,000
College Revenue Bonds of 2003, with interest at 3.25% at June 30, 2006 and until November 1, 2006, swap rate of 3.82% until November 1, 2012 and at variable rates thereafter that are based upon the BMA index.	5,325,000	5,325,000
College Revenue Refunding Bonds Series A and B of 2004, with interest rates ranging from 2.875% to 5.00%	16,510,000	17,485,000
Total bonds payable	32,270,000	33,690,000
Total long-term debt	$ 33,786,588	$ 35,821,066

The College currently has two line of credit arrangements with two local banks that provide the College up to a total of $2,700,000 for physical plant improvement projects and working capital. The first agreement is for capital expenditures and expires on December 29, 2006. The original amount of the note was $1,000,000, and was amended to $1,700,000 on March 10, 2005. The note accrues interest on outstanding borrowings at a rate equal to the (i) bank's prime lending rate minus .5%, or (ii) a LIBOR–Rate plus 1.50% for the applicable LIBOR-Rate Interest Period. Borrowings are secured by the gross revenues of the College, on parity with the Borrower's bondholders. The second agreement was for capital expenditures and working capital up to $1,000,000 and expired March 1, 2006. The note accrued interest on outstanding borrowings at a rate equal to the J.P. Morgan Chase Bank of New York City published prime lending rate minus .75%. A commitment fee of .05% was also assessed on any unused portion of the line of credit. The note was not renewed upon expiration. On March 23, 2006, the College entered into a one year $1,000,000 revolving line of credit for short term working capital with a bank to replace the line of credit which expired March 1, 2006. Borrowings on the line are unsecured and are a general obligation of the College. The line of credit expires March 22, 2007. The note accrues interest on outstanding borrowings at a rate equal to the LIBOR-flex rate plus 1.25%. A commitment fee of 0.125% is assessed on any unused portion of the line of credit. At June 30, 2006 and 2005 the balances outstanding under the lines of credit were $1,449,921 and $1,999,921 respectively.

On July 3, 1997, the College issued a $3,920,000 bond issue through the Authority (the 1997 Bonds) for the purpose of (a) the acquisition of apartment buildings for student housing; (b) the completion and automation of the College's library; (c) the renovation of McAuley Hall; (d) the construction of additional College facilities; (e) the funding of a debt service reserve fund; and (f) the financing of all or a portion of the costs relating to the issuance of the 1997 Bonds.

On November 1, 1999, the College issued a $3,500,000 bond issue through the Pennsylvania Higher Education Facilities Authority for the purpose of (a) purchase of four apartment buildings for student housing; (b) renovations to the Hammermill Library; (c) construction of eight townhouses for student housing located at 16 West Division Street at the campus located in the town of North East, Pennsylvania; (d) certain additional miscellaneous capital expenditures and (e) the payment of certain costs of issuing the bonds.

On November 1, 2001, the College issued a $5,500,000 bond issue through the Pennsylvania Higher Education Facilities Authority for the purpose of (a) construction of the Audrey Hirt Academic Center and (b) the renovation of the College's hockey rink.

On July 31, 2003, the College issued a $5,475,000 bond issue through the City of Erie Higher Education Building Authority (the Authority) for the purpose of (a) the acquisition of four apartment buildings on Lewis Avenue for student housing; (b) the acquisition of four apartment buildings known as "Highland Square" for student housing; (c) construction of two two-story residence halls on the College's Erie campus; (d) construction of a two-story Health and Safety Building on the College's North East campus; and (e) the payment of certain costs of issuing the bonds. On September 2, 2004, the College obtained approval from the Authority to amend the list of projects covered by the 2003 Bond Issue to include certain costs associated with the construction of a bookstore and the renovation of Old Main, both of which are located on the College's Erie campus.

On October 1, 2004, the College issued $13,225,000 College Revenue Refunding Bonds, Series A of 2004 and $5,140,000 College Revenue Refunding Bonds, Series B of 2004 (collectively, the 2004 Bonds) through the Authority. The 2004 Bond proceeds were used to finance a project consisting of (a) current refunding of all 1993 Bonds; and (b) the financing of the costs relating to the issuance of the 2004 Bonds. The 1993 Bond proceeds were used to finance a project consisting of (a) advance refunding of all outstanding debt under previously issued Bonds; (b) the construction of on-campus apartment buildings, townhouses and a parking deck; (c) the purchase of certain land and buildings on which the College is situated; (d) a portion of the costs associated with the construction of a concert hall; (e) the funding of a debt service reserve fund; and (f) the financing of the costs relating to the issuance of the 1993 Bonds.

The College is subject to certain financial and reporting covenants under the 1997, 1999, 2001, 2003, and 2004 Bond issues. The College is in compliance with these covenants.

As part of the 1993, 1997, and 2004 Bond issues, the Authority entered into a Sublease and Security Agreement, a Supplemental Sublease and Security Agreement, and a Second Supplemental Sublease and Security Agreement (the Agreements) with the College. Pursuant to the Agreements, the College is charged with operating and maintaining the related construction projects and making installment payments from its gross revenues in amounts sufficient to meet debt service requirements of the 1997 and 2004 Bonds.

The 1997 and 2004 Bonds are secured by all gross revenues of the College, subject to certain permitted encumbrances, and all existing and future equipment and fixtures of the College.

The 1999 Bonds are secured by a letter of credit with a bank in the amount of $2,984,583. The letter of credit expires November 15, 2009 and is renewable thereafter.

The 2001 Bonds are secured by a letter of credit with a bank in the amount of $5,454,583. The letter of credit expires November 15, 2009 and is renewable thereafter.

The 2003 Bonds are secured by a letter of credit with a bank in the amount of $5,425,953. The letter of credit expires November 15, 2009 and is renewable thereafter.

The mandatory redemption and sinking fund requirements to redeem or otherwise retire principal amounts of the 1997, 1999 and 2001, 2003, and 2004 Bonds are as follows:

- *1997 Bonds* — Ranging from $150,000 in 2007 to $265,000 in 2017.
- *1999 Bonds* — Ranging from $100,000 in 2007 to $300,000 in 2020.
- *2001 Bonds* — Ranging from $200,000 in 2007 to $500,000 in 2022.
- *2003 Bonds* — Ranging from $325,000 in 2007 to $400,000 in 2024.
- *2004 Series A Bonds* – Ranging from $800,000 in 2007 to $1,150,000 in 2017, $660,000 in 2018, $695,000 in 2019, and $80,000 in 2020 at maturity.
- *2004 Series B Bonds* – Ranging from $200,000 in 2007 to $345,000 in 2020, $315,000 in 2021, $330,000 in 2022, and $340,000 in 2023 at maturity.

Aggregate annual maturities of long-term debt at June 30, 2006 are:

2007	$ 3,283,254
2008	1,793,334
2009	1,825,000
2010	1,965,000
2011	2,010,000
Thereafter	22,910,000
	$ 33,786,588

Note 9: Derivative Financial Instruments

As a strategy to maintain acceptable levels of exposure to the risk of changes in future cash flows due to interest rate fluctuations, the College entered into an interest rate swap agreement for a portion of its floating rate debt. The agreement provides for the College to receive interest from the counterparty at 67% of LIBOR and to pay interest to the counterparty at a fixed rate of 3.82% on a notional amount of $5,000,000 at June 30, 2006. Under the agreement, the College pays or receives the net interest amount monthly, with the monthly settlements included in interest expense. The agreement is recorded at its fair value with subsequent changes in fair value included in expenses and other deductions.

Note 10: Net Assets

Net assets are classified based on the existence or absence of donor-imposed restrictions.

Temporarily Restricted Net Assets

Temporarily restricted net assets at June 30 are available for the following purposes or future periods:

	2006	2005
Student services	$ 19,421	$ 26,621
Institutional support	952,066	907,075
Loan funds	34,671	34,671
Instruction	1,698,522	1,294,934
Academic support	5,218	4,310
Scholarships	1,631,799	1,386,947
Plant operations and additions	542,840	1,511,774
Public service	24,819	17,495
	$ 4,909,356	$ 5,183,827

Permanently Restricted Net Assets

Permanently restricted net assets at June 30 are restricted to investments in perpetuity, the income from which is expendable to support:

	2006	2005
Institutional support	$ 1,099,810	$ 1,099,810
Scholarships	8,064,728	7,785,341
Instructional	261,510	199,248
Public service	62,209	62,209
	$ 9,488,257	$ 9,146,608

Net Assets Released from Restriction

Net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes or by occurrence of other events specified by donors.

	2006	2005
Purpose of restrictions accomplished:		
Instructional activities	$ 32,081	$ 10,943
Academic support	—	449
Student services	7,200	7,200
Institutional support	101,374	114,439
Operation and maintenance of plant	236,331	43,192
Scholarships	504,268	113,017
	881,254	289,240
Plant fund expenditures	2,316,856	351,818
	$ 3,198,110	$ 641,058

Note 11: Operating Leases

The College has various operating lease agreements primarily involving facilities, office equipment and vehicles. These leases are noncancelable and expire on various dates through the year 2017.

Total rental expense for 2006 and 2005 was $2,134,349 and $2,068,330, respectively.

Future minimum lease payments at June 30 were:

2007	$ 1,571,916
2008	1,291,967
2009	913,357
2010	551,701
2011	438,044
Thereafter	1,983,681
	$ 6,750,666

Note 12: Pension Plan

Retirement benefits are provided for College employees through the Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF) a national organization, and the Variable Annuity Life Insurance Company (VALIC), used to fund pension benefits for educational institutions. Under the arrangement, the College and plan participants make monthly contributions to TIAA-CREF and VALIC to fund retirement benefits through a defined contribution plan. The plan covers a majority of all eligible employees. The College's share of the cost of these benefits for the years ended June 30, 2006 and 2005 was $1,013,242 and $894,083, respectively.

Note 13: Contingencies and Commitments

The College is subject to claims and lawsuits that can arise primarily in the ordinary course of its activities. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits, if they were to occur, will not have a material adverse effect on the financial position, change in net assets and cash flows of the College.

Note 14: Expense Summary

Expenses classified by natural classification are summarized as follows:

	2006	2005
Salaries and wages	$ 23,135,305	$ 22,263,279
Fringe benefits	7,295,204	6,941,691
Contract services	2,797,837	2,612,415
Supplies	1,335,058	1,248,723
Travel	1,610,853	1,633,873
Repairs and maintenance	1,798,782	2,050,631
Utilities	2,271,815	1,982,198
Cost of sales for auxiliary enterprises	4,767,336	4,564,317
Bad debts	392,166	334,992
Rents and leases	2,134,439	2,068,330
Non-capital equipment	1,421,800	860,690
Interest on indebtedness	1,350,381	1,254,278
Insurance	668,336	567,158
Depreciation and amortization	3,357,413	3,352,671
Bond call premium	—	357,600
Loss on disposition of assets	—	245,162
Other	7,070,569	6,273,783
	$ 61,407,294	$ 58,611,791

Mercyhurst College
Notes to Financial Statements
June 30, 2006 and 2005

Note 15: Functional Expenses

The College's expenses on a functional basis are as follows:

	2006	2005
Instruction	$ 25,105,727	$ 23,187,219
Public service	272,389	268,982
Academic support	2,402,692	2,153,278
Student services	11,579,910	10,673,893
Institutional support	8,186,124	9,311,797
Auxiliary enterprises	13,038,076	12,177,109
Fundraising	822,376	839,513
	$ 61,407,294	$ 58,611,791

Supplementary Information

Mercyhurst College

Schedule of Expenditures of Federal Awards

Year Ended June 30, 2006

Federal Agency/ Pass-Through Entity/Cluster/Program	CFDA Number	Grant or Identifying Number	Amount
Department of Education			
Student Financial Aid Cluster			
Federal Work Study Program	84.033		$ 386,265
Federal Pell Grant Program	84.063		2,502,242
Federal Supplemental Education Opportunity Grant	84.007		460,786
Federal Perkins Loan Program	84.038		3,340,005
Federal Family Education Loan Program	84.032		20,940,062
			27,629,360
Pass-through from Pennsylvania Department of Education			
Vocational Education Program	84.048	23-600-3115	114,178
PT3 Prep Tomorrow's Teachers for Technology	84.342A	23-600-3115	2,674
Project Teach	84.215X	03-992-8544	89,136
ACH Program	84.215X	25-600-1265	6,243
Intelligence Research and Analysis	84.116Z		91,373
Art-Based Teacher ED	84.116Z		21,507
Total Department of Education			27,954,471
Department of Labor			
Pass-through from Pennsylvania Department of Labor			
Trade Adjustment Act Program	17.245	23-600-3107	122,098
Pre-Teaching Academy TANF Challenge Grant	17.	25-129-3830	17,931
Total Department of Labor			140,029
Department of Justice			
Pass-through from Pennsylvania Commission on Crime and Delinquency			
RIAP/University of Arkansas Terrorism	16.560	71-600-3252	17,915
RIAP/LFMSC Case Studies	16.	2003-4427700-000	55,494
Protective Services Institute	16.	2004-DD-BX-1.222	270,281
Knife and Saw Tool Mark Analysis	16.	2005-IJ-CX-K016	138,687
Total Department of Justice			482,377
Department of Health and Human Services			
Pass-through from Pennsylvania Department of Public Welfare			
Child Care Development Block Grant	93.575	25-600-1265	2,836
Institute for Child and Family Policy	93.556	25-600-1027	34,172
Total Department of Health and Human Services			37,008
Department of Defense			
MAI/Excavations at Rockshelters	12.421		233,466
National Security Administration	12.	H98230-04-C.0663	735
Structural Analysis	12.	H98230-05-D.0101	40,638
Integrated Roadmap	12.	H98230-05-D.0101	52,790
Galileo Study	12.	H98230-05-D.0101	39,926
Country Study	12.	H98230-05-D.0101	8,562
China Telecommunications	12.	H98230-05-D.0101	67,848
Galileo Video Update	12.	H98230-05-D.0101	2,642
Analytic Methodology	12.	H98230-05-D.0101	2,469
Wimax	12.	H98230-05-D.0101	27,333
Intergovernmental Personnel Act Mobility Program	27.011		70,150
Total Department of Defense			546,559
Department of Interior			
Pass-through from Pennsylvania State University			
Assistance to State Water Resources Research/PSU	15.805	3127-MC-USDI-0116	7,467
Department of Commerce			
Coastal Zone Management Implementation	11.419		760
Total			$ 29,168,671

Mercyhurst College
Schedule of Expenditures and Federal Awards
Year Ended June 30, 2006

Notes to Schedule

1. This schedule includes the federal awards activity of Mercyhurst College and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

2. Mercyhurst College provided no federal awards to subrecipients.

3. The FFEL Program consists of subsidized and unsubsidized Federal Stafford Loans (for students), Federal PLUS Loans (for parents) and FFEL Consolidation Loans (for both students and parents). Participating lending institutions, such as banks and credit unions, make these loans, which are guaranteed by state or national guaranty agencies and insured by the federal government. Federal statute requires that proceeds from Stafford Loans and PLUS Loans be disbursed to the College to be directly applied to students' accounts. New loans processed for students during the year ended June 30, 2006 were as follows:

Federal Family Education Loan Program	
Stafford	
Subsidized	$ 8,848,993
Unsubsidized	7,143,060
PLUS	4,948,009
	$ 20,940,062

Independent Accountants' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Financial Statements Performed in Accordance with *Government Auditing Standards*

Board of Trustees
Mercyhurst College
Erie, Pennsylvania

We have audited the financial statements of Mercyhurst College as of and for the year ended June 30, 2006, and have issued our report thereon dated September 1, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing out audit, we considered the College's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the College's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we no not express such an opinion. The results of our tests disclosed no instances of noncompliance or other mattes that are required to be reported under *Government Auditing Standards.*

We noted certain matters that we reported to the College's management in a separate letter dated September 1, 2006.

This report is intended solely for the information and use of the governing body, management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

BKD, LLP

September 1, 2006

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Independent Accountants' Report on Compliance and Internal Control Over Compliance with Requirements Applicable to Major Federal Awards Programs

Board of Trustees
Mercyhurst College
Erie, Pennsylvania

Compliance

We have audited the compliance of Mercyhurst College with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2006. The College's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of the College's management. Our responsibility is to express an opinion on the compliance of Mercyhurst College based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; an OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the College's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the College's compliance with those requirements.

In our opinion, Mercyhurst College complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2006. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements that are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as item 06-01.

Internal Control Over Compliance

The management of Mercyhurst College is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered the College's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants caused by error or fraud that would be material in relation tot a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the governing body, management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

BKD, LLP

September 1, 2006

Mercyhurst College

Schedule of Findings and Questioned Costs

Year Ended June 30, 2006

Summary of Auditor's Results

1. The opinion expressed in the independent accountants' report was:

   ☒ Unqualified ☐ Qualified ☐ Adverse ☐ Disclaimed

2. The independent accountants' report on internal control over financial reporting described:

   Reportable condition(s) noted considered material weakness(es)? ☐ Yes ☒ No

   Reportable condition(s) noted that are not considered to be a material weakness? ☐ Yes ☒ No

3. Noncompliance considered material to the financial statements was disclosed by the audit? ☐ Yes ☒ No

4. The independent accountants' report on internal control over compliance with requirements applicable to major federal awards programs described:

   Reportable condition(s) noted considered material weakness(es)? ☐ Yes ☒ No

   Reportable condition(s) noted that are not considered to be a material weakness? ☐ Yes ☒ No

5. The opinion expressed in the independent accountants' report on compliance with requirements applicable to major federal awards was:

   ☒ Unqualified ☐ Qualified ☐ Adverse ☐ Disclaimed

6. The audit disclosed findings required to be reported by OMB Circular A-133? ☒ Yes ☐ No

Mercyhurst College

Schedule of Findings and Questioned Costs (continued)

Year Ended June 30, 2006

7. The Organization's major programs were:

Cluster/Program	CFDA Number
Student Financial Aid Cluster	84.063, 84.007, 84.033, 84.032, 84.038

8. The threshold used to distinguish between Type A and Type B programs as those terms are defined in OMB Circular A-133 was $875,060.

9. The Organization qualified as a low-risk auditee as that term is defined in OMB Circular A-133? ☒ Yes ☐ No

Mercyhurst College

Schedule of Findings and Questioned Costs (continued)

Year Ended June 30, 2006

Findings Required to be Reported by *Government Auditing Standards*

Reference Number	Finding	Questioned Costs
	No matters are reportable.	

Findings Required to be Reported by OMB Circular A-133

Reference Number	Finding	Questioned Costs
06-01	Federal Program – Student Financial Assistance Cluster – Federal Family Education Loan Program (CFDA 84.032), U.S. Department of Education. Funding Period – Year ended June 30, 2006.	$0

Criteria: Special Tests and Provisions – The College must notify NSLDS about changes in student status within 30 days or, if a student is expected to be included in a response to a Roster File, within 60 days.

Statement of Condition: Changes in student status for two students were not reported to NSLDS within 30 days or included in a response to a Roster File within 60 days.

Effect of Condition: The students' status changes were not communicated to the NSLDS in a timely manner.

Context:

	Number	Dollars
Population	918	$4,508,717
Sample	30	169,395
Not in Compliance	2	3,376

Cause of Condition: One instance of noncompliance was due to the student not having been included in a roster file the month the student withdrew from College. The student was included in the next roster file which was more than 60 days after the student's withdrawal. The second instance of noncompliance was due to the student not having been included in a roster file submitted by NSLDS to the Clearinghouse, and therefore not reported back by the Clearinghouse to NSLDS.

Recommendation: We recommend that the College reevaluate the number of times the Clearinghouse receives roster files from NSLDS to ensure that communication of changes in student status to NSLDS is in compliance with Federal Regulations. In addition, we recommend that the College generate a report at the end of each month showing all students who withdrew, graduated or dropped out during that month and verify those students' status on the NSLDS website at the end of the following month to ensure that the status change was communicated to NSLDS properly and timely.

Mercyhurst College

Schedule of Findings and Questioned Costs (continued)

Year Ended June 30, 2006

Reference Number	Summary of Finding	Questioned Costs
06-01 (continued)	*Views of Responsible Officials and Planned Corrective Actions:* The College concurs with the finding. The College will implement the following procedures to prevent this from occurring in the future: 1. Reporting to NSLDS via the Student Clearinghouse will occur on a monthly basis during the academic year. 2. Retroactive withdrawals will be reported directly (manually) to NSLDS since those records are not picked up in the subsequent enrollment files sent to the Student Clearinghouse. 3. A procedure will be developed and implemented to ensure that data sent to the Student Clearinghouse is transferred to NSLDS.	

Mercyhurst College

Summary Schedule of Prior Audit Findings

Year Ended June 30, 2006

Reference Number	Summary of Finding	Questioned Costs
	No matters are reportable.	